

## Recent Economic Developments and their Repercussions for Small and Medium Enterprises



*Speech delivered by Dr. Emsley Tromp at ADECK fundraising lunch Wednesday, 21 October 2009*

Good afternoon ladies and gentlemen,

Our economy is currently facing many challenges. First, the world economy is experiencing its greatest slowdown since the Second World War. This undoubtedly affects the Curaçao economy in general, and the small and medium enterprises in particular. At the same time, we are in a process of constitutional changes that must lead to a status aparte for Curaçao. This process provides us an unique opportunity to address certain weaknesses of our investment climate that would benefit small and medium sized enterprises. I have been asked to discuss the recent economic developments and their impact on the small and medium enterprises in Curaçao. However, before discussing the local situation, I will start with the international environment.

Ladies and gentlemen, since July 2007 the global economy has experienced a severe financial crisis originating in the US housing and credit sectors. Due to the increased integration of goods, services and financial markets, the crisis has spread from the housing and credit markets in the United States to other markets and countries around the world. This has resulted into a deep worldwide recession with severe economic and social impact. There are few, if any economies that not have been affected by the crisis. Output has contracted in the major industrial countries, including the United States and the Euro area, and has slowed down in the emerging economies.

Fortunately, global economic growth has started to rebound recently and financial conditions have improved markedly. World economic recovery has been driven largely by wide-ranging and coordinated public intervention, particularly in the industrial countries through supporting demand and reducing uncertainty and systemic risk in the financial markets.

The pace of recovery is, however, expected to be slow as uncertainties remain in the financial markets and public intervention will gradually have to be withdrawn. Against this background, it is projected that the world economy will contract by 1% in 2009 while recovering by about 3% in 2010.

The global economic downturn has had severe repercussions for the Caribbean region. As external demand dropped, output in countries with relatively large manufacturing sectors contracted. In addition, foreign exchange revenues from tourism have been, dropping reflecting the weakening US, Canadian and European markets. Inflows from remittances and foreign direct investments have also been declining. As a consequence, real Gross Domestic Product is expected to contract in most countries in 2009 including the Bahamas by 3.9%, Barbados by 3.0%, and Aruba by 5.5%.

Contrary to most countries in the region, the economy of the Netherlands Antilles is not expected to contract in 2009. One of the main reasons why our economy is an exception in the region, is the implementation of the debt relief program and the Social Economic Initiative. The inflow of debt relief funds has a positive impact on the current account of the balance of payments. In addition, it contributes to a cash surplus at the general government level and, hence, a decline in public sector debt. Thanks to the debt relief program, our debt-to-GDP ratio is projected to decline from 82% to 62% during 2009.

An analysis by sector shows that activities in the tourism-related industries have, however, been negatively affected by the world economic recession. All islands of the Netherlands Antilles have experienced a drop in the number of

stay-over visitors. In Curacao, the number of tourist arrivals dropped by 1.4% during the first half of 2009, as a result of a decline in the North American and the Caribbean markets. The South American and European markets, on the contrary, expanded during the first six months of 2009. The latter was largely related to the appreciation of the Euro vis-à-vis the US dollar making Curacao an attractive tourism destination in terms of costs for the Europeans. Meanwhile, hotel occupancy rates dropped from 86.5% in the first half of 2008 to 74.5% in the first six months of 2009. Activities in the wholesale and retail trade sector weakened during the first months of 2009 because of the decline in stay-over tourism, slower activities in the free-zone industry, and lower domestic demand.

Furthermore, the transport, storage and communication sector showed a mixed performance in the first quarter of 2009. On the one hand, airport activities, as measured by the number of passengers handled, declined in line with the downturn in tourism. The number of passengers transported by the national carriers dropped also. On the other hand, harbor activities rose as a result of increased cargo movements and oil storage activities. The manufacturing sector recorded a remarkable decline in value added, attributable to the poor performance of both the "Isla" refinery and the Curaçao dry dock company.

The financial and construction sectors were the main contributors to economic growth in the first quarter of 2009. The increase in financial sector activities was driven entirely by the good performance of domestic financial services as activities in the international financial sector declined due to the financial crisis. Construction work expanded largely because of ongoing tourism-related projects. However, the growth in construction moderated compared to the first quarter of 2008, in line with the slower growth in private investment.

