INTERNATIONAL MONETARY FUND

Netherlands Antilles—Preliminary Conclusions of the 2008 Article IV Consultation

June 30, 2008

1. **A long period of stagnation appears to have ended in the Netherlands Antilles**. Economic growth accelerated sharply in 2007 and is likely to remain strong in 2008, at about 3 percent. Growth will be shored up by a fiscal stimulus, ongoing investments in the construction and tourism sectors due to improved investor confidence, and gains in tourism due to the euro appreciation and increased capacity. The current account deficit will remain large as a result, but will be financed by foreign direct investment and development aid, allowing reserve coverage to be maintained at existing levels. A negative factor is the global food and fuel price shock, which is boosting inflation.

2. **Sustaining investor confidence would be important for ensuring that growth remains above historical norms in the medium term**. The mission projects growth in the islands now comprising the Netherlands Antilles to moderate to some 2½ percent by 2011. This is cautiously optimistic, and is predicated on recovering export markets, increased capacity from recent infrastructure investments, and—owing to the introduction of a fiscal rule and debt forgiveness—improved business confidence.

Constitutional change: opportunities and challenges

3. **Looking forward, constitutional changes—now delayed to January 2010—present both opportunities and challenges**. The dissolution agreement envisages debt forgiveness conditional on the establishment of a balanced current budget rule and fiscal supervision; a common central bank for St. Maarten and Curaçao in charge of monetary and exchange rate policies and financial sector supervision; and a Social Economic Initiative (SEI) to promote structural and social reforms. Implementation has started, with a balanced budget rule and fiscal supervision already in place in Bonaire, St. Eustasius, and Saba, and about to begin in St. Maarten and Curaçao starting 2009.

4. **Taking this opportunity, a big push is underway to implement the necessary policy changes and reforms**. Work to establish the agreed fiscal supervisory bodies is well advanced. Local governments are preparing balanced budget plans for 2009–11. Proposals to reform the pension and healthcare systems have been drawn up, and are awaiting government action. Tax policy and administration reforms for Curaçao are in the planning stages. Key steps to improve corporate governance are scheduled for implementation in fall 2008. The Labor Force Development Commission of Curaçao—reflecting tripartite participation from government, employers, and unions—is finalizing a comprehensive protocol for improving labor force flexibility and skills, and increasing employment.

5. **The immediate challenge is to complete the transition phase expeditiously**. Specific details remain to be nailed down in some areas, complicating decision-making. For instance, the coverage, amount and schedule of debt relief payments remain unclear, with important implications for fiscal policy, liquidity management, and financial sector balance sheets. Despite agreement in principle to have a common central bank and common financial sector supervisory rules, the financial sector remains uncertain about possible regulatory changes after dissolution. Decisions regarding public sector institutional arrangements post-dissolution (including mechanisms to transfer central government tasks to local governments) are pending. In determining which institutions and regulatory bodies to share or duplicate after dissolution, the Curaçao and St. Maarten authorities should seek to keep agency costs down by exploiting economies of scale to the extent possible. Changes to the BNA's charter should not undermine its political independence.

6. **The bigger ongoing challenge for policymakers will be how to use the limited tools at their disposal to support growth, while containing vulnerabilities**. The exchange rate peg constrains the BNA's monetary policy toolkit, and the forthcoming balanced budget rule will all but eliminate the fiscal policy tool. The freedom of Antilleans to migrate to the Netherlands limits the ability of the labor market to adjust to shocks; high wages and high structural unemployment constrain cost competitiveness. Finally, the small size of the economy limits the scope to diversify economic activities and improve cost competitiveness through large-scale immigration. With fiscal and monetary policy locked in, **structural reforms—especially tax policy and labor market reform—take on added importance as the chief instruments to adjust to shocks and boost competitiveness**.

Against this background, the mission's recommendations focus on the following issues:

Fiscal policy: managing the strain on public finances due to pension and healthcare costs

7. **Fiscal policy needs to balance the twin objectives of preserving competitiveness and remaining sustainable**. This calls for low tax, wage, and social contribution rates relative to competitors to attract business; yet, wages, pensions, and safety nets need to remain competitive with the Netherlands to attract and retain skilled labor. At the same time, public finances need to make room for commitments arising from entitlement policies.

8. **Transforming the large current budget deficits to balance will require measures on both the revenue and expenditure side**. On revenue, measures could include broadening the tax base, continued improvements in collection, and hard budget constraints on public enterprises. In this regard, the proposed reforms of tax policy and administration and plans to adjust tariffs automatically and improve oversight of public enterprise finances are steps in the right direction. On expenditures, there will be a continued need for social transfers to mitigate the impact of high prices on vulnerable sections of society, and, absent reforms, transfers for entitlements. Therefore, fiscal adjustment would need to rely on rationalizing the

civil service and processes in the new political structure and limiting wage increases to productivity growth.

9. **Pension and healthcare reform is now urgent**. Pension payments are set to increase from 2009 onwards due to an ageing population, requiring budget transfers to the SVB (Social Insurance Bank) to meet its obligations. The proposed reforms—raising retirement age to 65 and eliminating the regressive income ceiling for social contributions—should bring pension parameters in line with those in the Netherlands (the main competitor in the labor market). Implementing these changes, and the planned control of healthcare costs, would not only eliminate the SVB's deficits, but could also create room for a reduction in social contribution rates, thereby improving competitiveness. Pension premium payments to APNA (Civil Service Pension Fund) are also set to increase due to inflation indexation. Raising pension premiums is not desirable as it would also increase government expenditures. A better solution would be to raise the retirement age in line with the SVB, make indexation conditional on the coverage ratio, and change the pension base to the average salary. Finally, allowing the pension funds to earn higher returns on their assets—without undue risk—will be important. **Absent pension and healthcare reform, current budget surpluses of some ½ percent of GDP would be required on average during 2009–11 to finance rising costs of entitlements**.

