The role of the Central Bank

Speech by Dr. E.D. Tromp on the occasion of the opening of the 4th branch of the Antilles Banking Corporation (St. Maarten), February 23, 2000

Ladies and Gentlemen:

It is with a great deal of pleasure that I have accepted the invitation to give the feature address on the occasion of the official opening of the Simpson Bay branch of the Antilles Banking Corporation. I wish to start by congratulating the shareholders, management and the personnel of the ABC bank with the opening of their fourth branch and the confidence they have placed in the Antillean economy in general and the Sint Maarten economy in particular. I hope that the future will prove your decision to be the right one.

Ladies and gentlemen, I am particularly happy with the fact that ABC bank, born out of a local initiative, has been undergoing such a spectacular growth. And based on their performance and prudent management I have every reason to believe that they have a prosperous future ahead of them.

I would like to take this opportunity to share with you some thoughts on the role of the central bank in encouraging and safeguarding savings. This is indeed a crucial matter, since the level of savings largely determines the long-term level of productive investment, which provides the basis for solid and stable growth. Moreover, the level and structure of savings affects, in various ways, the cost and means of financing enterprises, the profitability of the financial sector and the distribution of income between generations. This is particularly important in view of the central issue of financing retirement seen against the background of the ageing of the population.

The primary objective of monetary policy, ladies and gentlemen, is to promote the stability of the value of the guilder—that is, both its internal and external value. This objective is founded on the conviction that price stability makes it possible to ensure the full efficiency of the price mechanism and to avoid both arbitrary redistribution of wealth as a result of inflation as well as the costs and distortions caused by uncertainty and periodical adjustments of nominal value. In the case of the Netherlands Antilles with its open economy, inflation is by and large the result of the inflation rates imported from our major trading partners. Given moderate wage developments, our task becomes that of promoting the stability of the external value of the Netherlands Antillean guilder.

The positive effects of price stability obviously benefit savings. I personally see three aspects to this: an effect on the protection of the value of savings, an effect on their structure and allocation, and finally an effect on the distribution of savings within society. First, by aiming at price stability, monetary policy directly preserves the real value of a large proportion of financial savings. In a situation where inflation rises unexpectedly, a transfer of wealth occurs from creditors to debtors. This interferes with the optimal allocation of savings when the transfer of wealth does not correspond to the provision of a service or a real economic cost, but have all the characteristics of a windfall profit or an exceptional loss. It can result in a reduction in the amount of savings by discouraging agents' propensity to save and by transferring inflationary income from the private to the public sector, which has a lower savings ratio.

Furthermore, the primacy of price stability contributes to improving macroeconomic stability, thus encouraging long-term investment and hence economic growth and employment. The reduction in real interest rate following the reduction in the inflation premium works in the same way. I should like to note here that investment and savings are two sides of the same coin, i.e. the accumulation of physical or financial capital with a view to a future return.

Ladies and gentlemen, this brings me to an issue that has been put on the forefront of the national agenda: namely, the appropriateness of the levels and the relative prices of savings and investments in our economy. Put it differently, do we have the right level of interest rates and are they conducive to economic growth?

The current economic policy of the government is directed at promoting economic growth to broaden the tax base and thereby lowering the cost of fiscal consolidation. One argument that has been advanced by proponents of this strategy is that because of the rigidities in the capital market, interest rates are prohibitively high and as a consequence stalling the much-needed investments to restore economic growth.

In a market economy, ladies and gentlemen, the free interactions of demand for, and supply of financial resources determine the level of and the relative rates of interest. Given no market imperfections and no government interference and assuming free capital mobility, the real level of domestic interest rates should not be significantly different from the world level of real rates of interest.

In order to determine the real level of interest rates one has to correct for inflation including the risk premium. The real rates of interest should then reflect the productivity of capital.

The question that has been raised is why the real level of interest rates in the Netherlands Antilles has been higher than the world level of real interest rates? Is it because capital is more productive here than elsewhere or is it because the basic tenets on which the theory of capital market efficiency is premised do not hold for the Antillean case?

As I mentioned, by correcting the nominal rates of interest for inflation, one gets to the real level of interest rates. Given the low level of inflation in the Netherlands Antilles, the question then becomes if the real rates are appropriate? The fact that the Netherlands Antilles guilder is pegged to the US dollar means that the interest rates of the Netherlands Antilles are in fact tied to the US rates of interest. Thus, when talking about our rates of interest, the most appropriate benchmark to look at is the US rates of interest and those of economies similar to ours. One gets a measurement of appropriateness by comparing our real rates with the benchmark rates.

If we account for the spread between our rates and those of the US, reflecting risk premium and relative market efficiency, we have to conclude that it has been constant. Constancy means that one can draw the conclusion that our relative rates seem to be appropriate. It is the size of the spread however, —being the sum of the risk premium, market efficiency, and other factors— that determines the extent to which the levels of our rates are appropriate.

The level of the risk premium is determined by among others, the inflationary environment in which we operate and the general investment climate.

Inflation in the Netherlands Antilles has been low and as such contributes to a low risk premium. The general investment climate however, has been clouded by the fiscal problems facing our nation. The uncertainty surrounding an early resolution of our fiscal ills has contributed to a high-risk premium. The sum of the two determines the level of the risk premium.

The second factor determining the size of the spread is market efficiency. The efficiency of the market is determined by how well the market functions. Here both the size and depth of the market are determining factors. The market structure and conduct of market participants also have a determining impact on the efficiency of the market. In this regard it is important to take into account the regulatory regime and the supervisory framework that are in place and see the extent to which they are conducive to enhancing the functioning of the market.

