

Recent Economic Developments in the Netherlands in a Regional Perspective: Risks and Opportunities

Speech by dr Emsley D. Tromp, President of the Bank van de Nederlandse Antillen at the Annual Strategic Meeting of the KPMG Dutch Antilles La Romana, Dominican Republic, June 20, 2003

Introduction

It is a pleasure for me to join you this evening on the occasion of your Annual Strategic Meeting. Next week, the Central Bank of the Netherlands Antilles will present its 2002 Annual Report. Therefore, I think this is a timely occasion to discuss with you the most pressing issue on my mind: the need to rebuild confidence in the Netherlands Antillean economy. Allow me to thank Mr. Ralph Palm for the invitation and to congratulate him on the initiative to bring policymakers to discuss with you the environment in which you are likely to be operating.

The Netherlands Antillean economy is currently at a critical juncture. In a recent Staff Report for the 2003 Article IV Consultation Discussions, the IMF staff concurred that the balance of risks for the Netherlands Antillean economy has improved lately. But for us to seize the upside potential, the overriding priority must be “an expeditious and sizable fiscal adjustment to reverse the unsustainable accumulation of public debt, and the sustained implementation of a well-considered structural reform agenda to raise productivity and improve employment prospects.”

But, ladies and gentlemen, the issues referred to by the IMF staff are not new. Over the past two decades, the economy of the Netherlands Antilles has experienced several adverse shocks, and it is only now beginning to recover. The repeal of withholding taxes in the US in the 80s was perhaps the biggest shock; that act caused the collapse of several highly profitable international financial services in the Netherlands Antilles. An important source of foreign exchange income and tax revenue simply faded away. The second major shock was the withdrawal of the Shell Oil Company from Curacao and the temporary closure of the oil refinery. This refinery had been a mainstay of the Curacao economy for almost three quarters of a century. Another set of shocks occurred in the 90s, when the Windward Islands were hit by several devastating hurricanes. Much of the economic infrastructure on the islands was destroyed, including about half the number of available hotel rooms. The accumulated effect of these shocks is estimated at the equivalent of at least 20 percent of GDP. For most developing countries, this would have been sufficient to cause an acute economic crisis requiring sharp adjustment in the exchange rate, reductions in domestic factor prices (including wages), and/or adjustment in net public spending.

We were able to maintain our peg to the US dollar without large-scale internal economic disruption thanks to our comfortable level of international reserves, a nominal wage cut in various sectors of the economy, payments of indemnities by the insurance industry, an increase in domestic public debt, and Dutch development aid. I have to add, however, that we have not fully recovered from those shocks. The various adjustment programs designed to address these imbalances never were implemented fully or were abandoned prematurely. As a consequence, since the mid-90s, the Netherlands Antilles economy has recorded low growth rates, followed by a double-dip recession, accompanied by large-scale emigration.

The Current State of the Economy

In last two years, the Antillean economy has shown signs of economic recovery. The gross domestic product (GDP) grew by 0.6 and 0.2 percentages, respectively, in 2001 and 2002. This modest growth was recorded under quite unfavorable external conditions: the September 11 attacks, economic slowdown in the United States, and political turmoil in Venezuela. This recovery was led largely by the export-oriented private sector. Buoyant tourism and international financial and business services in Curacao were the main contributors to the GDP growth. In contrast to foreign demand, domestic demand turned downward in 2002, with an overall decline in consumer and business investment spending. In addition, public consumption and investment declined significantly during this period. Against that background, the unemployment rate decreased marginally to 14.2 percent, and inflationary pressure abated sharply with consumer prices up only half a percent in 2002, compared to 1.7 percent in 2001.

Concomitant with the developments in economic activities, the current account of our balance of payments recorded a significant improvement. This improvement, combined with the improvement in the financial account, resulted in a balance of payments surplus. After two years of positive developments in our balance of payments, our official foreign exchange reserves have exceeded our targeted international benchmark of three months of import coverage for the first time since 1988.

