

Alberto Romero: At the beginning of a new century: the current economic and financial situation in the Netherlands Antilles

Speech by Mr Alberto Romero, Executive Director Bank van de Nederlandse Antillen at the "Aruba and Curaçao Tourism and Public Finances" seminar, 3 March 2001.

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Introduction

Ladies and gentlemen, good morning. I would like to thank the UNA for inviting me today to present to you an overview of the economic and financial development of the Netherlands Antilles during the last 15 years.

Let me also express my appreciation for my friends of the Central Bank of Aruba that are here today and that have accepted the invitation of the UNA to participate in this seminar. During the last decade the cooperation between the Central Bank of Aruba and our Central Bank has grown to become one of mutual respect for each other's work and there also exists a great desire between staff members of both institutions to cooperate with each other, to share information and work closely together on topics of common interests.

As you all know, our economy has been suffering from a severe recession since 1996. During the year 2000 only, the Antillean economy shrank as measured by the gross domestic product (GDP) by an estimated 4.4%. This decline can be explained by a weak domestic demand, migration, new tax measures, lay-off, all of which resulted in reduced private consumption. Private investment also declined due to a lack of confidence in and uncertainty of the economic future of our country. In addition, the difficult financial situation of the governments constrained further domestic public expenditures.

All these factors contributed to a further lowering of the domestic spending and this is now reflected in a depressed economy and a constantly shrinking GDP since 1996.

Going back to the last decade of the 20th century our real GDP recorded an average growth of only 0.7% as compared for instance to all developing economies which showed an average growth of 2.4%. As an economist it is in a sense puzzling to see that, while the world economy has been expanding during these past few years, and our major trading partners, the USA and Holland, are showing remarkable positive overall economic performance, we do not seem to benefit from these developments and are even falling behind in the region.

One would wonder as to what the main causes are for our poor performance, particularly if placed within the context of new emerging international trade relations and a positive business environment.

Let me give you my views on the various internal weaknesses that have, to a great extent, hampered economic growth in the Netherlands Antilles during the past few decades.

- In the first place the mounting disequilibrium in the fiscal balances of the governments as a result of the weakened tax base and rising expenditures on wages, salaries and interest is a main reason for the poor economic development;
- In the second place, and closely related to the fiscal imbalance, is the weak balance of payments outcome. Given the openness of our economy, the medium to long term effects of fiscal imbalances will unequivocally be reflected in imbalances in the current account of the balance of payments;
- Thirdly the rigidity in the labor market and the related high general cost of doing business, to a great extent have resulted in high unemployment. There is a simple law in economics that has proven to be useful for policy-makers. Whenever the per unit labor cost rises above the productivity level of labor, employment opportunities will shrink and unemployment will rise. In addition the poor results in the educational field and inconsistent human resource training programs have resulted in a high youth unemployment and massive migration of this younger age-group of our community to Holland;

- The various attempts to modify, adapt and re-shape our tax structure has gradually raised the tax burden on the islands of the Netherlands Antilles and this has resulted in additional cost effects that is now spreading throughout the economy;
- The policies to correct perceived market failures in the past has caused our product market to become rigid and, associated with this development, the price mechanism did not correctly reflect the demand and supply situation in the various market segments;
- Finally the lengthy discussion between the two layers of government has practically paralyzed the urgently needed efficient functioning of the decision making process.

Some of the above mentioned weaknesses, particularly those associated with high budget deficits, triggered an unsustainable high public debt and as a consequence of this a financial crisis that started originally in the public sector, but is now spreading throughout our society, creating a social and economic crisis, accompanied by increasing poverty and a migrating population.

To address the topic of this seminar I have chosen to single out two main areas of risk that have intensified due to the crisis in the public sector. I will first start with the consequences of the public sector's financial situation for APNA's public pension scheme. In addition to the negative effects of the imbalance in the public sector on the pension fund, we also see that the interest burden in the budgets of the governments have magnified due to the uncontrollable debt situation.

