

# Towards a Country Status for Curacao: Financial and Social-Economic Implications



*Speech by Dr. E. Tromp, President of the Bank van de Nederlandse Antillen on the occasion of VBC's 2008 L.B. Smith Lecture. May 30, 2008, Willemstad, Curacao*

Ladies and gentlemen, good afternoon,

It is with a great deal of pleasure that I accepted the invitation of the Curacao Business Association to deliver the 2008 L.B. Smith lecture. I was asked to share my views with you on the financial and social-economic implications of the constitutional changes for the future country of Curacao. This topic is very timely because we all are confronted daily with news about the progress, drawbacks, complications, and differences of opinion related to this change of historical proportions we are preparing for that will shape our future prosperity and welfare.

An overwhelming amount of work has to be done to get our island ready for its future status as a country. Along the way, we are confronted with numerous threats and challenges that we must address to keep the process going. Despite the many differences that exist between our politicians, employer and employee associations, and other groups in our society, we share the common goal of Curacao as an autonomous country in the Kingdom of the Netherlands. If we all focus on this common goal that binds us, we will be able to overcome our differences and reach the desired country status within a reasonable period of time. Although target dates are important to keep the processes of change going, I strongly believe that having all the essential legislation and institutions in place, sound public finances, and approval and funding for programs for structural reform and poverty relief are indispensable for Curacao to successfully assume its country status.

Ladies and gentlemen, I have structured my address around three broad areas: (1) public finances; (2) structural reform and poverty alleviation; and (3) monetary and financial sector supervision. However, before I go into more detail on these areas with respect to the constitutional changes, I would first like to discuss with you the current state of Curacao's economy and the challenges emitting from the international environment we are part of.

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 to approximately 3.5% is estimated for 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 into an improvement in the labor market. The unemployment rate declined from its peak of 18.2% in 2005 to 12.0% in 2007. Youth unemployment also declined during this period from 44.0% to 24.2%. Although this decline is more than welcome, more progress is needed if we are to make durable inroads in our quest to eradicate poverty.

The improved economic performance has been led primarily by the private sector. In particular, private investments grew strongly, but private consumption also contributed significantly to the expansion. The high investment growth was due largely to the construction of new hotels and the expansion of existing ones. 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 28%, the highest growth figures in the Netherlands Antilles. Consequently, the occupancy rate rose rapidly and has now surpassed the 90% limit. The rising occupancy rate created confidence among 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. Moreover, cruise tourism is also performing well after its recovery in 2005, although the growth rate is decelerating.

Most other sectors also performed well. The airport handled 19% more passengers in 2007 than in 2006, owing to the strong growth in tourism. The harbor recorded an 8% growth in freight handled and 5% more ship calls. Moreover, the oil industry noted increases in refining, storage, and transshipment. In contrast, activities in ship repair and international financial & business services declined, the latter perhaps partly the result of the international financial turbulence.

The great volatility in international financial markets originating from the crisis in the US sub-prime mortgage market since mid-2007 and the continuing increases in the prices of oil, other raw materials, and food cast dark clouds over the world economic climate. Due to our small and open economy, Curacao relies heavily on international trade, which is affected in various ways by these international developments. Import prices are rising rapidly, resulting in a higher inflation rate. We estimate an acceleration in the inflation rate to 3.5% in 2008, due primarily to higher food costs and domestic gasoline and utility prices. In light of the stringent budget rules concerning eligibility for the debt relief, the government cannot absorb the rising oil prices anymore and has started a gradual increase of the gasoline and utility prices. Consequently, private demand is expected to be tempered, slowing economic growth.

The weaker groups in our society, such as persons relying on government support (“onderstand”) or a state pension (AOV), will suffer most from the price increases because they have no means to absorb them. Therefore, I support the efforts made by the government to compensate these groups for the impact of the rising prices. However, the compensating measures must not jeopardize the budget target or cause a disproportionate burden for other groups in our society.

It is expected that the US economy will go through a brief recession in 2008, which is likely to affect the number of American visitors to our island. However, with a 20% share in total visitors and the favorable outlook for European visitors related to the strong euro, the overall impact should be moderate. Finally, the foreign investments of our local financial institutions will be affected by the declining international interest rates and securities prices in the wake of the financial crisis.

