

The Role of Central Banks in Promoting Sustainable Growth

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Ladies and gentlemen, good afternoon,

Introduction

It was with a great deal of pleasure that I accepted the invitation to address you on this seminar on “Current Issues in Central Banking” on the occasion of the inauguration of the new office building of the Central Bank of Aruba. The Central Bank of Aruba and the Bank van de Nederlandse Antillen share a common history that goes back to 1828. In 1828 the then King of the Netherlands, King William I established the Curacaosche Bank to finance and promote trade in the colony Curacao. Over time, this Bank grew into a full fledged Central Bank responsible for the conduct of monetary policy and the supervision of financial institutions in the Netherlands Antilles—including Aruba. With departure of Aruba from the Antillean constellation, the Bank van de Nederlandse Antillen was divided into two autonomous institutions entrusted with the conduct of monetary policy and the supervision of financial institutions in the two respective countries of the Kingdom.

Despite this legal separation, the two central banks continue to cooperate on various matters. It is for this reason that I am glad that Hassalani Meheran who initiated and promoted this process of collaboration between the two central banks, is also present here today. This cooperation includes technical assistance, policy coordination and the exchange of ideas and experiences in various areas of central banking. Given our close ties, it is probably no coincidence that we both moved into a new office building this year. I would like to use this occasion to congratulate my Aruban colleagues with this milestone in their twelve years of existence.

I am also very pleased to see so many of my colleagues and friends with whom I had and still have frequent contact as a central banker. This creates an excellent opportunity for a productive and fruitful exchange of views and ideas on current issues in central banking, which is the topic of this seminar.

Ladies and gentlemen, I have been asked to talk about the role of central banks in promoting sustainable growth. Let me start by saying that central bank's policy in small open economies as ours should be based on two overriding principles: (i) the protection of the value of the national currency and (ii) the preservation of overall financial stability.

In periods of economic difficulties however, central banks may be subjected to increasing pressure to pursue policies that may not be consistent with the two principles mentioned earlier. Central banks may be pressured to provide financing to the government, provide credit to the private sector and pursue policies to lower interest rates that may be inconsistent with the underlying economic fundamentals. However, as history taught us monetary policy can provide only temporary stimulus to the economy. Subsequently monetary policy must be followed by corrective measures.

Central banks should refrain also from engaging in activities that may put them in direct competition with commercial banks. This is tantamount to un-leveling the playing field and will interfere with the effective performance of central bank functions. To avoid this, central banks should have a medium-term horizon in the conduct of policies aimed at promoting sustainable growth and job creation.

Ladies and gentlemen, I will continue my address by focusing on the necessary conditions for creating an environment conducive to more investments and, hence, economic growth. As we shall see, these conditions are closely related to the main objectives of central banks that I mentioned earlier, underpinning the role of central banks in promoting sustainable growth.

The regional pattern and composition of capital flows suggest that investors have become more sensitive to economic fundamentals in host countries. What I mean to say is that investors are factoring macroeconomic variables into their investment decisions. These macroeconomic variables include among other the size of the current account deficits in relation to foreign exchange reserves, government debt, government deficits, inflation, domestic savings, growth potential, and the soundness of the banking system. This implies that a stable macroeconomic environment is critical for a stable and sound development of the financial sector. A stable financial sector and the sound development of the financial system in the long run depend on the quality of our financial institutions and the effectiveness of banking supervision.

Therefore, macroeconomic stability, high quality financial institutions, and effective banking supervision are necessary conditions and key success factors for sustainable growth. Let me elaborate on this issue further.

Macroeconomic stability

A stable macroeconomic environment promotes savings necessary to finance investments--a precondition for achieving sustainable economic growth. In today's global environment, market perceptions are important explanatory variables in determining where capital flows. Thus, if we are to attract the needed capital to sustain the growth of our economies, we have to pursue policies that the market perceives as credible and will result in growth and stability. This means: (i) sound macroeconomic policies, (ii) comprehensive structural reform, and (iii) good governance.

The economies of Aruba and of the Netherlands Antilles are characterized by their smallness and openness. External economic relations account for a substantial part of national expenditures, while economic activities are concentrated around only a few important pillars such as tourism, financial services, and oil refining, which are mostly dependent on foreign markets.

Our region has been beset by adverse macroeconomic conditions in the 1980s and 1990s: terms of trade shocks, rising debts, natural disasters, loss of international competitiveness in key export industries, and inappropriate macroeconomic policies --particularly fiscal policies-- were largely responsible for the persistence of balance of payments deficits.