Against this background and in line with the latest forecast of the world economic growth, we expect economic growth in the Netherlands Antilles to slow to 0.8% this year. For 2010 we project the economy to expand by 1.3% given the expected recovery of the world economy.

Needless to say that the projected economic slowdown for this year translates into lower activities for the small and medium sized enterprises. Small and medium enterprises are either active in the sectors that are being affected by the slowdown, including the hotels and restaurants sector, the wholesale and retail sector, and the international financial services sector or provide services to these sectors. The main pressures faced by these enterprises are weak demand, both domestic and foreign, and tighter credit conditions.

According to the Central Bureau of Statistics, 97% of all enterprises in Curacao are small or medium sized. These enterprises are crucial for the island economy as they account for 56% of employment and 31% of Gross Domestic Product.

Given their importance, it is imperative that actions should be taken in order to help the small and medium enterprises survive these times of economic slowdown, and subsequently, benefit of the opportunities the projected economic recovery will offer.

Ladies and gentlemen, we are currently in the historic process of the dismantling of the Netherlands Antilles. In the near future, Curacao will become an autonomous country within the Dutch Kingdom. An autonomous status will provide us with the unique opportunity to address certain economic issues in a more island-specific way and thereby stimulate economic growth. Evidently, this will be beneficial for the business community, including the small and medium sized firms.

A crucial aspect in this context is macro-economic stability. One of the greatest threats to our macro-economic stability is in my view our vulnerability to external shocks. Our balance of payments has become more susceptible to external shocks with far-reaching implications for the real economy. The rapidly expanding current account deficit during the last few years, financed by capital inflows from abroad exposes an increasing external vulnerability, which has been masked by the recent inflows of funds related to the debt relief program. A sudden reversal of capital flows could deplete our foreign exchange reserves quickly, undermining confidence in our currency.

As we are preparing to close the last chapter of the Netherlands Antilles, it is crucial that we address these vulnerabilities to promote the welfare of the new countries' citizens. With regard to the monetary system in the new constitutional structure, it has been agreed that the countries of Curacao and Sint Maarten will form a monetary union with one central bank and a common currency. However, the balance of payments vulnerability compels us to consider alternatives, one of which is dollarization. Three of the five islands comprising the Netherlands Antilles, i.e., the BES islands, have chosen to introduce the US dollar as the legal tender once their new status takes effect, while Sint Maarten is already de facto dollarized. Moreover, the US dollar is widely accepted in Curacao. Therefore, it would not be such a big step to formally dollarize Curacao and Sint Maarten.

Having the dollar as legal tender removes the possibility of a balance of payments crisis with the risk of devaluation. An economic downturn or reversal of capital flows would not turn into a currency crisis. An immediate benefit from the elimination of currency crises would be a reduction of the country risk premium, consequently lowering interest rates. In other words, the spread between the interest rates of the dollarized economy and the United States is reduced. Lower interest rates benefit growth by reducing the cost of credit, encouraging investments.

In addition, as a result of dollarization, transaction costs, related to the conversion into foreign currency, are lowered. This would benefit trade, including tourism and foreign direct investments. Due to the perceived currency risk, local financial institutions might be more inclined to invest in foreign assets. In the absence of currency risk, the appetite to invest capital locally might increase.

By adopting the US dollar, the financial system becomes more open to international capital flows. Capital mobility promotes financial intermediation, competition and efficiency among institutions, and promotes confidence in the financial system. It also encourages integration of the domestic financial system with the rest of the world.

Although the public finances of Curacao and Sint Maarten are closely monitored by the budget supervisor CFT, dollarization would provide an extra long-term constraint for fiscal policy as it eliminates the possibility of printing money to finance fiscal deficits. Hence, the restrictions on increasing the money supply can improve policy credibility given our long history of fiscal deficits and troubled adjustment programs.

Nevertheless, dollarization has also some disadvantages. First, the authorities lose monetary policy as an instrument to steer the economy, limiting the available policy mix to correcting macroeconomic disequilibria. Second, the "lender of last resort" function of the central bank disappears. Finally, under dollarization, the central bank would lose its main sources of income, i.e., investment of the foreign exchange reserves and seigniorage from issuing banknotes.

