The implications of the financial and economic crisis for the financial services industry

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Speech by Mr. Alberto Romero on the occasion of the 2010 Globalaw Americas Regional Meeting, June 11, 2010

Good morning, ladies and gentlemen.

It is a pleasure for me to join you today on the occasion of the 2010 Globalaw Americas Regional Meeting. Today I would like to share with you my views on the implications of the financial and economic crisis for the financial services industry.

Ladies and gentlemen, the first decade of this new millennium has seemingly been jam-packed with crises and turmoil around the world. The decade started off with the dotcom crisis, which resulted in a spectacular drop in the value of international stock exchanges in the major financial centers. In 2006, prices in the housing markets in the United States reached their peak after which real estate values plummeted by at least 20%. During 2007, many hedge funds operating in important financial centers were faced with liquidity and capitalization problems, resulting in the liquidation of several funds and a staggering loss of value for their shareholders. The next crisis that knocked on our doors was the international financial crisis in 2008-2009. This crisis has had the most implications for the United States, Europe, and the Asian markets. As we speak today, many Southern European countries are facing major troubles because of mounting public debt and difficulties accessing capital markets to finance their growing budget deficits. In addition, the debt problem of Greece is threatening the role of the Euro as the second reserve currency in the world.

The financial crisis and the economic disequilibria affecting us today are not new phenomena. During the 1980s, the Latin American countries of Argentina and Brazil were faced with similar problems. The current financial problems of Greece, Portugal, Spain, Italy, Ireland (the so-called PIIGS) - all forming part of the Euro area - are a good example of how disequilibria in one country can spread to other countries. More specifically, the situation in Greece today is a good case study because it reveals how consistently weak management of public finances over a period of years leads to rising public debt. Fiscal budgets were approved year after year in Greece despite the fact that they were not in accordance with the budgetary agreements of the stability pact for the countries using the Euro. Today Greece has a public debt-to-GDP ratio of 120% and a budget deficit of 14% of GDP. Consequently, the country is forced to pay 13.5% interest on 2-year government bonds in the international financial markets. Greece's experiences provide a clear example of how badly managed economies will in the end produce serious problems for the authorities of these countries. Responsible, sound, and safe management of public funds is the only viable way to stay out of difficulty in the long run and to avoid having to pay a high price for the refinancing of outstanding debt instruments.

Ladies and gentlemen, in my presentation today I will highlight three topics. I will start by giving you an overview of the importance of the financial services industry of Curaçao for the island's economy and the specific challenges facing the local authorities in the immediate future. Given the changing environment and how the international financial community perceives the financial services rendered by small jurisdictions like ours, we have to be responsive to these perceptions and work to comply fully with current international tax standards. The common trend today in this area seems to be the continuously growing exchange of information among countries. Global actions aimed at achieving closer cooperation between countries to avoid harmful taxation will without a doubt determine the agenda in the coming years.

The second topic that I would like to elaborate on is the situation in the global economy and developments in the financial markets. What are the risks and threats of the financial crisis, and what have we learned from it? One thing is clear: despite the negative impact of the financial crisis around the world, our economy has weathered this crisis well. According to preliminary data, our economy expanded by 1% (GDP growth) in 2009, while the unemployment rate dropped below 10% for the first time in decades.

Last, I will discuss some implications of the credit crisis for the financial and particularly the banking industry. What are the most important lessons to be learned, and how committed are we to work together to avoid future crisis situations?

Ladies and gentlemen, the financial services industry is one of Curaçao's major economic sectors in terms of value added, employment, and foreign exchange generation. On average, the financial intermediation sector contributes 16% to GDP. A sectoral breakdown reveals that domestic banks contribute 5.4% to GDP, insurance and pension funds, 5.2%, international financial services, 2.5%, and other financial services, 3.1%. Moreover, during the 2005–2008 period, financial intermediation contributed roughly 7% to total employment. The international financial services in particular are important in terms of foreign exchange generation as they contribute on average 11% to the total foreign exchange revenues from the exports of goods and services. It should be noted, however, that these exportshave been declining gradually from 12% in 2000 to 7% in 2008.

Considering the importance of the financial industry for our economy, global trends in the financial industry will be a major challenge Curaçao's authorities will have to face. In addition, our authorities must be able to cope with the many local developments to insure that Curaçao's competitiveness is supported and boosted as much as possible in the future.