The appropriate response to these external shocks to our economies would have been consistent monetary, fiscal and trade policies, combined with policies to promote savings, investment, and the enhancement of our foreign exchange generating capacity. Of course, we must allow for differences in emphasis and intensity, depending on the specific economic circumstances and characteristics of the various countries. However, we have not always responded timely and adequately to these shocks.

The Netherlands Antilles did not escape the winds of adverse macroeconomic conditions. The origins of the current financial-economic crisis started some 15 years ago with a series of large external shocks which hit the three main pillars of our economy. In this respect I can mention the repeal of the withholding tax in the United States, which caused the collapse of a number of highly profitable activities in the international financial and business services sector. Another major shock was the oil crisis, which affected us in two ways. First, it caused a large devaluation of the Bolivar, which ended the buoyant shopping tourism from Venezuela to our islands. Second, it prompted the closure of Shell's Curacao refinery. These two major shocks were aggravated by a number of smaller shocks, such as several devastating hurricanes on the Windward Islands, the discontinuation of certain trade privileges on the European market, and the uncertainties surrounding the change of the Tax Arrangement for the Kingdom.

The impact of the shocks and inadequate policy responses by the authorities resulted in large macro-economic imbalances. It became evident that only a major restructuring of the economy would create a basis for sustainable growth. At the end of 1995, the Netherlands Antilles embarked on a structural adjustment program in close cooperation with international organizations, such as the IMF, the IDB, the FIAS, and the World Bank. Our structural adjustment strategy entailed a three-pronged approach: (i) re-establishing confidence in the public sector by pursuing fiscal consolidation and structural reform, (ii) a growth strategy, and (iii) a social policy.

During the past six years, we have made considerable progress in restructuring the public finances and implementing structural reform. The government bureaucracy has been reduced, wage costs have been brought under control, and the civil servants pension scheme has been partially reformed. The improvement of cost efficiency in the government apparatus has further reduced expenditures.

On the revenue side, a shift from direct to indirect taxes was initiated with the introduction of the turnover tax, the base of which has been broadened gradually. Tax assessment and collection have been improved, while arrears have been reduced. Furthermore, user fees for government services are applied more broadly. In addition, public sector financial administration and reporting has been enhanced. I have to note here that while considerable progress has been made, we still need to go a long way to get our budgets in equilibrium. I like to stress here on the need to take timely measures.

In the field of structural reform, various measures have been implemented to foster competition and to create a business climate conducive to more investments. Labor legislation has been modernized and the product market is being made more competitive. Progress also has been made in the capital market: disclosures have improved, and the interest rate level has declined. The privatization process has also started. All of this has been done with the objective of improving our business climate and, hence, restoring economic growth.

Given the involvement of the IMF in the structural adjustment of the Antillean economy, strong emphasis was placed

on fiscal adjustment and an appropriately tight monetary policy. Our significant internal and external macroeconomic disequilibria warranted this approach. However, the accompanying growth strategy and social policies were neither timely nor fully implemented. As a consequence, it is only now that we are seeing signs of recovery from the recession we endured during the adjustment process. This lack of synchronization of policies resulted in a large part of our population migrating to Holland in the hope of a better future.

The experience of the Netherlands Antilles serves to illustrate that the timing and sequencing of the policy measures in adjustment programs are of critical importance. Furthermore, adjustment programs should be appropriately tailored, taking into account differences in economic structure, institutional arrangements, and institutional capacity when implementing and monitoring the program. If these points are overlooked, it can lead to unnecessary derailment of the program and will consequently affect authority's credibility and commitment to adjustment.

Aside from these country specific points, ladies and gentlemen, there are some overriding principles that apply to all countries in promoting a stable macroeconomic environment. First, economic discipline is the cornerstone of success. It helps shape the market perception and investors' confidence in the policies pursued by a country. Second, policies should be consistently implemented to assure economic agents that the favorable business climate will last. Third, credibility is very important: once lost, it takes great efforts and time to regain.

The central bank's role in promoting a stable macroeconomic environment is reflected through the design and implementation of its monetary policy, representing one of the main pillars of overall macroeconomic policy. This role is extended further in the coordination of monetary and fiscal policies and the advising of government on overall macroeconomic policy. On the long run, financial stability cannot be maintained unless monetary policy is complemented by sound fiscal policy.

Having said this, I now would like to turn to the issue of the quality of the financial sector.

Quality of the financial sector

A stable macroeconomic environment is a necessary, but not sufficient condition to create a climate conducive to sustainable growth. The second key factor for success is quality financial institutions.

Financial institutions of high quality are usually the driving force behind a stable financial system. To maintain quality financial institutions, several things are needed: (i) an adequate admission and licensing policy, (ii) a comprehensive and effective supervisory framework, and (iii) appropriate mechanisms to resolve distressed financial institutions.