Rationalizing the APNA pension scheme

Another important side-effect of the situation in government finances is the imbalance in the public pension fund system (APNA) that I would like to discuss with you next.

Since 1998 the governments have focused their efforts on rationalizing and reforming the public sector pension scheme. It is important to note that the cost savings efforts that the governments have introduced into the pension scheme must be seen as important positive steps to bring the public pension system more in line with private sector pension schemes. Despite the increasing criticism on the foreseen reforms, one should have do bear in mind that the long term viability of the fund is at stake if no reforms are undertaken now.

Various cost saving measures were implemented with the objective to balance the contribution of the participants in the scheme on the one hand and to safeguard their pension benefits in the long run. Some of the most important rationalization measures were:

- Raising the retirement age to 60 years;
- full pension rights will be obtained after 35 years of service for new participants in the scheme instead of 30 years;
- the early retirement option for new participants into the fund was eliminated while a gradual phasing out of this option for those that acquired this right prior to 1998 is being worked out;
- the inclusion of the AOV (old age pension) into the public pension scheme.

Due to all these amendments into the APNA scheme the total premium paid has abruptly been reduced from 34% in the past to the current 16%. In addition this 16% premium scale has now been changed into a so-called dynamic premium system, which was proposed by the management and board of the APNA.

This dynamic premium scheme is based on the crucial assumption on the level of the funding ratio, being the ratio between the liquid assets and the pension liabilities.

If the funding ratio at a given point in time becomes higher than 115% the dynamic contribution scheme automatically adapts the total premium to be paid to the APNA by lowering it by 1% points from 16%. If on the other hand the funding ratio falls below the 95% threshold, the total premium will have to be raised by 2% points from the basis of 16%. With a funding ratio between 105% and 115% the total premium can be maintained at its present level of 16%.

Based upon these assumptions made by APNA the present 16% dynamic premium scale is in the short term at the safe end. Recently¹ also an IMF panel of experts concluded that this premium

¹ Special IMF mission that studied the pension scheme from January 29 to February 8, 2001

scheme could be maintained in the short term on condition that the actuarial assumption used in the calculation of this new premium scheme be re-evaluated by an independent actuarial study.

Other important considerations however, should be studied in more detail in order to mitigate the longer term risk to the public pension system. One of these risks factors is the modus operandi of all island governments that together contribute to the premium system. In the past decade without any exception all of the island governments and the general government were unable to meet the full pension contribution and therefore forced the pensionfund management and board into renegotiating and converting premium arrears into new interest bearing loans. It is also important and fair to state that the governments were able to fully comply with the interest payments obligations to the fund.

One of the consequences of this payment attitude results in a forced annual or automatic 'investment' of the APNA in government securities, and due to this development currently 45% of the balance sheet assets of the public pension fund is made up of receivables from the governments. The liquidation of these assets to comply with the short term pension obligations will become crucial at one point in the future and this needs closer attention and monitoring of the APNA management and board.

As long as there is certainty that these government securities can be readily and easily liquidated into a secondary security market, there is no risk at all for the pensionfund obligations. The story becomes more worrisome if the liquidation of these securities cannot easily be converted into cash. This should be, in my view, the focal point in the discussions among the participants of the APNA pension scheme in the coming years.

In the past some other possible solutions were brought forward for consideration to APNA and the governments in order to safeguard the long term viability of this public pension scheme. Some of the options discussed were:

- the opening up of the scheme for other non-governmental participants to reduce the risks of over investment into one type of security;
- a further increase in the retirement age to e.g. 62 or 65 years to also better reflect the life-expectancy on the islands;
- reorientation of the premium system from a "defined benefit" system into a "defined contribution" system.

In my view these are important issues to be discussed in order to further rationalize the APNA pension scheme in the future.

The relation public debt and interest payments.

The second important side effect of the consistently high budget deficits of the past is shown in an increasing share of interest payments into the total public sector expenditures. This phenomenon is also related to the aforementioned conversion of arrears to creditors (including APNA) into interest bearing loans.