Ladies and gentlemen, the fundamental changes in relative prices of commodities (the so-called silent tsunami) and their consequent impact on our cost of living, the volatility and turmoil in the international financial markets which greatly impacted capital flows and hence investment projects and the recession in the United States are all tantamount to an increase in taxation on our economy. This will impact our economic growth negatively and will bring its pressure to bear on our standards of living if no timely and appropriate policy measures are put in place. I therefore call for the institution of a blue ribbon committee on the national level if not on the Kingdom level to address these trying issues. The primary objective of this committee must be to devise ways and means to address the fundamental changes that are taking place in the world economy to mitigate their deleterious effect on our economies. Prominent among their recommendations should be policies to decrease our dependence on imported energy by looking for alternative energy sources consistent with a sustainable economic development.

Ladies and gentlemen, in addition to the threats emanating from the current international developments, preparing Curacao for its new constitutional status will dominate our policy agenda in 2008 and the years ahead. The constitutional change brings many uncertainties, but it also creates unique opportunities to correct the many financial-economic and social imbalances on our island with the support of the Dutch government. The main objective is to prepare the island adequately for its status as a country with a sound financial position and a solid social-economic foundation, crucial conditions for a sustainable growth of our economy.

The sound financial position has everything to do with Curacao’s public finances. The accumulation of annual budget deficits resulted in an unsustainable debt level of NAf.2.5 billion in 2005, the year earmarked for the application of the debt relief, and it grew further to NAf.2.9 billion at the end of 2007. These debt levels correspond to 59% and 63% of GDP, respectively. The annual interest payments on the debt have reached NAf.150 million, absorbing 20% of tax revenues and 15% of expenditures. Given the initial 2008 deficit of NAf.170 million, it can be concluded that without this high interest burden, Curacao’s budget would have been nearly in balance. In addition, high interest expenses crowd out funds needed for important policy areas, such as crime control, education, health care, infrastructure, and poverty alleviation. Moreover, a high debt burden substantially constrains our capacity to raise funds and hence our ability to grow. These results have significantly eroded the policy autonomy of our decision makers.

To reduce the high level of debt to a sustainable level requires a long and painful adjustment process. Given the current erosion in public infrastructure and services due to a lack of funds and the prevailing poverty in Curacao, I do not think this is a viable approach. The only realistic solution for the debt problem is a swift and significant reduction of the debt burden. This solution is included in the agreement between the central government, the governments of Curacao and St. Maarten, and the Dutch government of November 2, 2006, better known as the “Slotverklaring.”

In the "Slotverklaring", the Dutch government agreed to take over the debt of the entities up to the level corresponding with an interest burden rule. In the case of Curacao, this rule prescribes that the interest expenses in the budget may not exceed 5% of the average revenues of the preceding three years. Since the experts are still busy calculating the exact amount and composition of the debt to be assumed, the final outcome is not yet known. However, based on some broad assumptions, let me try to shed some lights on these figures. The average revenues of Curacao as a country are estimated at approximately NAf.1.6 billion per year, resulting in maximum allowed interest expenses of NAf.80 million per year. Assuming an average interest rate of 7.5% on the debt results in a maximum allowed debt level of approximately NAf.1.1 billion, corresponding with a debt-to-GDP ratio of 25%. Compared with the actual debt of NAf.2.5 billion at the end of 2005, the Dutch government would take over 56% of Curacao's debt. I did not include Curacao's share in the unallocated central government debt in my calculation. Because Curacao's own debt already exceeds the level corresponding with the interest burden rule by a substantial amount, its share in the central government debt will be taken over by the Dutch anyway.

The debt relief and authority to borrow are bound by four strict conditions and control that will substantially enhance fiscal discipline and transparency. First, the current account of the budget may not have a deficit and must be presented in a multi-annual framework. Second, interest expenses may not exceed the 5% rule. Third, the recommendations of the Financial Position Working Group on improvement of financial management and control must be implemented as planned. Fourth, the entire budgetary process from preparation of the draft budget to the accountability of its implementation is subject to supervision by an autonomous supervisory authority. I fully support this rules-based supervisory framework because it will guarantee lasting sound public finances. However, this framework is quite a change from the current rather loose implementation of the budgetary rules. So, especially in the beginning, this new approach is bound to create frequent tensions with the supervisory authority; the recent experiences of Bonaire, Saba, and St. Eustatius serve as an example here.

Ladies and gentlemen, I would like to share my thoughts with you on a number of issues regarding the debt relief. First, when will the debt relief start for Curacao? After the Island Council finally ratified the "Slotverklaring" at the end of August 2007, expectations were high that the debt relief would go into effect in 2008. The island government even amended its budget to take into account the interest savings. Together with a set of measures, it would be possible to present a balanced budget for 2008. However, the preparations for the constitutional changes, including the debt relief, are taking much longer than initially anticipated. Recent information suggests that the "Algemene Maatregel van Rijksbestuur" regulating the supervision of Curacao's budgetary process will be approved by the end of this year, meaning that the debt relief will not become effective until 2009. In a worst case scenario, Curacao will end up with a deficit of NAf.170 million in 2008 instead of a balanced budget, contributing to a further increase in the debt.