The main regional financial centers, including the Netherlands Antilles, have a well-developed banking system as well as various non-banking financial intermediaries. The commercial banks are equipped with trust, insurance and investment departments that provide both local and international services.

The main banking sectors of the region are comprised of both domestic and international banks that are mainly subsidiaries and affiliates of major international banks of industrialized countries such as the United States, the United Kingdom, the Netherlands, and other European countries. However, noteworthy is the nascent development of Caribbean financial institutions with regional ambitions, of which RBTT Bank is a good example.

Notwithstanding the numerous financial institutions, there is a lack of well-developed money and capital markets in the Caribbean. Therefore, in comparison with the industrialized countries, financial institutions, especially banks, still play a very prominent role in the allocation of resources in our economies, and are the main channels through which economic development is financed.

Due to the globalization of the marketplace and technological advancements, especially in the application of computer technology and telecommunication systems, our local financial sectors have undergone substantial changes becoming more dynamic and innovative. The number of new financial products and services has expanded dramatically, and modern technology has added a new dimension to the activities in this sector.

Several other factors have contributed to the broadening of financial intermediation and monetization in the Caribbean economies. For example, the growth and expansion of non-bank financial intermediaries, such as credit unions, insurance companies and mutual funds forced commercial banks to seek innovative ways to expand and diversify their operations in order to maintain their competitiveness and profitability. In this regard, commercial banks are increasingly diversifying into non-traditional financial activities such as leasing and insurance services. As a consequence, distinctions between commercial banks and other financial institutions are blurring and as financial assets become more accessible, the difficulties of maintaining monetary control are increasing.

However, despite the rapid growth in the activities of non-bank financial intermediaries, commercial banks still dominate the financial system in the Caribbean, and bank loans are still the primary source of financing. In addition, another important factor is the oligopolistic nature of the bank-based financial system in the Caribbean and its consequent implications for the pricing of financial services.

Another interesting feature in the Caribbean financial infrastructure is the fact that most loans are collateralized. The phenomena can be best explained by informational asymmetries in the credit market. There is some evidence that problems related to imperfect or asymmetric information may be more severe in small economies like those in the Caribbean, particularly with regard to foreign investors.

Indeed, the sources of information in the Caribbean countries are still limited compared to other countries. Moreover, most banks in the Caribbean are not equipped with a financial-economic research unit and, consequently, do not engage actively in research on investment prospects. This limits their ability to pursue innovative and flexible policies to bring about sectoral shifts in the employment of their resources.

Hence, because of internal limitations and the fact that the information bases of the banks in the Caribbean region are not very extensive, they rely heavily on collateral security as an information acquisition device and a means of protection against credit risk.

The role of the central bank in promoting quality financial institutions lies in the design and implementation of policies, which encourage domestic savings to remain at home and to flow to the local financial institutions. Thus, more local resources can be mobilized to finance the investment required for sustainable economic development. Moreover, savers must be assured of the liquidity of the instruments issued by financial institutions as well as about the soundness of the institutions themselves. Furthermore, the financial instruments offered must provide reasonable earnings, competitive with alternative uses of funds. Particular attention should be paid to the liquidity of financial assets, which can be promoted by the further development of the capital market.

In this respect, the Bank van de Nederlandse Antillen has made significant progress in the development of an active secondary market in government securities. With the gradual broadening of the capital market with, for example, securities issued by development finance institutions, we can further contribute to the channeling of funds for development and growth. The Bank van de Nederlandse Antillen also strives to promote domestic savings by exempting long-term deposits –more than two years to maturity– from the calculation of the reserve requirement commercial banks have to hold.

Banking regulation and supervision

In addition to creating a stable macroeconomic environment and quality financial institutions, an adequate regulatory and supervisory framework to guarantee a sound financial system is imperative. Thus, the third key factor for success in creating a stable climate conducive to sustainable growth is effective banking regulation and supervision.

In terms of public policy, the need for adequate prudential supervision arises ultimately from four fundamental policy concerns: (i) safety and soundness of individual banks, (ii) maintaining healthy competition and a level playing field, (iii) consumer protection, and (iv) systemic stability. In other words, prudential supervision should provide reasonable assurances for efficient banking in a healthy competitive environment, protect depositors, and promote the stability of the financial system in the long run. In order to accomplish these goals, the supervisory authority should have a transparent and effective regulatory framework to exercise adequate and comprehensive supervision on a consolidated basis.