In 1986 for instance the interest payments in the budgets of the governments amounted to NAf 25.4 million or 7.9% as a share of the total public expenditure. The most recent data on the public sector interest burden shows that for February of 2001 the total interest payment amounts to NAf.226.4 million or 15.6% of the total expenditures of the general government. This means that in a 15 years' time-span the share of the interest payments in the total expenditures have doubled. This development should be of great concern for policy makers on the islands for various reasons. Some of these reasons are:

- If for instance the governments had been able to theoretically operate the public sector without debts in the past 15 years, this would have generated savings of over 200 million guilders in the year 2001 only;
- Furthermore, these 200 million guilders of interest savings would have generated in the private sector billions of guilders of investments because of the fewer crowding out effects of public expenditures than we are currently experiencing;

- The deterioration in public assets as a consequence of maintenance backlogs would have been reversed if only part of the savings mentioned in this context would have been invested in these assets;
- Finally we should imagine the positive effects that investment of these 200 million in savings had generated in the educational field for the entire community.

I have given you just a few general remarks on the positive external effects that a more balanced and responsible management of public funds would have generated in the past decades.

The focus on new economic areas of development for the future

Considering the fact that the real per capita income of the Netherlands Antilles and Aruba² is more than US\$ 10.000 this situation does not put us in the range of the 'poor countries'. On the other hand there seems to be a concern, particularly on the islands of the Netherlands Antilles, that the distribution of this income is not equitable among all members of our community. According to some studies done last year on the poverty situation on the islands of the Netherlands Antilles, there seems to be an increasing poverty among our fellow countrymen and some of them regrettably have taken the easy way out of poverty through migration to the Netherlands.

In the past 20 years the islands of the Netherlands Antilles have been hit by a number of external shocks which are still having an important negative effect on the GDP of our country. I do not have to repeat here the reasons for these external shocks nor will I dwell in detail on the background of the external shocks, but recent estimates put the income effect of these external shocks at approximately 20% of GDP or over 800 million guilders. Particularly for well developed economies this type of severe economic blows of this magnitude would have thrown them back for years in development if no external assistance had been available. As an example the Latin-American debt crisis of the 80s is an excellent reference point in time to illustrate how external shocks can severely hamper economic development in larger and less vulnerable economies. Still, many countries in Latin America are slowly recovering from these shock even today.

How have we reacted to these external shocks here since 1986? There is a number of ways that can be given on how we are managing ourselves out of this crisis:

Migration as a social safety net:

During the last 5 years and estimated number of some 40.000³ persons from our islands (mainly from Curaçao) left to Holland to secure a better future for their families.

The migration has dramatically affected the workplace, so much that it is one of the explanations for the tempered decline in the unemployment rate. This migration makes it also more difficult to quickly recover from the recession on the islands. For the year 2000 we estimate that the unemployment rate declined from 15.5% to approximately 14.9%, in spite of the economic downturn. This is to a great extent attributable to the migration effects.

Labor market flexibility:

Another important explanation for the structurally high unemployment rate is the rigidity problems the labor market on the islands of the Netherlands Antilles. Under the program of economic recovery that this government signed with the IMF on September 15, 2000 significant positive steps were undertaken to increase flexibility in our markets. Most of the economic measures agreed upon with the IMF are focused on enhancing labor market flexibility and improving the business climate.

For example, almost all measures related to the labor market are focussed on increasing the flexibility for the employer to adjust capacity to market demand. Furthermore, the procedures for obtaining a permit for establishing a business are being streamlined, and it was agreed to introduce more flexibility in regulations on shop opening hours. Moreover, legislation on e-commerce and on the establishment of economic zones (E-zones) has been adopted by parliament in order to promote business

² For Aruba the real capita income as per the end of 1999 reached US\$11.600

³ Preliminary information of the Statistics (CBS) "Census 2001" indicates that the population of Curaçao dropped from 144.000 to 130.000 from 1992 2001

development. In addition to these local efforts, several international organizations are involved in assessing the business climate. The Foreign Investment Advisory Service (FIAS), a subsidiary of the World Bank, is looking into the attractiveness of the Netherlands Antilles as a location to invest, while the OECD has evaluated the legislation for the international financial and business services sector.