While the Antillean economy has shown significant resilience despite a difficult external environment, the sustainability of this recovery is being threatened by the sharp deterioration in the public finances. Increased personnel costs and interest expenditures combined with falling tax revenue collection raised the government deficit

to 5S percent of GDP. A related concern is the consequent, increasing debt-to-GDP ratio. Our debt-to-GDP ratio has reached a level that requires immediate and sustained bold actions in the fiscal field if we are to avert a significant deterioration of the already uncertain macro-economic environment.

Looking ahead, the continued growth in the export-oriented service industries is expected to further sustain the economic recovery this year. However, the geopolitical uncertainty, as a result of the Venezuelan crisis and terrorism threat in the United States, may affect tourist services in Curacao. Given the relatively favorable financing conditions for the government, a slight rebound in consumer spending is projected leading the way for a modest S percentage point economic growth this year—slightly better than last year. Noteworthy is that the expected growth in consumer spending is supported further by a modest improvement in employment possibilities and wages. Inflation, as measured by changes in the consumer price index (CPI), will accelerate to two percent, in line with developments in the United States. I do not expect inflation to be a source of uncertainty for businesses and consumers in 2003.

Regional Economic Developments

Ladies and gentlemen, before elaborating on the future prospects of the Antillean economy, allow me to place the recent economic developments in the Netherlands Antilles in a regional context. Regional economic activity is estimated to have decreased by 0.5 percent in 2002. The economies most affected by the economic slowdown have been Venezuela, Aruba, Barbados, and Jamaica.

Venezuela's economic situation became more vulnerable in 2002 due to domestic problems, a sharp deterioration in its fiscal position, and external factors. As a result, private-sector confidence weakened accompanied by large outflows of private capital. In addition, the government experienced serious difficulties in rolling over maturing domestic debt and gaining access to the international capital markets. All these factors – together with cuts in oil production –led to a substantial contraction in economic activity in 2002, and the rate of inflation accelerated to 31.2 percent on an annual basis. Projections for 2003 range from a 15 to 20 percent drop in economic activity, while inflation is expected to soar to 50 percent on an annual basis.

Underlying these projections are the recent general strike and the political uncertainty. Once domestic uncertainties have been settled, economic activities are expected to rebound by 3 percent.

After growing at over 4 percent per year from 1996 to 2000, the Aruban economy experienced two years of retrenchment, with GDP falling by an estimated 1.2 and 3.8 percent, respectively, in 2001 and 2002. This downturn reflects a sharp reversal in private-sector investment activity caused by especially weak tourism activity following the U.S. recession and the September 11 attack. Higher private and public investment and a modest revival in tourism should boost economic growth in 2003 to over 4 percent. With higher tourism capacity and continued sustained investment, economic growth is expected to remain at around 3 percent in the medium term.

After eight years of consecutive economic growth, real GDP in Barbados contracted in 2001 and 2002 by 2.7 and 1.8 percent, respectively. The main cause of this turnaround lay in the adverse impact of the September 11 attack on tourism and the global economic slowdown. Inflation fluctuated around 2 percent, and unemployment reached 10.5 percent of the labor force. The overall public-sector deficit widened sharply from 0.7 to 5.1 percent of GDP, mainly due to civil-servant wage increases, fiscal stimulus, and deterioration in the finances of public enterprises. The Barbadian economy is expected to revert to a positive growth path, but its prospects hinge largely on resurgence in global tourism demand.

In contrast to these developments, some countries in the region managed the adverse international environment quite well. These countries include for example, the Dominican Republic, Trinidad & Tobago, Guyana, and Jamaica. Preliminary data showed that economic activity in the Dominican Republic accelerated from 2.7 percent in 2001 to 4.0 percent in 2002. This growth was supported by rising investment, including a substantial increase in foreign direct investment in the electricity, telecommunications, free-trade zone, and tourism sectors. The rate of inflation in the Dominican Republic accelerated from 4.4 percent in 2001 to 10.5 percent in 2002. The economic prospects are that the economy will continue to grow at an average rate of 2.5 percent. Inflation will decline gradually.

