INTERNATIONAL MONETARY FUND

Kingdom of the Netherlands—Curacao and Sint Maarten
2011 Article IV Consultation Discussions: Preliminary Conclusions

September 19, 2011

The two newly-autonomous countries face substantial challenges, requiring sustained efforts over the near and medium term. Economic growth has been low, unemployment remains high, and population aging pressures are becoming significant. The current account deficit has widened to worrisome levels, primarily reflecting low competitiveness, rapid credit growth, and inadequate pass-through of increases in international food and oil prices to consumer prices. Strong measures will be needed to facilitate external adjustment. Credit growth should be reduced to help cool domestic demand pressures. Strong fiscal efforts are required to address pressures related to aging and institutional build-up, and to support external adjustment. Deep structural reforms are also needed to increase wage and price flexibility and competitiveness, and to improve the business environment.

Background

1. **Following the dissolution of the Netherlands Antilles on October 10, 2010 Curacao and Sint Maarten became autonomous countries within the Kingdom of the Netherlands, with a currency union**. Alongside, the Dutch government gave substantial debt relief to both countries, although the finalization of the discussions on the payment of arrears for Sint Maarten remains to be completed. Agreement was reached on new fiscal frameworks as well. Average living standards are relatively high in comparison with the region. The banking sector also appears sound, and weathered the global crisis relatively well.

2. **The two countries share some similarities, but there are distinct differences as well**. Both are small highly-open island economies, but Curacao's economy is more than three times larger than that of Sint Maarten, and more diversified. Tourism exports are much more important for Sint Maarten than for Curacao, accounting for around 82 percent of GDP and 13 percent of GDP, respectively. Curacao has other important sectors including the oil refinery, the free zone, and international financial services (IFS). Sint Maarten has enjoyed considerable success in increasing cruise tourism arrivals, boosting its average GDP growth significantly above that of Curacao over the past decade. Nevertheless, growth rates in both countries have been low, and unemployment rates are high, particularly among the youth. Population aging is a challenge in both countries, particularly for Curacao, and is generating significant fiscal spending pressures. Sint Maarten also needs to upgrade and establish the institutions to provide a range of services previously being the responsibility of the Netherlands Antilles government.

3. **Macroeconomic challenges are substantial**. In addition to low growth, high unemployment, and aging pressures, the current account deficit for the currency union has widened rapidly in recent years to 25½ percent of GDP in 2010, well above historical levels (which averaged 3½ percent of GDP over 2000–06), and calls for dollarization (adopting the US dollar as legal tender) or dismantling the currency union have been rising in official circles.

- Even after eliminating identifiable temporary factors, such as increases in FDI inflows and the breakdown of Curacao's oil refinery, the mission estimates that the underlying current account deficit remains large at over 15 percent of GDP.

- Pronounced weaknesses in export performance (with both countries losing export market share in recent years), demand pressures primarily from rapid bank credit growth, and inadequate pass-through of recent increases in international oil and food prices particularly in 2010, appear to be the main drivers of the external deficit. The pass-through mechanism has however improved since June 2011.

- A complete separation of the current account deficit between the two countries is not possible because of data gaps, but the available data indicates that the widening is primarily due to Curacao.

While international reserves have risen in recent years, vulnerabilities are substantial, and strong efforts are needed to reduce the current account deficit to sustainable levels by restraining demand—including tighter monetary policy by the central bank and tighter fiscal policy—and overhauling the regulatory framework to enhance wage and price flexibility and improve the business environment.

4. **In several areas comprehensive policy responses are at an advanced stage of preparation and prompt implementation will be key**. In Curacao, new tax legislation has been passed, and measures to overhaul health sector legislation, raise the retirement age, set up an e-government system to speed up the granting of business licenses and permits, set up a competition authority, strengthen competition rules and liberalize administered prices are at an advanced stage. Sint Maarten has upgraded its tourism development strategy, is overhauling its health sector to contain costs, is in the process of reviewing its social system, and intends to improve the business license and permit framework, and to increase the retirement age.

5. **Increased dialogue between social partners is needed to foster a consensus on reforms and boost private sector confidence.** Business sentiment appears to be declining in both countries, amid rising concern about the economic outlook and uncertainty about future public policies. Private sector representatives in both countries called for a structured dialogue on reforms, involving government, business, and unions, to provide a broad social consensus, clarity, and confidence building on the reforms needed. Both governments intend

to further strengthen the dialogue through the social economic councils entrenched in their constitutions.