With respect to the first argument against dollarization, the loss of a policy instrument, the following counter argument can be made. Given the limited scope to pursue independent monetary policy under the current exchange rate regime, this loss would not be substantial. The recent adjustment periods have indicated that small open economies like ours are limited to fiscal policies and structural measures to remain competitive and hence improve their investment climates. With regard to the issue of profitability and the function of the central bank as lender of last resort, it is important to put the current reality into perspective. The lion share of the central bank's profit consists of license fees, which will continue to exist under the regime of dollarization. In addition, since the balance of payments constraint is no longer binding, the need to hold foreign exchange reserves to maintain the peg no longer applies. Therefore, the Bank's reserves will all become investable funds, thereby preserving the profitability of the Bank. To address the issue of lender of last resort, we need to accelerate the introduction of a deposit insurance scheme. Aside from providing depositors with added security, the funds of such a scheme, some of which can come from the current reserve requirements, will support the function of lender of last resort. Moreover, the government would have to assume this function even under the current exchange rate regime. This became abundantly clear during the recent international financial crisis.

Hence, dollarization would result in no perceptible changes in the profit of the central bank and hence no impact on the government budget. Rather, it might lead to an increase in the Bank's profit since the balance of payments constraint always has confined the Bank to pursue a policy of profit maximization. The Bank also has non-interest sources of income in terms of the fees it charges the financial institutions to cover the costs of financial sector supervision.

A careful assessment towards a realistic balance between the advantages and disadvantages of dollarization for Curacao in particular should be part of the public debate in choosing the most suitable monetary system for the future countries in the Kingdom. The balance seems to point in the direction of dollarization, given our vulnerabilities in the present world economic order.

However, dollarization does not stand alone as a remedy for economic ills. It must be accompanied by a series of structural reforms in order to achieve economic growth and development in the long term. These reforms will improve our competitiveness and create opportunities for businesses, including small and medium enterprises.

First, in the absence of monetary policy instruments, external shocks that require a change in real wages will not have lasting effects on the rate of unemployment if the labor market is flexible. This flexibility may need to take form of downward flexibility of nominal wages, and low hiring and firing costs. Another aspect of the labor market that needs to be addressed is the reduction of the qualitative mismatch between demand and supply. In my opinion, education is crucial in order to reduce this mismatch. Our vocational institutions should take into account to a much greater degree the skill needs in the private sector.

A second area for reform is the further development of our capital market, promoting more financing opportunities for entrepreneurs and more local investment opportunities for investors. The latter has become even more relevant as a result of the declining significance of government bonds as an investment instrument in light of the debt relief. The development of private debt instruments and equity-based financing should especially be promoted. These types of financing are still rarely used on our island, but they are significantly cheaper than bank financing. Specifically for start-ups and small and medium enterprises, the establishment of a venture capital fund could be crucial to raise the necessary financing for promising investment projects.

Another important area of reform is the reduction of administrative barriers. One of the most common complaints from the business sector is the number and complexity of government formalities and paperwork that frustrate new investment initiatives and, hence, the opportunity for stronger economic growth. The elimination of the double layer of government on the island is certainly a step in the right direction. However, it should be complemented by streamlining administrative procedures aimed at eliminating all unnecessary bureaucracy, and simplifying the procedures for obtaining business and work permits and business visas.

We must realize that “entrepreneurial firms” are the ones that will really benefit from the arising economic opportunities. In addition, the likelihood of surviving is also higher among firms that are creative and entrepreneurial. In this context being entrepreneurial entails identifying and introducing new products, new ways of production, distribution, and marketing. At the same time, an entrepreneur is not afraid of taking risks. In my opinion, our business owners should become more entrepreneurial to maximize the benefits from the economic opportunities offered by the future country of Curaçao.

Ladies and gentlemen, small and medium enterprises play a crucial role in our economy as they are an important contributor to employment and GDP. As a result, we should take all the necessary steps to create a business environment that stimulates the creation and growth of truly entrepreneurial small and medium enterprises. Especially in these times when the world economy is recovering from a severe crisis and the development of a new world economic order.