

## Threats and Opportunities for the Economy of Curacao in a Period of International Financial Turbulence



***Speech by Dr. E. Tromp on the occasion of the fundraising seminar of Fundashon Stanley Lamp. Willemstad, Curacao, April 4, 2008***

Ladies and gentlemen, good afternoon,

I think you agree with me that to stand still at the impact of the international financial turmoil on our economy is a well-targeted theme for this seminar. I very much appreciate this initiative of the Stanley Lamp Foundation and the generous support provided by our local KPMG office headed by Ralph. I fully endorse the objective of the foundation to promote the education of our youth and, hence, their development and the development of our society as a whole. This is a crucial condition for building up a successful country in the new constitutional structure of the Kingdom. I think the late Stanley can be very proud on Ference and Roan, who have become successful professionals and are a perfect example of the huge return that good education generates, not only for them and the companies they work for, but also for Curacao.

In my address this afternoon, I shall focus on the macroeconomic aspects of the current international financial developments. First, I shall briefly describe the causes of the current international financial instability and discuss some of the consequences on our economy. This will be followed by a brief overview of the recent developments in the economy of Curacao. Together with the opportunities created by the constitutional changes, I shall subsequently indicate some of the reforms that are necessary to create a solid foundation for strong sustainable growth and resilience against future external shocks.

The current international financial turmoil ranks very high on monetary policy makers' agenda around the globe. Virtually every day brings a new surprise in the financial markets. The scale and speed at which financial globalization has developed generated excesses in financial markets that are currently unwinding. The recent events represent an overdue repricing of risk, triggered by significantly higher-than-expected defaults in US subprime mortgages. The ample availability of liquidity in the international financial markets promoted the development of innovative but complex new securities with a distant link to the original loan (the so-called originate and distribute model). The lively trade in these securities and, hence, their high liquidity gave a false sense of reduced risk. Financial institutions worldwide invested large sums in these securities. When American home owners got into problems servicing their mortgages, among other things, caused by weakening economic circumstances related to the sharply rising prices of oil and other raw materials, investors became aware of the associated risks and started to sell these securities. Due to a lack of buyers, prices dropped rapidly, making the securities worthless. Also other structured financial products suffered from the evaporated trust in mortgage-backed securities. Because of the enormous amounts invested in these securities, the write-offs have grown to gigantic proportions, causing major problems for many well-known international financial institutions. As a result, the share prices of these financial institutions fell sharply on securities exchanges worldwide and dragged most other share prices in their fall. Investors have become very nervous and react strongly on economic news resulting in volatile developments in securities prices.

Since the origin of the current international financial instability lies in the United States, this economy is expected to go through a brief recession this year, affecting also countries that rely significantly on exports to the US market. As a result, world economic growth is projected to slow. Particularly a US recession is likely to affect the number of American visitors to our islands. The market share of American visitors in the total number of visitors determines the

impact on the tourism sector on the respective islands. In Curacao, this share is approximately 20%, implying that the impact will be moderate.

What about the financial sector? Our local financial institutions have no or very limited exposure to mortgage-backed securities or other structured financial products, resulting in a negligible direct impact from the crisis around these securities. Of course, they will be affected indirectly by the declining international interest rates and securities prices in the wake of the financial crisis. The international financial and business services sector is likely to be affected to a greater extent, because the companies operating in this sector are very active in the international financial markets and have a larger exposure to innovative financial products. Nevertheless, since these companies operate outside of our economy, the domestic impact will probably be limited to some reduction in the services provided by local companies and professionals.

Due to the peg of our guilder to the US dollar, the sharp reduction in US interest rates we have witnessed in the last few months results also in lower domestic interest rates. This development is enhanced further by the debt relief as part of the constitutional changes. The repayment of a major part of the government debt by the Dutch government will result in an increase of domestic liquidity and lower yields on new debt issues. Lower domestic interest rates will promote higher consumption and investment growth, resulting in a higher growth rate of our economy.

Given this favorable outlook, I like to turn now to the current state of our economy and the likely impact of the current international financial turbulence on our economy. That is to say: looking ahead, how does the consequent drop in the US interest rate affect our economic developments? The economy of Curacao is finally picking up after a marginal annual average growth rate of 0.3% in real terms since the end of the economic recession in 2001. Economic growth increased to 1.4% in 2006 and a further acceleration is expected in 2007. The inflation rate remained stable at 3.0%, which is relatively high as a result of the impact of the rising world oil prices. The stronger growth was translated in an improvement of the labor market. The unemployment rate started to decline from its peak of 18.2% in 2005 to 12.0% in 2007. Youth unemployment declined also during this period from 44.0% to 24.2%. Although this decline is more than welcome, I think the fact that almost a quarter of our youth is unemployed remains unacceptable.