Recent developments

6. **Following economic contractions in 2009, in the wake of the global crisis, activity was anemic in 2010**. The mission estimates that in 2009 GDP contracted by 1¼ percent in Curacao and 2 percent in Sint Maarten, as global turmoil led to significant declines in exports and domestic demand. In 2010, we estimate GDP growth of about ½ percent and zero in Curacao and Sint Maarten, respectively. Exports in Curacao declined further due to a sharp decline in oil refinery output and continued contraction in tourism. As a result the contribution of net exports to GDP turned negative, largely offsetting the impact of strengthening private consumption. In Sint Maarten, a rebound in cruise tourism was largely offset by continued decreases in stayover arrivals, while domestic demand and imports remained subdued. With lower growth, the progress in reducing unemployment rates in both countries stalled. In Curacao, the unemployment rate stayed around 10 percent over 2009–10, after steady declines since 2007, while, in Sint Maarten, the unemployment rate stayed around 12 percent after steadily declining since 2003. Inflation declined sharply during the crisis, but has since increased with renewed oil and food price pressures. Credit continued to outpace nominal GDP growth in 2010, and since 2004 the credit/GDP ratio has risen by about 20 percentage points. Banks are profitable and capital and liquidity buffers appear robust, though the Non Performing Loan (NPL) ratio has been rising.

7. **Excluding the impact of debt relief, both island governments run modest fiscal deficits over 2009–10**. Excluding debt-relief grants, Curacao had fiscal deficits of ¾ percent of GDP in both 2009 and 2010. Fiscal expenditure data for 2009–10 for Sint Maarten are still unavailable, but the mission's estimates indicate fiscal deficits of about one percent of GDP in both 2009 and 2010, excluding the impact of debt relief. As of end-2010 public debt stood at 34½ percent of GDP and 28¼ percent of GDP in Curacao and Sint Maarten, respectively.

Outlook and risks

8. **Low growth is expected to persist over 2011–12**. In Curacao, available indicators indicate that domestic demand is decelerating in 2011, likely reflecting declining consumer confidence and a tighter fiscal stance. However, exports appear to be growing modestly, led by tourism—with increased hotel capacity and new flight connections—and renewed activity in the oil refinery. In Sint Maarten, continued declines in stayover tourism have offset the strong rebound in cruise tourism. In this context, we expect GDP to be broadly flat in both countries in 2011, and to grow by ¾ percent and ½ percent in Curacao and Sint Maarten, respectively, in 2012. Alongside, unemployment rates are expected to stay elevated. Inflation is expected to stabilize around 2¾ –3½ percent in both countries. The current account deficit is expected to improve somewhat, but remain substantial.

9. **But some pickup is anticipated over the medium and long term if needed reforms are promptly implemented.** With the current regulatory framework and policy uncertainties exerting a significant drag on activity, growth potential will be heavily influenced by the pace of implementation of reforms to improve competitiveness and wage and price flexibility. Overall, the mission projects growth rising to about 2 percent in both countries by 2016, still on the low side. Low exposure to the faster growing Asian and Latin American countries will limit upside potential in both countries. And aging will weigh on potential growth over the medium and long run. Space constraints may also limit the long term scope for increasing tourism, which would particularly affect Sint Maarten.

10. **Uncertainties to the outlook are substantial but tilted downward**. Growth rates are highly correlated with major trading partners (particularly the U.S. and European countries), which themselves are confronted with major downside risks to activity from fragilities in sovereign debt markets, and the possibility that the contractionary impact of simultaneous fiscal tightening in several advanced countries could exceed current estimates. If those risks materialize, spillover effects on Curacao and Sint Maarten could be substantial. Domestic risks are largely related to the large current account deficit and constrained policy options for responding to shocks. Shocks to external financing flows could potentially generate a sharp adjustment in domestic demand and growth.With monetary policy constrained by the peg, fiscal policy constrained by the new framework, and significant structural rigidities, any adverse shocks could have a more pronounced and prolonged impact on the outlook than currently envisaged. Upside risks, on the other hand, originate primarily from unexpectedly strong emerging market growth spurts which raise global growth, and the possibility of attracting large investment projects into both countries.

Policies

11. **Against this background, Curacao and Sint Maarten must seize the moment and implement policies to mitigate external vulnerabilities, entrench fiscal soundness, and advance structural reforms to enhance competitiveness and growth**. A reduction of about 10 percentage points of GDP is needed to bring the underlying current account deficit to historically sustainable levels over the medium term. This could be facilitated by measures to restrain credit growth, supported by fiscal consolidation. In addition, structural reforms to generate wage and price flexibility and improve the business environment will be needed to realize durable gains in competitiveness. Moreover, clarity is needed on dollarization and the future of the currency union to provide investors with a stable business environment and to avoid undermining confidence in the economy and the guilder.