This brings me to a second issue: what do we do with the debt accumulated after the end of 2005? If the debt relief starts in 2009, the deficits accumulated after 2005 will have added approximately NAf.550 million to Curacao's outstanding debt. This means that the maximum allowed debt will be exceeded by 50%. Clearly, if this amount is left out, we will not attain a sound financial starting position, the main objective of the debt relief. This issue must be resolved for successful debt relief.

The final issue I'd like to mention concerning the debt relief is its impact on our capital market. The entire debt relief for all entities will result in NAf.3.5 billion flowing into the economy in the next 10-15 years from the settlement of payment arrears and the repayment of loans. Although part of this amount will end up abroad, a substantial amount will remain in our economy, increasing the availability of funds for the private sector and thereby contributing to a further decline in domestic interest rates. Borrowing at lower rates of interest will promote higher domestic consumption and investment leading to higher economic growth. On the other hand, our financial institutions have to deal with lower interest income, which should be compensated for by increasing efficiency and tapping other sources of revenue. Our institutional investors are a special case because they are subject to restrictions on investing abroad. They hold about 75% of the local government bonds, which will largely be redeemed. Since there are insufficient local investment alternatives at a comparable risk/return rate, the Bank has announced a special provision allowing these funds to be invested abroad.

In addition to the debt issue, another major issue regarding the public finances is the government apparatus. Curacao is becoming a country, which implies new tasks and responsibilities. This change of status provides a unique opportunity to design a new effective and efficient government structure. To do so requires several things. First, the government tasks must be defined, including the tasks being taken over from the central government. I understand that this exercise is almost completed with the assistance of consultancy company KPMG. Second, legislation on which to base the implementation of the government tasks must be prepared and approved. I believe current legislation generally will be adequate, complemented by the necessary amendments. Third, the government apparatus must be adequately staffed in accordance with the requirements listed in the job description of each position. The positions can be filled from the current pool of civil servants of the island as well as from the central government; if necessary, additional training can be provided. Positions that remain open should be advertised and

filled with external candidates. Current civil servants who do not meet the job requirements and cannot be properly retrained should seek employment in the private sector. I think it is inevitable that setting up a new government apparatus from two existing entities will result in involuntary layoffs. Otherwise, the perceived benefits from the elimination of the present dual layer of government can never be realized. We have to focus on two major objectives in this exercise: (1) an efficient and effective government apparatus for the country of Curacao, and (2) adequate compensation, counseling, and training for the civil servants who become redundant to create opportunities for them to secure a job in the private sector. Finally, the principles of good governance should be embedded in the new government apparatus to guarantee effective and responsible spending of our tax money, efficient high quality services to the public, and effective sanctions for misconduct and abuse.

Ladies and gentlemen, to sustain the current economic recovery and to make our economy more resilient to external shocks, we must implement our structural reform agenda with much more vigor than has been the case so far. I have discussed this issue on many previous occasions, but given the lack of progress, allow me to repeat the necessary reforms briefly.

Let's start with the labor market. Reform in this area concerns two major aspects: (1) flexibilization of rules and regulations, and (2) reduction of the qualitative mismatch between demand and supply. Despite some improvements, rules on hiring and firing are still considered too rigid, while mandatory benefits and overtime compensation are high. Bolder steps towards more flexibility are needed to improve our competitiveness and create new jobs more easily, provided that individual protection against abuse is preserved. To reduce the qualitative mismatch between labor demand and supply education is the key. Our institutions that provide education should take into account to a much greater degree the skill needs in the private sector. Closer cooperation between the public and private sectors can help accomplish this goal. Although education is primarily a government task, the private sector should not hesitate to take its own initiatives. Companies could support education and training in their specific industry financially and/or provide internships and training. I heartily welcome the initiative of the Curacao Hospitality and Tourism Association to start a Hotel Academy, which will deliver properly trained staff for the many jobs that are being created in the booming tourism sector.

A second area for reform is the further development of our capital market, promoting more financing opportunities for entrepreneurs and more local investment opportunities for investors. The latter has become even more relevant as a result of the declining significance of government bonds as an investment instrument in light of the debt relief. The development of private debt instruments and equity-based financing should especially be promoted. These types of financing are still rarely used on our island, but they are significantly cheaper than bank financing. Specifically for start-ups, the establishment of a venture capital fund could be crucial to raise the necessary financing for a promising investment project. The development of these instruments also can stimulate the development of a securities exchange. In summary, a well-functioning capital market will promote the realization of promising investment opportunities leading to faster growth in productivity and output.