The improved economic performance is primarily private sector led. Particularly private investments grew strongly, but private consumption contributed also significantly to the expansion. The high investment growth was due largely to the construction of new hotels and the expansion of existing hotels. This wave of new investment projects was triggered by the remarkable recovery in the number of tourists since 2006. During the previous three years, the number of stay-over visitors remained stagnant, reflected by an average annual increase of only a half percent. However, 2006 posted a growth of 6% and 2007 even 28%, the highest growth figures in the Netherlands Antilles. Consequently, the occupancy rate rose rapidly and has surpassed now the 90% limit. The rising occupancy rate created confidence with the existing hotels that the time was right to expand their room capacity. In addition, the potential for further strong growth in the number of tourists attracted new investors and the attention of large international hotel chains. Curacao's tourism is still rather underdeveloped compared to many destinations in the region, including Aruba and St. Maarten. So, there is substantial room for further growth. Moreover, cruise tourism is also performing well after its recovery in 2005, although the growth rate is decelerating.

The result of the investments in hotels is that room capacity will be expanded by approximately 1,000 units in 2008. Based on current construction and intended projects in the years ahead, an average 1,000 rooms per year will be added between 2009 and 2111. Applying the common multiplier in the hotel sector that each room creates 2.5 direct and indirect jobs, approximately 10,000 jobs will be created from now until 2011, enough to eradicate unemployment in Curacao. Prominent among these are: (i) the Santa Barbara Plantation master plan which envisions not only the luxury Hyatt Regency Curaçao hotel, but also as a 30-slip marina, beach club, 52 vacation club units, 128 condominium homes, 106 residential lots and 94 terrace homes. Additionally, it will include an 18-hole championship golf course, the first signature golf course on the island, designed by top golf architect Peter Dye; (ii) The Rif master plan which encompasses not only the 243 room 5-star Renaissance Hotel, but also a 50-slip marina, another 5-star hotel, a 3-star hotel, condominiums, a second mega pier and food and retail facilities; and (iii) The Jan Thiel master plan which envisions a 5-star 350 room Westin hotel, condominiums and residential homes. The investments to realize these projects run into billions of guilders, creating the prospect of strong economic growth in the coming years. Realization of these projects may put us on growth path consistent with sustainable double digit growth for some times to come.

Ladies and gentlemen, this encouraging outlook however, is not guaranteed. While the prospect of a permanent resolution of our debt problem in the context of the constitutional changes and the consequent drop in the US interest rate have significantly improved the availability of funds to finance our growth, there are still some dark clouds on the horizon. Our current investment climate has several deficiencies that will seriously hamper the realization of these projects if not addressed adequately.

The policy agenda to enhance the investment climate should focus on those government policies that promote incentives and opportunities for firms to invest productively, create jobs, and expand. This policy agenda should cover a broad terrain including stability, security, regulation, taxation, finance, infrastructure, labor markets, and a speedy and efficient decision making process to approve project by the government apparatus. Since it involves so many issues, investment climate improvements should be an ongoing process of policy adjustment and fine tuning. We have to start now with these policy adjustments if we want to make progress in the improvement of our investment climate and prepare our island effectively on its new constitutional status of a country within the Kingdom.

With this in mind and with so many policy areas influencing investment-driven economic growth, priorities are essential, and we must be careful to ensure that they are combined in a coherent manner. If I have to make a selection, I would single out the following policy areas to address with priority:

- The labor market;
- The capital market;
- The existing red tape and bureaucracy; and
- The tax regime.

In these areas, the effectiveness of measures depends on policy transparency, good governance, broad public support, and economic and political stability. I would like now to share my views with you on the challenges for the government of Curaçao in addressing these four policy areas on the road to the new constitutional status and a bright future.

One of the weaknesses of our investment climate is the still inflexible labor market, because of the rigid rules on hiring and firing, the mandatory benefits, and the high overtime compensation. Despite all the recommendations that have been given by international organizations to reform the labor market regulations, little progress has been made. Indeed, measures have been taken to flexibilize the labor market, but some of them have been reversed, though approval procedures became more even-handed and decision times were shortened. To enhance our competitiveness and potential growth, it is essential to be able to use labor more flexibly, provided that individual protection against abuse is preserved.

Despite a decline in our unemployment rate, it remains high in double-digit figures, especially among our youth. The main reason for Curaçao's structural unemployment is not so much the absence of jobs, certainly not in view of the demand for labor in the booming tourism sector, but a qualitative mismatch between supply and demand. Despite our high literacy rate and the availability of institutions providing higher education and language training, many investors find that the availability of well-trained workers is limited.

Our investment climate will, therefore, benefit greatly from public investment in education and training to reduce the qualitative mismatch between labor demand and supply—an area championed by the late Stanley Lamp. Being important determinants of our long-term growth potential, we should therefore have an economic policy that focuses on enhancing investments in physical as well as human capital. Investment in our human capital, for example through improving education and training, will enhance the way that investments in physical capital are put to use. The investments in human capital must be targeted towards our youth as well as the unemployed population. This is especially important in view of the thousands of jobs to be filled in our tourism sector in the coming years. You will agree with me that economic progress should in the first place benefit our own people. We should attract labor from abroad only if positions cannot be filled on the local labor market.