Monetary and financial sector

12. **In principle, the existing exchange rate peg remains appropriate, though dollarization could also be adopted under the right conditions**. In common with the majority of small island economies, the Netherlands Antilles, and now Curacao and Sint

Maarten, have adopted fixed exchange rate regimes because floating typically generates excessive volatility of nominal and real exchange rates due to small markets. Either the current peg or dollarization would continue this tradition. However, dollarization, while removing the threat of currency crisis, would also permanently remove exchange rate adjustment from the policy toolkit, leaving wage and price flexibility as the primary means to recover competitiveness.

13. **We recommend that any plans for dollarization should wait until the competitiveness and the flexibility of both economies have been substantially enhanced**. Notwithstanding concerns about the current account deficit, there have been no indications of pressures against the guilder. Also, membership in the Kingdom of the Netherlands provides an implicit guarantee against a disorderly exit from the peg. Thus there is no particular urgency to dollarize. Moreover, dollarization would also constrain the lender of last resort function of the CBCS. Given current weaknesses in competitiveness, dollarizing without first enhancing wage and price flexibility risks locking-in protracted low growth, with adverse effects on fiscal sustainability and employment. We also see little economic rationale currently for dissolving the currency union, as it could dampen the efficiency of the banking sector and raise supervisory costs. There is also a risk that continued efforts in this direction may undermine confidence and the investment climate in both countries.

14. **Ensuring that credit grows slower than nominal GDP will help curb the current account deficit**. Relaxing limits on foreign investment by domestic nonbank financial institutions would help contain credit growth and domestic demand. Under current rules, domestic nonbank financial institutions can invest no more than 40–60 percent of their assets abroad without penalty. This has forced pension funds and insurers to invest large portions of their portfolios in bank deposits. Recent global turmoil has also caused them to invest more in local instruments. In turn, ample deposits have stimulated rapid credit growth, boosting domestic demand and contributing to the current account deficit. Incentives for lending to the private sector have intensified with debt relief and the new fiscal rules, which have substantially reduced the scope for banks to invest in public debt. The mission therefore welcomes the CBCS's plans to gradually relax the limits. The recent increase in reserve requirements is also a step in the right direction, and we recommend further measures by the central bank to help reduce credit growth, including higher reserve requirements and risk weights or tougher provisioning rules.

15. **The mission also urges the authorities to press ahead with plans to enhance crisis resolution arrangements**. The authorities are moving towards setting up a funded deposit guarantee scheme, which is welcome, but progress has been stalled by the discussions on dissolving the currency union. We urge that efforts in this area be redoubled, and also recommend that to enhance its effectiveness as a crisis resolution tool it should be preferably authorized to fund bank resolution operations (including by financing the transfer of deposit books and "purchase and assumption" transactions) if they reduce costs, and enjoy depositor preference. We are also encouraged that other crisis resolution arrangements are in place,

including: (a) robust understandings with parents of foreign banks on the support that would be forthcoming for distressed subsidiaries; (b) a clear regime with appropriate objectives (including financial stability), tasks and powers for the official administrators of intervened banks; (c) orderly liquidation procedures for banks. To strengthen arrangements further, we recommend that clear understandings be developed on the roles of the two governments in the event that public bailout of a bank is ever contemplated.

Fiscal

16. **The 2011 fiscal outturns in both countries are on track with respect to the fiscal rules.** Data on budget execution indicate that Curacao will achieve a current budget surplus in 2011, as savings on expenditure on goods and services due to efficiencies from the integration of Netherlands Antilles and Island Curacao government operations are realized. Sint Maarten is also on track to achieve a balanced current budget outcome in 2011. Including capital expenditure, Curacao is expected to run a balanced overall budget, while, in Sint Maarten, significant delays in major planned infrastructure spending will imply an overall deficit of ½ percent of GDP, well below the 5¼ percent of GDP deficit budgeted for 2011.

17. **And further welcome efforts are anticipated in the 2012 budgets and beyond to ensure continued adherence to the fiscal rules**. For 2012, Sint Maarten faces significant spending pressures related to institutional build-up, and substantial efforts are underway to streamline current spending to match current revenues. Moreover, plans are well advanced to set up a new national health insurance scheme with premiums and coverage adjusted to ensure sustainability ahead of the onset of spending pressures. In the case of Curacao, pressures related to health care and pensions are already significant, and comprehensive measures are planned shortly to integrate the public sector funds, increase the health insurance premium, and contain costs through re-examining insurance coverage and deductibles and reducing the rate of growth of spending on equipment, pharmaceuticals, and personnel. To contain pension pressures, plans are being developed to increase the statutory retirement age from the current 60 years to 65. Other measures are also being considered for the public sector pension funds in the two countries (APS and AP), such as reducing the rate of accrual of benefits and redefining the pension base over a longer time period.