Jamaica's economy was hit by a series of shocks including the outbreak of violence, the impact of September 11 on tourism, and heavy floods. Government response to these shocks was to cushion the impact on the economy. However, public finances worsened significantly, and the reduction in public debt was not realized fully. As a consequence, the economy grew by 1.2 percent in fiscal year 2002. The rate of inflation dropped from 7 percent in 2001 to 6 percent in 2002. Unemployment remained at 15.5 percent of the labor force.

If we return home and place our recent economic development against this regional background, the following picture emerges. With an annual per capita income of approximately US\$ 16,000.00, the Netherlands Antilles rank third in the Caribbean region, after Aruba and the Bahamas. Our high level of per capita income is a good indicator of the level of economic development we have achieved so far, despite the adverse shocks experienced during the last two decades. Another key indicator of the state of the economy, in terms of net export capacity or net national savings, is the current account of the balance of payments as a percentage of gross domestic product. On this respect, we are

among the top five countries in the region, with a current account deficit of about 5.5 percent of GDP. Like most Caribbean countries, our main source of foreign exchange income is tourism. However, developments in public finances are in sharp contrast with regional developments. With a fiscal deficit of more than 4 percent of GDP, we are among the five countries in the region with the worst fiscal performance.

Economic Prospects for the Netherlands Antilles

Ladies and gentlemen, despite the favorable growth prospects this year, the medium term growth prospects are less certain. Our long-term growth prospects continue to be overshadowed by the unsustainably high budget deficits, increasing debt-to-GDP ratio, and high debt-servicing cost. The broad and pervasive uncertainties that these unresolved issues in the public sector are casting on our economy are holding back a more vigorous recovery in the short term.

Despite our best efforts, there will always be risk; it is an inherent characteristic of a small open economy like ours. But we have created the risk we are facing today. This risk is unusually large and difficult to quantify: uncertainty associated with the prolonged budget deficits, the high level of the public debt, and the increasingly large burden of the debt service. The financing of the budget deficit and the refinancing of maturing government bonds increasingly are putting pressure on the local financial markets. The relatively high interest rates we observe on the domestic financial markets, despite historically low international rates, are a direct result of the increasing public demand for funds.

This pressure not only has resulted in relatively high rates for governments, but the costs of doing business for the private sector also are increasingly high. An inherent feature of corporate financing in developing countries is the prevalence of bank-based financing. Because of the size and lack of a well-developed secondary market, equity-based financing is very limited.

The high cost of capital and uncertainties lead to postponement of business investment decisions. As a result, financial resources are being misallocated, and our growth potential will not be exploited fully. The lack of equity financing presents some opportunities to develop venture capital schemes to foster further growth of our economies. KPMG as a leading company in the field of tax and management consulting and accountancy can play a pivotal role in this area.

A related concern to me is that the so-called “political” uncertainties, and their implications for economic recovery, have made executives gun-shy about taking risks. As a central banker, I am not advocating imprudent decision-making. But the functioning of our market-based economy depends on sound risk-taking. And one kind of risk—a critically important one—is business investment. Therefore, it is important to work to eliminate those impediments to create an environment conducive to more investments and, hence, economic growth.

At this point, you may be wondering why the expansion hinges largely on business investment. After all, business investment accounts for only about 25 percent of GDP. Why does future growth depend on business investment? The answer is that business investment in productive capacity, especially in the export sector, and new technology generate new economic activity and productivity growth. This growth will lead to higher foreign exchange inflows, cash flow, and profitability which in turn support wage growth and/or employment. The ensuing growth in disposable income supports consumer spending growth and sustained economic development.

Another risk is the uncertainty associated with developments in our main trading partners: Venezuela, the United States, and the Netherlands. The interdependence of a globalizing world means that in the design of a country's policies, due considerations must be given to developments in other countries. Given our size, developments in any one of our major trading partners have the potential to deliver large shocks to our economy. The foreign exchange crisis in Venezuela and the terrorism threat in the United States, for example, are affecting tourism development in this country and, indeed, in the whole Caribbean region.

Conclusion

Against this backdrop, the question becomes: How can we address these uncertainties to underpin this fragile recovery and foster sustained economic growth over the medium and long term? Moving forward, we must focus on a strategy to create a sound macroeconomic environment. That is, if we are to exploit the opportunities and at the same time limit the risks, we must have good governance, sound institutions, sound fiscal policies including fiscal discipline, sustainable public debt, further structural reforms, flexible markets, privatization, and alleviation of poverty.