Furthermore, during a two-week mission in December 2000, the World Bank visited all the islands in an effort to develop a long term economic growth strategy for the Netherlands Antilles.

Debt financing to pay for adjustments:

The third way we are trying to get out of the crisis is through debt refinancing. I have to clarify my position on this by saying that this is not the correct way of resolving the crisis.

Since 1986⁴ our governments have adopted the policy of adjustments through additional local financing and accumulation of arrears. To a great extent this policy option explains the growing debt and interest burden in the public sector budgets.

Coming back now to the more recent economic and financial situation, I can say the following. On the fiscal front, a budget deficit of NAf.160 million (3.6% of GDP) is estimated for the year 2000. Compared to 1999, government revenues have increased considerably due to more tax revenues.

This increase resulted from the rise of turnover tax rates and measures to improve the tax assessment and collection. On the other hand, expenditures increased also, mainly because the government had to pay part of the claims related to the Parker-guarantee to a foreign financial institution.

The NAf. 160 million budget deficit equals the target agreed upon with the IMF in the Memorandum of Economic Policies, signed on September 15, 2000. This program, which has to be implemented before the end of March 2001, contains a number of measures in various areas, such as the reduction of the budget deficit, the flexibilisation of the labor and product markets, and trade liberalization. Furthermore, the program contains targets for the level of credit extension and the foreign exchange reserves. As a result of the agreement with the IMF, the Dutch government has made available a substantial amount of liquidity support in 2000 (NAf. 110 million). The release of these funds is conditional on the progress made in the implementation of the policy measures.

For 2001 no economic recovery is yet foreseen, as economic activity is expected to drop by 0.5%. This decline is related to the drop in public expenditures in an effort to cut the budget deficit by 50%.

In addition to the decline in public expenditures, private consumption will drop further due to continued migration, the reduction in the number of civil servants and the freeze on government salaries.

In contrast, private investment is expected to pick up in 2001. This increase is related to several large investment projects in the tourism sector and at the Isla refinery. Contrary to domestic demand, foreign demand is expected to increase as a result of a recovery in stay-over tourism.

The inflation rate accelerated from 0.8% in 1999 to 5.1% in 2000, mainly due to the increase in turnover tax rates. In addition to this domestic factor, the sharp increase in the oil price and the increase in inflation at our main trading partners contributed to the higher price level.

The tourism industry is currently undergoing a difficult period. Stay-over tourism has been slow for some time, and the spectacular increase in cruise tourism has not been able to compensate for this. The decline in stay-over tourism particularly for Curaçao and Bonaire, is related to the weak Euro, which makes our islands more expensive for European visitors. Fortunately, the average length of stay and the average amount spent on the islands have increased slightly, dampening the effect of the drop in the number of visitors.

The tourism industry in the Netherlands Antilles is expected to improve, as room capacity will be restored in St. Maarten. The projections for Curaçao looks quite positive also, as a number of investment projects are under way, like Brionplein Hotel, Kura Hulanda, Cornelisbaai, and Jan Thiel Baai.

⁴ This was the last year that the general government had a positive balance in their budgets.

Furthermore, there are plans for tourism related projects at Caracasbaai and Blauw Baai, while the Curaçao Ports Authority is considering a second mega-pier to accommodate the growth in cruise tourism.

To conclude, we have to acknowledge that the Antillean economy has been going through a deep recession during the past few years. The financial crisis with the government spread through the entire economy, creating a social and economic crisis. The only way out of this negative spiral is to tackle the financial problems of the government. The government has made considerable progress in the implementation of the policy program agreed upon with the IMF, but some delays have surfaced during the last two months. The reduction in the financial needs of the government, coupled with the gradual restoration of confidence, will lay in my view a solid basis for sustainable economic growth. Economic growth will create better prospects for jobs and an improvement of living standards.