The benefits of having a banking supervisory framework, which regulates the entrance, supervision and liquidation of institutions in the banking sector in an efficient and effective manner, is self-evident. To avoid weak banks from entering the financial system, adequate admission and licensing policies must be implemented, based on a sound legal framework. In this regard, in 1990, the Netherlands Antilles adopted the policy that in principle, only international banking institutions belonging to the World Top 1000 –based on total assets– will be admitted to the banking sector. I have to say that this policy has served us well. Despite the trying economic times that we went through during the last six years, our banks have weathered the financial storms with impressive resiliency.

This policy was a qualitative decision to guarantee admission of only quality banks into the financial system. By making this decision, the Netherlands Antilles chose a policy of controlled growth in the banking sector, given the benefits for financial stability in the long run.

In addition to the admission policies and guidelines, stringent licensing requirements to operate a banking institution should be in place to guarantee the safety and soundness of the financial institutions. These requirements should at least cover minimum capitalization in line with international standards, good liquidity ratios, a sound business plan for

the medium and long term, and fit and proper shareholders. Moreover, also management has to be fit and proper and with the necessary professional training and experience supported by an adequate internal audit systems and good corporate governance. Finally, in order to prevent bank failures as much as possible and to resolve failing banks in a timely manner, an effective intervention framework is necessary.

Taking the importance of banking in our society and its role in the process of economic development into account, the implementation of the concept of adequate and comprehensive financial supervision in the Netherlands Antilles has been one of the main focal points for the supervisory authorities and its main stakeholders. A word of caution is at the order. Banks should not be forced to operate in an over-regulated and over-restrained structure. But still the elements needed for the proper transmission of monetary policy through a safe and sound banking system should be maintained.

In addition to appropriate legislation and regulations, adequate supervision also comprises effective off-site surveillance and on-site inspection. It is known and acknowledged that desk supervision without periodic investigation of the books and records of the institutions is ineffective, since misstatements, omissions, overstatement of the value of assets, or understatement of the liabilities will necessarily lead to an overstatement of the institution's solvency position.

Despite the efforts of banking supervisors, international practice has shown over and over again that failing or distressed financial institutions may threaten the stability of the financial system from time to time. Therefore, in addition to adequate preventive measures, an adequate system of curative or problem-resolution measures with respect to troubled financial institutions is imperative in maintaining the stability of the financial system. Also, with the increasing globalization of our economies and financial systems, threats to the financial system may come from a variety sources--both internal and external.

Hence, the legal supervisory framework should provide for adequate mechanisms for liquidation and the restructuring of distressed institutions. While liquidation is an administrative measure not directed at continuity, the liquidation process is a natural response to a failed institution and must be handled well to preserve confidence in the system as a whole. On the other hand, restructuring a failing entity is directed towards its continuation as a financial institution in the financial sector. At an early stage there may still be some value in selling a distressed institution or turning it around into a profitable institution.

Evidently, central banks must have full responsibility for bank regulation and supervision, particularly in Caribbean economies, to realize economies of scale in staff and information technology necessary to exercise their supervisory tasks efficiently and effectively. Banking institutions, sanctioned by a license from the central bank, share in the responsibilities to protect the value of the currency. They indeed become the conduit through which monetary policy is transmitted and their special relations with the central bank, for example through borrowing facilities, are of vital importance for maintaining overall financial stability.

Concluding remarks

Ladies and gentlemen, it must be clear to all of us that central banks play an important role in promoting sustainable growth and development. This role should not be exercised directly, since this tends to conflict with the effective performance of the core central bank functions. Therefore, central banks should focus on creating the necessary conditions in which growth and development can prosper. These conditions are based on the two overriding principles of: (i) protecting the value of the national currency and (ii) the preservation of overall financial stability.

This means that, first, we must pursue sound and appropriately coordinated economic policies to minimize potential sources of instability. Fiscal consolidation is not enough. It is the quality of expenditures that is important. Structural adjustment is no instant cure. Once we have achieved a healthy macroeconomic environment, we should muster permanent discipline. To be able to react quickly and effectively to new opportunities in the world economy, we have to promote private sector activities and open up our markets. This will create an investment climate that both domestic and foreign investors find attractive to invest to bolster growth and development.

Second, we must have a stable and sound financial system. From the discussion above, it is abundantly clear that it is not possible to have a sound financial system with quality financial institutions without adequate and effective supervisory policies, including adequate policies to resolve distressed financial institutions effectively and efficiently. The concerns for safety and soundness of individual banks, maintaining healthy competition and a level playing field, consumer protection, and systemic stability call for a transparent and comprehensive regulatory framework. And in a world that is constantly changing, we must subject our regulatory and surveillance activities to constant reforms to maintain a sound regulatory and supervisory environment.

By pursuing these policies we will make a lasting contribution to growth and development. It is through this channel that we as central bankers can contribute to the enhancement of the general welfare of our community.