The reduction of administrative barriers for doing business is the third area of reform I would like to mention. One of the most common complaints from the business sector is the number and complexity of government formalities and paperwork that frustrate new investment initiatives and, hence, the opportunity for stronger economic growth. The elimination of the double layer of government on the island is certainly a step in the right direction. However, it should be complemented by streamlining 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 a one-window agency to serve potential investors as well as to provide aftercare services to existing investors is long overdue. Moreover, when we begin our new constitutional status, we must be cautious not to implement any new measures that might adversely impact our investment climate. What we should do is to embrace the possibilities offered by the new status by making our administrative system more transparent and efficient.

A final area of reform that must not be neglected is tax reform. With the new status approaching, Curacao 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. The result 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. In this regard, I welcome the initiative of the Minister of Finance to put in place a mechanism to ensure the swift implementation of the recommendations made by the Ellis committee.

Ladies and gentlemen, the higher economic growth that can be attained by implementing these reforms will ultimately also result in poverty reduction, but I do not think that the poor can wait any longer. Therefore, the reforms must be accompanied by targeted social programs for the poor that alleviate their immediate needs. The funds that become

available with the recently signed Social Economic Initiative, which contains programs targeted at economic as well as social progress, will greatly facilitate the implementation of the necessary reforms and support for the poor.

The third area I would like to discuss with respect to the constitutional changes, and one which is particularly close to my heart as a central banker, is the future of our monetary system and financial sector supervision in the new constitutional arrangement. The "Slotverklaring" explicitly states that there will be one central bank for Curacao and St. Maarten responsible for monetary, financial, and integrity supervision based on one set of laws. Rationally considered, I fully subscribe to this statement. It means that the current central bank will be broadly maintained, continuing its good reputation and credibility in safeguarding the stability of the monetary and financial system. I believe this is very important in light of the uncertainties surrounding the numerous changes that will take place on the road toward the new constitutional status of the islands. In addition, with a common central bank, economies of scale can be maintained with regard to the high costs of highly educated staff and modern information and communication infrastructure. Moreover, a common central bank will provide a larger common economic area with broader economic diversification, which may dampen the impact of a shock occurring on one of the islands.

If Curacao and St. Maarten as autonomous countries share a common central bank and currency, they form a monetary union. Since autonomous countries have their own policy responsibilities, a monetary union requires a high degree of policy coordination and harmony to ensure a balanced and effective monetary policy. In addition, a well functioning monetary union requires free movement of goods, services, capital, and labor between the countries. These requirements may be difficult to reconcile with the desire for more autonomy by Curacao and St. Maarten since this desire was the main driving force behind opting for country status. Ladies and gentlemen, autonomy dies from suicide and not murder. We must begin, however, with the understanding that strong political commitment is required to give up some of the newly won policy autonomy in the interest of a stable and effective monetary union. In addition, the central bank's independence should not be subject to discussion. The Bank should be managed by persons with a high degree of professional standing and integrity, irrespective of nationality or place of birth. With regard to the supervisory board of directors, the governments of the two countries could be allowed to nominate candidates according to a predetermined number for each country and provided that certain professional and integrity standards are met. If we fail to comprehend this, we will not be able to create a stable monetary environment conducive to growth and stability. A deviation from those basic tenets for a common central bank will render this objective meaningless. We will need to work well together because we have a great challenge before us. It is our own incredible success that we face.

As mentioned, like an inheritance the new found opportunities can be exploited successfully or be squandered. Though not far from inconceivable, if our politicians cannot come to an agreement on a common central bank, what will be the next best alternative? Curacao will likely continue the current central bank with the existing monetary and supervisory infrastructure. Keep in mind that Curacao comprises 70% of the Antillean economy, while most financial institutions have their local headquarters on the island. However, Curacao's central bank will start with a lower revenue base as a result of the division of the foreign exchange reserves with St. Maarten and the omission of income from the issuance of banknotes and currency transactions with banks in St. Maarten. The decline in revenues should be compensated by increases in other sources of revenues and cost reductions.

Ladies and gentlemen, we have opened an important new chapter in Curacao's history that will result in an autonomous country within the Kingdom of the Netherlands. This chapter is being written by many authors and consists of many sub-plots. Together we are all responsible for preserving the main storyline and finishing the chapter in time. It is my earnest hope that when we achieve our country status we do not lose our people. Let's demonstrate that we are ready to carry out this responsibility and work tirelessly toward a strong and prosperous country.

Thank you for your attention!