1. First and foremost, ladies and gentlemen, we have to address public-sector imbalances and restore business confidence. Toward that end, we must restore balance in the public finances and reduce the cost that the government bureaucracy is imposing on the economy as a whole. Once we move beyond the uncertainties associated with the public finances, I think the economic recovery is bound to regain momentum. Given our past track record, we need to convince the market that our fiscal policies are credible

and sustainable in the medium term. Our fiscal problems are structural, and will require sustained actions to overcome. Any fiscal consolidation is bound to weigh heavily on the poor. Therefore, in designing a fiscal consolidation program the social safety nets must be strengthened.

2. We have to promote new investment, particularly in export-oriented industries, that will create employment, foreign exchange income, and growth. We must raise the productivity level in existing enterprises by investing in new technology. Rising worker output reduces unit costs and improves private-sector profitability, over time allowing businesses to raise workers' wages without affecting our competitiveness. Several studies, including a recent World Bank study, have identified some key projects in our growth industries to jump-start the economy. Service industries, especially those not connected with retail and wholesale trade, generally are less affected than manufacturing and construction industries by changes in aggregate demand and supply conditions. This is the rationale for the argument that service industries bring stability to an economy. As we all know, and as underscored by these studies, the long-term comparative advantage of the Netherlands Antilles lies in tourism and other labor-intensive service industries. I would like to stress in this context that the authorities and business community in the Netherlands Antilles fully recognize the need to focus on the tourist industry. Full advantage should be taken of the island's deep-water port and maritime service facilities. I also would like to emphasize that we have, or can create, comparative advantage and growth potential in such activities as international distribution and transshipment through our port, international financial services, other niche-service industries, light manufacturing, and artisan crafts.
3. Finally, for well over a year now, monetary policy has been appropriately accommodative to underpin this recovery. Foreign exchange reserves are at an all time high, and interest rates are at an historical low. Even though we have not yet seen an expansion in demand for credit from businesses, they have at least been able to refinance existing debt at lower rates. Again, I think this is a positive development for business investment. However, monetary policy affects only the price and the aggregate amount of credit in the economy: allocation of credit is carried out by financial markets. And it is my strong belief that markets — imperfect as they may be — make better decisions about resource allocation than bureaucrats. I do think, though, that business demand for capital will grow as soon as the current political uncertainty is resolved.

In concluding, ladies and gentlemen, the difficult macroeconomic environment forces us to focus increasingly on the financial sector. I take pride in noting that our local financial sector has shown tremendous resiliency by weathering the various economic shocks we have experienced in the past decades. In addition, it has withstood the adverse developments in the international financial markets and domestic uncertainties associated with the public finance. This performance is in no small part attributable to the soundness of the regulatory framework and policies, which resulted in healthy balance sheets. The IMF, as part of its Financial Sector Assessment Program, underscores this view.

The medium- and long-term economic prospects for the Netherlands Antilles will be determined largely by how well we deal with the risks and economic facing us. Bold leadership is required to balance the government budget, stabilize the debt-to-GDP ratio, restore confidence, and exploit the investment opportunities in key growth sectors. By getting the fiscal policy back on track and accelerating the structural reforms, we project an average economic growth of 2 – 3 percent over the coming years. The main growth sectors will be tourism, international financial and business services, and the transportation industries. In line with the increased economic activity, we expect consumer spending to pick up again due to a further drop in unemployment and wage advancements. The rate of inflation will remain more or less constant around this year's level, and our external position will remain stable. This will restore confidence in our economy again and foreign direct investment will return to the islands in search of profitable opportunities. The challenges for you as leaders of the business community, in devising a strategy for the period ahead, are to seize the opportunities by reinforcing a culture of good governance, sound risk taking, and entrepreneurship. After all, it is only through growth that real progress can be made in creating durable jobs and hence alleviating poverty and ultimately improves the welfare of all of us.

I wish you a productive and fruitful session and thank you for your attention.