10. **The introduction of a balanced budget rule and fiscal supervision starting 2009 is welcome, but implementation will be key**. Although balanced budget requirements were not observed in the past, the prospects of successful implementation have improved due to the merger of different layers of government, the participation of the Kingdom of the Netherlands in the supervisory body, and a reduced expectation of future bailouts post-dissolution. Nevertheless, it will be important to ensure proper accountability and insulate the supervisory body from political pressure.

Monetary policy and financial sector stability: challenges in liquidity management

11. **Debt relief and its implications for liquidity will have to be managed judiciously to avoid hurting financial sector balance sheets**. If debt relief takes the form of large buybacks of government securities, the economy could be flooded with liquidity beyond its capacity to absorb, just as new investment opportunities (government securities) diminish due to the fiscal rule. The options for monetary tightening are limited, given already-high reserve requirement ratios. Conventional sterilization would be cost-prohibitive, hurting the BNA's balance sheet, and therefore the budget. It would also imply a transfer of liabilities from the government to the BNA, defeating the purpose of debt relief. Forcing institutional investors with large holdings of government securities to invest these amounts locally—given the scarcity of alternate domestic assets—would drive down domestic interest rates, and endanger balance sheets (again, with eventual fiscal consequences). Alternative domestic assets for investment will take time to develop, and may not be of the size and risk-return profile ideal for institutional investors. Banks could invest these sums abroad, but may

instead seek higher rates of return by on-lending these funds domestically. This could translate into pressure on bank balance sheets as banks undertake more risky lending, and further increase asset prices. Unduly rapid domestic credit expansion could—in the extreme—also fuel an import boom that could undermine the BNA's exchange rate target.

12. **A three-fold approach to resolving this problem could be considered**. First, an effort to reach agreement with the Dutch government on a sufficiently gradual schedule of debt relief payments to avoid excess liquidity. Second, within the limited scope available, some tightening of monetary policy instruments by the BNA may be appropriate. Third, the "60:40" investment rule for institutional investors should be gradually phased out. A one-shot abolition of controls should be avoided as it could generate macroeconomic imbalances in an economy used to captive funding sources. The gradual elimination of capital controls would have the additional benefit of further improving financial sector competition on the funding side and force banks to preserve profitability by improving operational efficiency and diversifying income sources. The improvement in competition could be further facilitated by greater financial integration with Caribbean countries (supported by strong supervision), and the consolidation of smaller banks—as is underway—to level the playing field.

13. **The financial sector is broadly healthy, but institutions and supervisors face a more difficult environment in the period ahead**. Financial institutions' profit margins are under pressure from both intensified competition and—as a side-effect of debt relief—lower income from high-yielding government securities. Since banks may face incentives for greater risk-taking to maintain profitability, the BNA will need to be especially vigilant to guard against a deterioration in lending standards. In this environment, speedy parliamentary consideration of draft laws to upgrade the legal framework for financial sector supervision would be welcome.

Structural reforms: key to preserving investor confidence and higher living standards

14. **Structural reforms will be the most important tool to improve competitiveness, preserve investor confidence, and sustain higher living standards**. The draft tripartite protocol and the SEI contain useful proposals, that depend on implementation as a package to yield the desired results.

15. **Tax policy changes will need to balance the impact on budget revenue versus competitiveness**. The preliminary tax reform proposals appropriately aim for a revenue-neutral rebalancing of the tax burden, with lower income and corporate tax rates—which would improve competitiveness—and higher indirect tax rates. Personal income and corporate tax rates are high by regional standards, with the tax burden borne disproportionately by the largest firms and workers, deterring foreign investors and skilled labor. The impact on the poor could be mitigated by carefully targeted income subsidies, within the constraints of a fiscal rule. A simplification of the tax regime through the

elimination of exemptions and streamlining of rates would improve collection and level the playing field. In addition, the tax authority should persevere with its efforts to negotiate double taxation agreements, which are important for the competitiveness of the international financial sector.

16. **The draft tripartite protocol to improve productivity and living standards is encouraging, but implementation will be key**. The strategy emphasizes "flexicurity" to help individuals protect themselves as "lifetime" employment diminishes, and puts the onus on all parties to contribute collectively to improving productivity in a way that would create jobs, upgrade skills and improve living standards. For example, dismissal and work permit regulations act as taxes on hiring, and their relaxation would allow businesses to hire productive workers, create jobs and invest in upgrading skills and productivity, thus improving living standards over time. While the planned increase in minimum wages will affect competitiveness in the tourism sector, this could be mitigated by some of the measures envisaged in the draft reform package.

Statistics

17. **While improvements have been made in compilation, there is scope for further shortening the lag in producing statistics and improving dissemination**. Long-standing plans to improve dissemination are now underway, but the production of additional core statistical indicators remains stalled for want of funding, a situation that should be rectified. The pending decision on how to produce statistics for St. Maarten after dissolution should take into account the large overhead costs and time required to form a separate statistics agency. Earlier dissemination of preliminary financial sector data would be helpful. In this context, BNA plans to automate and accelerate the frequency of reporting by institutional investors are welcome.

We thank the authorities for the fruitful discussions and their warm hospitality, and wish them success in their endeavors.

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