The ongoing constitutional reform is one of the major local developments affecting Curaçao's economy. It is important to note that the new country of Curaçao will enjoy the same internal autonomy the Netherlands Antilles currently enjoys. The challenge will be for the new country of Curaçao to continue using the existing infrastructure that consists of, among other things, the current financial and legal framework and international treaties of the Netherlands Antilles, to promote and support the island's economic development. Once the central government is dismantled, the two- tier government system that we have known for so many years will become a part of the past. In its place, the government of the country of Curaçao will consist of a mix of civil servants from both the central government and the island government of Curaçao. In addition, the new entity will have to make sure it continues to comply with the new budgetary and financial norms agreed upon with the Netherlands and the implementation and enforcement of the new corporate government rules.

Maintaining a financial industry that is healthy, flexible, and transparent is another major challenge Curaçao and other financial centers are facing and will continue to face in the future. Since 2008, international tax transparency and information exchange standards have been very high on the political agenda. This development is a result of the many financial scandals that have negatively affected several countries worldwide. In addition, the global financial crisis highlighted the relevance of maintaining healthy and transparent financial centers. The G20 has made tax transparency one of the major discussion items at its last several meetings, stating that action will be taken against non-cooperative jurisdictions, including tax havens. The general consensus is that the era of banking secrecy is over and that sanctions will be taken against those who do not meet international standards for the exchange of tax information.

The OECD (Organization of Economic Cooperation and Development) periodically publishes a list of countries that the Global Forum has assessed as against the implementation of the international tax standard in their jurisdiction. Information exchange requires that jurisdictions enter into international agreements to be in a position to provide administrative assistance in all tax matters. Since 2009, many agreements have been signed by jurisdictions previously labeled by the OECD as not substantially implementing the information exchange standard. We can be very proud that the Netherlands Antilles was removed from the grey list of the OECD in September 2009. Consequently, the Netherlands Antilles is now listed among the 72 jurisdictions--including many developed countries--that have substantially implemented the internationally agreed upon tax standard. Furthermore, the Netherlands Antilles is currently negotiating with several countries to reach agreements aimed at avoiding double taxation and at the exchange of tax information.

In line with developments in the international financial industry, the CIFA (Curacao International Financial Services Association) has focused on developing a unified vision and strategy for the financial services industry to make sure Curaçao can maximize the opportunities available to the island. CIFA's vision is to make Curaçao the gateway of choice, both inbound and outbound, for channeling cross-border international financial services transactions with Latin American countries, such as Argentina, Brazil, Mexico, and Venezuela. For Curaçao to become a premier and globally competitive financial services center and to reach the status of one of the top ten financial services centers in the world, the current tax treaties network of the Netherlands Antilles should be expanded.

However, the core business of Curaçao's international financial sector currently consists mainly of services based on tax benefits, characterized by a very limited amount of company activity. Therefore, the authorities of Curaçao should aim to create onshore structures with 'substance'. Compliance and substance are the two key factors Curaçao should focus on. This focus does not necessarily imply the total elimination of low corporate tax rates. It does imply the promotion of transparency and elimination of the perception of being a low tax jurisdiction, in order to shift away from being a "tax haven" to becoming an "investor haven". This shift could be accomplished through the introduction and promotion of new niche products and services and the expansion of the Dutch Caribbean Securities Exchange (DCSE). The launch of the DCSE in the beginning of 2010 was an important step towards achieving our goal of providing an exchange that offers time- and cost-efficient listings for international corporations and investment funds and an alternative to the Anglo-Saxon exchanges in other jurisdictions.

To achieve our ultimate objective, however, additional conditions must be met. These conditions include reducing the corporate tax rate, cultivating a strong and professional labor force, making our labor market more flexible to improve our competitiveness, investing in state-of-the-art technology, and moving towards providing red carpet services. By creating the necessary framework that complies with international standards and provides business services with 'substance', we will be able to offer investors a safe, secure, and flexible business environment, one that may become an important hub for the regional head offices of international enterprises.

Ladies and gentlemen, as I indicated, my second topic today is current developments in the global economy and the financial markets. In an effort to prevent a collapse of the global financial system, authorities, particularly in advanced economies, took extraordinary measures aimed at supporting demand and reducing uncertainty and systemic risk in financial markets. These measures included the expansion of retail deposit insurance schemes and the provision of guarantees for bank liabilities other than deposits. In addition, banks received billions in capital injections and guarantees for their assets in return for government ownership stakes. Central banks also provided generous liquidity support and cut interest rates. Nevertheless, these efforts could not prevent a worldwide recession. Overall, the global economy contracted by 0.6% in 2009. Output contracted in most of the advanced economies, including the United States and the Euro area. In addition, economic activities slowed in the emerging markets and developing economies. As a consequence, many economies experienced a significant increase in unemployment.