Our markets are limited in size by the sheer fact that we are a small country both physically and in terms of population. However the constrain of our size can be removed to the extent that our markets are integrated in the world economy. This implies that capital has to be mobile. In an economy with a pegged exchange rate however, the mobility of capital may temporarily be constrained by balance of payments considerations.

Another tenet of the capital market rigidity argument of proponents of the growth strategy is that the market structure of the banking sector is highly concentrated and hence its performance reflects monopolistic pricing. Ladies and gentlemen, while the concentration ratio in the Netherlands Antilles banking sector is high, our situation is not unique. In analyzing the financial market, one cannot and should not limit the analysis to the banking sector. Due to technological advances and financial innovations, the banking sector is facing competition both domestically from near banking institutions and other financial institutions like pension funds and insurance companies in the extension of mortgages, credit unions and financing companies in the extension of consumer loans and externally from foreign financial institutions.

In addition, if one compares the three months inter bank rates for the Euro and the Swiss franc—markets with concentration ratio of over 70%—one gets a rate of respectively 3.62% and 2.38% as opposed to a three month inter bank rates for US dollar of 6.11% in a market with a concentration ratio of 20%. This serves to illustrate that concentration ratio is not a significant explanatory factor in explaining high rates of interest.

Our regulatory regime and supervisory practices, I can assure you ladies and gentlemen, have been a contributing factor in the well functioning of the marketplace. This is evidenced by the fact that if we observe the rates on government instruments, they have been showing a narrowing margin with US rates on similar instruments since the Bank started acting as the agent of the governments for the issuance of government paper. To enhance the functioning of the market mechanism, the Bank in 1989 introduced the so-called Dutch auction system in the issuance of government paper as opposed to the administered price system, which was then in place. In addition, we encouraged the further development of the secondary market for government paper by standing ready to buy and sell government paper in that market.

While these factors (i.e. risk premium and market efficiency) are, under normal circumstances, the explanatory factors in determining the level of interest rates, we see that they alone do not fully account for the level of rates we are observing in the Netherlands Antillean economy. What to a large extent have been exerting a big influence on the level of interest rates in the Netherlands Antilles are the unsustainably high level of budget deficits—and its consequent crowding out effects. If we analyze the fiscal situation during the last decade, the pattern that emerges is one of overspending and over-borrowing by the governments with a debt-to-GDP ratio of almost 70%. This has led to a situation that the government's share in the financial transactions of the whole economy is over 50%.

This situation is putting upward pressure on the rates of interest and goes a large way in explaining not only the high levels of interest rates but also the widening margin between the Netherlands Antillean rates on government instruments and US ones of similar maturity. If we are to improve the functioning of the capital market in the Netherlands Antilles, we have to rid ourselves of the distortionary effects of the current budgetary policy. Looking ahead however, the lack of progress in presenting a budget that can be financed from domestic non-bank sources indicates that those distortionary effects of the budget deficits will remain with us for some time to come.

Another argument that has been advanced to explain the high level of interest rates is the current stance of monetary policy. Tight monetary policy, ladies and gentlemen, is a natural ingredient of a monetary policy for price stability—a policy that ultimately aims for a stable development of production and employment.

Thus, ladies and gentlemen, in answering the question of the appropriateness of the current level of interest rates in our economy, the simple answer is that it is a reflection of the current state of our economy being burdened by the unsustainably high level of fiscal deficits. Is it conducive to high levels of investments and economic growth and employment? The answer is no. The appropriate course of action therefore is fiscal consolidation. One aimed at a lasting improvement of our public finances. If we are to avoid the mistakes of the past, we have to ensure that the quality of the measures taken is such that the adjustment in the fiscal field will be a durable one.

Getting back to the issue of price stability, it ought to be noted that price stability has major implications for the social distribution of efforts to save. Price stability is especially beneficial for the less well-off sectors of society, which often lack sufficient information to protect their savings in a period of inflation. At a time when we are very preoccupied by adjusting working hours and retirement age, it is essential that everyone should have the opportunity to save, i.e. to set aside part of their future income, in a relatively safe manner.

However, the principle of monetary stability very clearly highlights the issue of the distribution of income between generations. In a situation where the proportion of public spending has reached unsustainably high levels, the role of private savings in the future financing of retirement attains a crucial dimension.

Ladies and gentlemen, aside of the positive effect of price stability on domestic saving, other economic policies should contribute to a favorable climate, through structural measures aimed at increasing flexibility in the labor market and efficiency in the markets for goods, services and capital.

Price stability and a well-functioning financial market are beneficial to the development of savings and their optimal allocation. It would allowed to jeopardize this favorable environment.

Thus, insufficient fiscal consolidation leads to continuous eviction by the government of a significant part of the available private savings. In the same way, excessive taxation and wage increases out of line with growth in productivity, take away the dynamism from investment and consequently also from savings.

Ultimately the health of the financial sector is essential to the protection of savings. With the current regulatory framework, the Bank is well equipped to monitor risk developments in the financial sectors and to take appropriate actions where these developments could potentially affect overall monetary and financial stability.

In these areas, the role of the Central Bank is to always uphold confidence in the currency, to contribute to the well functioning of the financial system and to encourage prudent macroeconomic policies, which influence the will and capacity to save and hence invest.

I thank you for your attention!