In addition, our education and training system should not only focus on the labor force in those sectors where our economy has a competitive advantage. It should also focus on creating a skilled labor force that can attract knowledge-based industries and services companies, particularly in high value-creating activities, to promote diversification of our economy. Such diversification is essential to reduce our vulnerability to external shocks. The resulting increase in productivity will have a more permanent impact on our long-term growth prospects. Thus, for Curaçao to become more attractive for investors, we must take some major actions to improve the quality of our labor force and the functioning of the labor market.

Ladies and gentlemen, another major bottleneck for investments in our country is the lack of long-term financing, the implicit high interest rates, and the absence of vehicles to provide equity capital to the various projects that are being undertaken. The high cost of capital leads to the postponement or even cancellation of business investment decisions. The issuance of private debt securities, equity, and the establishment of a venture capital fund for promising new businesses can be considered solutions to overcome these bottlenecks. Hence, the further development of our capital market will make the transmission of financial resources to investors more efficient and less costly. As a result, local investors will not have to rely solely on bank financing, which is more expensive

because of the intermediation costs involved. This is an area where I think much progress can be made in light of the forthcoming constitutional changes and the opportunities arising out of the current turbulence in the international financial markets.

A welcome development in our domestic capital market is the prospect for a further decline in interest rates, contributing to lower financing costs. Interest rates showed already a gradual declining trend caused mainly by increased competition among domestic financial institutions and from abroad. This trend is expected to be enhanced by the debt relief agreed with the Dutch government coupled with the decline in US interest rates as a consequence of the economic downturn. The redemption of a considerable part of the government debt will substantially increase the availability of funds for the private sector at more attractive terms. In addition, yields on new government bond issues will decline due to a lower risk premium associated with a reduced debt and more competition among investors for these bonds. The substantial oversubscription on the latest bond issue by the central government at prices above nominal value serves as an example.

Another weakness of our investment climate is the current administrative barriers, the long and unacceptable delays in administrative decisions by government departments and excessive discretion in administrative functions. In particular, the requirements for start-ups, procedures for obtaining permits for non-nationals, and migration regulations are seen as a major source of frustration by the business community. Ladies and gentlemen, establishing a business and getting a basic business license are automatic in most countries and are usually accomplished in a matter of days or even hours. On our island, however, these processes are discretionary and can take months or in some cases even more than a year. The long delays in obtaining permits are equivalent to a substantial loss of opportunities to capture investments. In other words, the existing red tape and bureaucracy weaken our competitiveness relative to other economies in the region. If we are to benefit from the current favorable environment with respect to the tourism sector and move to a path of higher growth, it is essential that progress be made in this area.

One of the main changes accompanying the new constitutional status of Curaçao is the elimination of the double layer of government. This will reduce the administrative barriers in the government apparatus considerably, facilitating the decision-making process of policies and projects. In this respect, it is important that the government streamlines its administrative procedures, aimed at eliminating all unnecessary bureaucracy and simplifying the procedures for obtaining business and work permits and business visas. In addition, the creation of the mentioned one-window agency to serve potential investors as well as to provide aftercare services to existing investors is long overdue. Moreover, when we start with our new constitutional status, we must be cautious not to implement any new measures that might have an adverse impact on our investment climate. What we should do is to embrace the possibilities that the new status offers us by making our administrative system more transparent and efficient.

Ladies and gentlemen, another policy area that needs our attention is the tax system, which plays also a key role in shaping the investment climate. On the one hand, the government needs revenues to fund the public services – including those that improve the investment climate – and to accomplish its social goals. On the other hand, taxes represent a cost to firms, which reduce their incentives to invest and create jobs. All societies, including our own, struggle to find a balance between efficiency, equity, and sustainability of the tax system. To realize such a balance, it is crucial that policy makers maintain an effective policy dialogue with the business community.

A number of studies on the Curaçao economy conducted by international organizations in recent years concluded that there is a need for fiscal reform. With the new status approaching, Curaçao will have the opportunity to include all the necessary reforms in a new tax system, contributing to the improvement of the investment climate.

In my view, the new tax system of Curacao should be simple and transparent. Direct tax rates should be competitive compared to other countries, especially in our region, to encourage consumer spending and investment by raising disposable income. This will lead to more economic activities, broadening the base of the sales tax. In addition, a more effective and efficient assessment and collection system should also be an important component of the new tax system, since it can ensure budget neutrality in the face of the reduction in direct tax rates.

Ladies and gentlemen, we are part of a globalized world and the current international financial instability will also affect our economy, although I estimate the direct overall impact to be rather limited. In fact, our economic performance is improving and the prospects are encouraging, especially in tourism. To meet current and potential investors' expectations, we should speed up the implementation of structural reforms to create an attractive investment climate. Together with the changes taking place to prepare the island for its new constitutional status, providing an excellent opportunity to correct the economic and social imbalances in our society with substantial financial and technical Dutch support, we will be able to create a solid foundation for strong sustainable growth in the years ahead of us. With the right decisions, hard work, and broad consensus among all stakeholders, I am convinced that we will realize a better future for all of us in the new country of Curacao.

Thank you for your attention.