Fortunately, global economic growth has rebounded recently, and financial conditions have improved. According to the International Monetary Fund's most recent World Economic Outlook, global growth is projected to expand by about 4¼ % in 2010 and 2011. However, the pace of recovery differs across and within regions. Economic growth in emerging and developing countries is projected to be strong, reaching around 6¼ % in 2010 as inventory investment expands, led by prospects of improved demand in both advanced and emerging economies. In addition, growth in countries such as Brazil, China, and India is picking up as a result of increased capital inflows.

In contrast, the advanced economies, are projected to recover only moderately by around 2¼ % in 2010 and 2011 following a decline of about 3% in 2009. This sluggish performance will be due largely to weak private demand. Private consumption in the United States, which was the main driver of growth before the crisis, is recovering slowly as consumers are being more prudent. Meanwhile, private demand growth in Europe is hampered by the weak banking sector that limits credit supply.

When we take a closer look at Europe, i.e., the euro area, it seems that we have begun a new episode in the international financial crisis. The first phase of the crisis started with the subprime mortgage-related turmoil in 2007 and affected mainly the financial markets. During the second phase, the financial crisis spread into the real sector causing trade, consumption, and investment to fall worldwide. Now, we have reached the third stage in which the financial markets have started to question the sustainability of economic policies, particularly in light of the dire state of public finances. As a consequence, the financial markets have started to question the sustainability of the economic recovery itself. This third phase has hit Europe in particular and has resulted in a strong decline of the euro.

The current problems in Europe, and in the euro area in particular, are related to three factors: (1) a credit boom in certain countries including Greece, Spain, and Portugal due to lower interest rates after these countries joined the eurozone; (2) a lack of risk management in economic policy in these countries; and (3) the fact that the Stability and Growth Pact was neither adhered to nor enforced, despite its being the cornerstone of the European monetary union. Public deficits in these countries have been increasing over the past several years due to shortsighted fiscal and economic policy. National economic policy rarely included long-term strategies to improve the countries' competitiveness. In addition, public finances deteriorated even more during 2008 and 2009 as a result of public sector interventions to avoid a collapse of the financial sectors.

Greece has been registering high borrowings and debt for many years, mainly because the country overspent while its revenues fell. As a consequence, Greece became highly indebted and has lost about 25% of its competitiveness since the adoption of the euro. By the end of 2009, the general public deficit in Greece had reached 13.6% of GDP, and public debt had increased to 115% of GDP, the highest debt burden in the euro area. Given these numbers, the financial markets stopped lending to Greece, forcing it to appeal to the European Union and the International Monetary Fund for assistance. Greece has now adopted a major adjustment program, which includes structural reforms and fiscal adjustments.

Given the debt crisis in Greece, investors currently prefer dollar-denominated assets to euro-denominated assets. Confidence in the euro remains shaky despite the measures taken to ease the situation in Greece because Portugal, Italy, Ireland, and Spain also are faced with high deficits and mounting public debt, fueling fears of contagion. Amidst worries that the European monetary union is on its last leg, and news that some countries, for example Iran and China, are planning to sell their euro reserves, the euro has been declining sharply against the US dollar, dropping 15% so far this year. As is often the case in times of financial turmoil, many investors have been buying gold because the metal is considered a "safe haven". Due to investors seeking to protect their wealth amid Europe's sovereign-debt crisis, gold reached a record price of $1,249.40 an ounce on May 14th, 2010. According to predictions, it may trade at $1,400 to $1,600 an ounce in the next two years.

The current unhealthy financial situation of many governments has led to appeals for not only broader supervision of banks, but also for (1) a restructuring of the banking sector, which would prevent banks from investing in certain derivatives and trading with their own money, and (2) measures to make sure banks pay for any future financial meltdowns they cause. The general concern is that in the past, banks relied too much on the implicit guarantee that they would be "saved" through government intervention, and that, therefore, they took too many risks. Consequently, both in Europe and in the United States, legislation is now being drafted to make banks increase their share of equity drastically, and to force them to contribute to emergency funds that can be used to limit future banking crises. Banks can be made to contribute to such funds either through special bank taxes levied on a share of their outstanding liabilities, or by taxing certain financial transactions. No matter which approach is taken, the aim is clear: to end the situation in which financial institutions pocket the profits they make when they take excessive risks, and if they incur big losses, the taxpayer is forced to pay the bill. ("Privatize profits and socialize losses")