18. **In our view, fiscal tightening of some 2-3 percent of GDP is needed over the near to medium term to support the efforts to reduce the current account deficit.** Given the relative size of Curacao and data suggesting that it is primarily responsible for the widening of the current account deficit, the bulk of the adjustment will need to come from Curacao. As noted above, significant tightening is already expected in Curacao for 2011, which is a step in the right direction. In addition to efforts to contain aging and institutional buildup-related pressures, areas that could be targeted in this effort include social benefits, goods and services, and wages. Social benefit spending in Curacao is substantial and could be better targeted. Scope for savings on expenditure on goods and services arising from synergies from

the merger of Netherlands Antilles and Island Curacao governments appear substantial, given pronounced under-utilization of budgeted amounts for this category in the 2011 budget. And public sector wage moderation would strengthen consolidation efforts while also providing a strong signal for private sector wage restraint. In Sint Maarten, scope for reducing expenditures appears limited, given institutional gaps. However, tax reforms as well as compliance increasing measures being developed will likely need to be moderately revenue enhancing.

19. **Public debt appears sustainable in both countries over the medium term, assuming continued adherence to the fiscal rules**. Thanks to debt relief, debt-GDP ratios are relatively low. Our projections, assuming continued adherence to the fiscal rules, indicate that for Curacao, the debt ratio is on a slightly declining path over the medium term, while, for Sint Maarten, debt rises temporarily in the near term on account of substantial public investment but stabilizes thereafter.

20. **Comprehensive tax reforms, which will help enhance competitiveness by reducing rates on labor and profits, are being prepared in both countries**. Rebalancing from direct to indirect taxes would also support productive activity and moderate consumption, thus contributing to a reduction of the underlying current account deficit.

- New legislation in Curacao envisages revenue-neutral reforms that broaden the tax base, raise the sales tax rate, and lower personal and corporate income tax rates. These are commendable and move in the right direction. We are also encouraged by the authorities' intentions to go further in this area along the lines recommended by the 2009 Technical Assistance mission of the IMF's Fiscal Affairs Department, which proposed a corporate tax rate at 20 percent, the top income tax rate at 35 percent, and a VAT at 10 percent.

- Tax policy reform in Sint Maarten also aims to broaden the tax base, shift from direct to indirect taxes and moderately increase overall tax revenue. We recommend that the timing of implementation of reforms be brought forward as much as possible. Given the shared border with the French side, synchronization of tax policy on both sides would be critical to avoid arbitrage across borders. Membership in the Caribbean Regional Technical Assistance Center (CARTAC) would provide useful technical assistance in this endeavor.

Structural reform

21. **Deep structural reforms are needed to enhance price and wage flexibility and improve the business environment**. With a currency peg, domestic price and wage flexibility is the primary channel by which the economy adjusts to shocks and sustains competitiveness.

- Labor market legislation and regulations should be overhauled in both countries, as intended, to substantially enhance wage flexibility, the ease of adjusting company workforces, and incentives for job search. This would also help reduce the proliferation of short-term contracts and the grey economy.

- The business licensing and permit regimes should also be substantially streamlined, as decided by both governments, so that the process of forming new businesses becomes timely and predictable.

- The widespread use of administered prices should be phased out and replaced by strong competition legislation, as planned. In addition, pricing of petroleum products should continue to be adjusted on a monthly basis in line with international prices to stimulate appropriate demand responses and minimize losses in public utilities.

- Measures to increase the efficiency of public utilities and strengthen the corporate governance of public enterprises would also help improve the business environment.

We also suggest that tri-partite processes, involving government, employers, and workers, be strengthened to facilitate regular consultation and consensus of all major stakeholders in the structural reform process, as has been done successfully in many countries including the Netherlands and Aruba.

Other

22. **We would like to stress that there is an urgent need to upgrade the statistical infrastructure**. Data gaps are substantial, representing a significant impediment to macroeconomic diagnosis and policy-making in both countries. For example, nominal expenditure-side national accounts data have not been published since 2006, and there are no data on deflators or real GDP. Data on fiscal expenditures for Sint Maarten are not available as yet for 2009–10, complicating the assessment of its fiscal policy. Moreover, data on the operations of the Netherlands Antilles central government in 2010 are limited, impeding a proper assessment of the degree of fiscal tightening in the currency union in 2011. Fiscal reporting standards still need improvement. Estimates of individual island current account deficits are subject to significant margins of uncertainty, as some imports destined for Sint Maarten are booked as Curacao imports.

23. The mission is grateful for the high quality and openness of the discussions, and for the cooperation and hospitality received from the Curacao and Sint Maarten authorities and private sector.