Ladies and gentlemen, the third and final topic I would like to highlight today is the implications of the credit crisis for the financial and the banking industry. The recent financial crisis has taught us some critical lessons and has revealed some important weaknesses of the global financial system. As we all know, innovation in the financial sector resulted in the development of new instruments that were supposed to expand the diversification of the risk for savers and investors. However, financial regulation was not equipped to detect the risk concentration and flawed incentives behind these innovations. In fact, regulators were not aware of the underlying risks of the financial innovations and the interconnectedness between activities and institutions. As a consequence, financial institutions and other investors took risky decisions beyond the regulatory net.

The financial crisis has made us more aware of the negative externalities that financial innovation and financial globalization can create. One important lesson that can be drawn from this crisis is that markets cannot function properly without effective regulation and supervision. Therefore, there is now a general consensus that financial sector regulation has to be strengthened and broadened in order to prevent similar financial sector crises in the future. Generally, five areas are recognized where actions should be taken.

First, financial regulation should be broadened to include all financial activities that pose economy-wide risks. Second, capital regulation and liquidity and risk management have to reflect both individual institution risks and their potential to form systemic risk. Hence, regulation should also have to focus on strengthening financial institutions' management of liquidity and risk. Third, a macro-prudential approach to regulation is required. Traditionally, financial sector regulation has been centered on the stability of individual institutions. However, a macro-prudential approach that considers the systemic implications of the collective behavior of financial institutions also is needed. Fourth, information disclosure and corporate governance practices need to improve to enhance market discipline. As for information disclosure, derivative market instruments in particular need to be subject to greater transparency. In the area of corporate governance practices, conflicts of interest must be reduced by making remuneration schemes or bonuses more consistent with long-term success instead of short-term profits. And fifth, there is a need for greater coordination across countries in both the design of regulation and the monitoring of systemic risk. The recent financial crisis has emphasized the need for international cooperation and policy coordination. As financial markets have become increasingly integrated and financial centers interconnected, no country can escape the effects of a financial crisis, no matter where it occurs. Hence, financial sector regulation and supervision cannot stop at the national borders. In fact, recent experience in dealing with the crisis has shown us that international policy coordination can be very effective.

Cooperation and policy coordination in the areas of financial sector supervision and regulation also are crucial on the Kingdom level. To address our financial sector's vulnerabilities, a financial supervisory structure in which every country within the Kingdom will have its own supervisory institution, complemented by a standard-setting body at the Kingdom level or Committee of Kingdom Supervisors, is recommended. This body should consist of the presidents of the respective central banks and should be in charge of preparing legislation in line with international best practices, the timely implementation of rules and regulations, and monitoring compliance. Such a structure will guarantee compliance with international supervisory standards. In addition, this structure will create a level playing field with uniform rules within the Kingdom and promote credibility and transparency. The existing cooperative agreements between the central banks of the Netherlands, Aruba, and the Netherlands Antilles can serve as a basis for the development of a firm supervisory architecture and the achievement of sound financial institutions and financial stability in the new countries of the Kingdom.

Ladies and gentlemen, today I had the pleasure of sharing my views with you on the implications of the financial and economic sector for the financial services industry. First, I discussed the importance of the financial services industry of Curaçao and the challenges local authorities will have to face in the future. Next, I highlighted the situation in the global economy and developments in the financial markets. Finally, I reviewed the implications of the credit crisis for the financial and the banking industry. The conclusions that we can draw today from all this are as follows

- 1.The regulation and supervision of the financial services sector will need to be strengthened and broadened to prevent similar crises in the future.
- 2.Banks and other financial institutions will become subject to stricter supervision to prevent them from taking excessive risks, possibly through mandatory higher equity levels. In addition, they will be forced to contribute to emergency funds that can be used in case of financial turmoil.
- 3.Top management bonuses will become more long-term oriented; quick profits and quick bonuses will become a thing of the past.
- 4.Both at the local and international levels, cooperation and policy coordination in the areas of financial sector supervision and regulation are crucial to achieve and maintain financial system stability.
- 5.The role of the Euro in the world depends heavily on how well the euro area is able to manage its deficits and outstanding debt. Without proper budget discipline, the euro will lose its value, and hence, its role as the world's second reserve currency.

Thank you for your attention!