Emsley Tromp: The policy challenges in the Monetary Union of Curaçao and Sint Maarten

Speech by Dr Emsley Tromp, President of the Central Bank of Curaçao and Sint Maarten, at the Inauguration of the Simpson Bay Causeway, Sint Maarten, 25 January 2014.

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Good evening ladies and gentlemen,

First, allow me to congratulate the people of Sint Maarten on the inauguration of the Simpson Bay Causeway. For many years, traffic congestion in this area was a major obstacle; it had an increasingly negative impact on the quality of life on the island and was an impediment to economic growth. We are convinced that the completion of this infrastructure project will remove an obstacle to growth in Sint Maarten. Authorities now have to direct their policy actions to other complementary measures to put Sint Maarten's economy on a higher and sustained growth path. As you know, the *Centrale Bank van Curaçao en Sint Maarten* was involved in the financing of this important project. The Bank's involvement, as I will elaborate on later, was motivated by our desire to help further the development of the capital market in Sint Maarten and, as with the Aqualectra loan, to broaden our instruments to conduct a more market-based monetary policy. However, it would be a remiss if I do not mention here the motivation and dedication with which my colleague drs Rob Reijnaert put into this endeavor to make our participation possible. A heartfelt thanks is at the order. Thank you Rob!

I'd like to use this opportunity to discuss the main economic developments in the monetary union during 2013 and the economic prospects for 2014. My focus today will be on the economy of Sint Maarten. As mentioned, I will also elaborate on the reasons why, from a monetary perspective, the Bank was actively involved in the process of financing the Causeway project.

Ladies and gentlemen, preliminary figures reveal that economic developments in the monetary union were mixed during 2013. On the one hand, Sint Maarten recorded an economic expansion of 1.1%, which was a slowdown compared to the growth of 1.5% registered in 2012. On the other hand, the economy of Curaçao shrank by 0.5% in 2013, following a contraction of 0.1% in 2012. Both countries benefited from the lower international oil and food prices during 2013. As a result, Sint Maarten's inflation rate dropped from 4.0% in 2012 to 2.7% in 2013. Meanwhile, Curaçao posted an inflation rate of 1.5% in 2013, down from the 2.3% a year earlier.

An analysis based on preliminary data of the sectoral performance in Sint Maarten shows that the real GDP growth in 2013 resulted primarily from the manufacturing and the construction sectors, mitigated by a decline in the financial intermediation sector. Real output growth in the manufacturing sector was the result of more repair activities on yachts that visited Sint Maarten. The construction sector performed well due to an increase in both private and public investments. investments rose because of public infrastructure projects, including the construction of the Simpson Bay Causeway.

In the utilities sector, real value added grew primarily because of an increase in water production. Activities in the wholesale and retail trade sector also expanded because of a rise in domestic spending, moderated by a decline in tourism spending.

Meanwhile, real value added growth in the restaurants & hotels sector remained flat, attributable mainly to weakened activities in stay-over tourism. While the number of visitors from North America and the Caribbean increased, the European, South American and Central American markets witnessed a decline. Cruise tourism contracted during the first half of 2013, but picked up afterwards.

The transport, storage & communication sector recorded no growth as an increase in airport-related activities was offset by a decline in activities in the harbor. Airport-related activities rose, driven by more passenger traffic at the *Princess Juliana International Airport*. The poor performance of the harbor was caused by a decline in the number of ships that visited the port of Sint Maarten. The financial intermediation sector put a drag on real GDP growth, due to a decline in net interest income of the commercial banks.

Looking ahead, growth in Sint Maarten has to be seen against the background of developments in the world economy. In 2014, we expect world economic growth to accelerate supported by increased output growth in the advanced economies. Meanwhile, growth in the emerging economies will slow down. Sint Maarten will benefit particularly from the projected improving economy of the United States. Therefore, real GDP in Sint Maarten is projected to expand by 1.6% in 2014 driven by increased activities in the tourism and transportation sectors. Meanwhile, inflationary pressures will ease to 2.4% due mainly to a projected further decline in international oil and food prices.

Ladies and gentlemen, one of the main challenges that we have been confronting in the monetary union is the high deficit on the current account of the balance of payments. The current account of the balance of payments is structurally in deficit, as the trade deficit cannot be compensated by the services, income, and current transfers balances. Since 2010, the deficit on the current account has been above 15% of GDP. Conventional wisdom suggests that in the case of open and small economies such as Curaçao and Sint Maarten, deficits over 4-5% of GDP are not sustainable in the long run.

Until 2011, high capital inflows and external financing exceeded the deficit on the current account resulting in an increase in the gross official reserves. However, in 2012, a turnaround occurred as the inflow of capital and external financing was not sufficient to cover the current account deficit. Consequently, the monetary union recorded a deficit on the balance of payments as reflected by a decline in our gross official reserves.

It is against this background that the *Centrale Bank van Curaçao en Sint Maarten* has aimed its monetary policy at tightening the excess liquidity in the money market. Given the high deficit on the current account of the balance of payments, a private sector credit growth exceeding GDP growth, and a declining trend in international reserves, the Bank has been gradually increasing the reserve requirement percentage. The rationale for increasing the reserve requirement is that by reducing the available liquidity in the money market, commercial banks' credit extension and thereby domestic spending and import growth can be contained. However, increasing the reserve requirement alone has not been sufficient because of the high excess liquidity in the money market.

Consequently, the Bank complemented the reserve requirement instrument with a credit measure to contain the growth in private credit extension and bring it more in line with nominal GDP growth. Since its introduction in February 2012, the credit measure has been extended three times, for a period of 6 months, the current period ending at the end of February 2014. Also, the credit measure has been eased gradually and loans to projects that strengthen the economy and international reserves are exempted. At its introduction in 2012, no growth of private credit extension was allowed; however, for the period September 2013 to February 2014, a maximum growth in credit extension of 3% compared to the end of August 2012 has been allowed.

I should like to emphasize that the credit measure sets a limit only on the growth of credit. Hence, in the case of Sint Maarten, where credit extension has actually been declining since 2011, the credit measure has no effect. The decline in private credit extension in Sint Maarten clearly indicates certain weaknesses in the economy's macroeconomic environment. These weaknesses may be the result of either a decline in the demand for credit or a reduction in the supply of credit by commercial banks.

Ladies and gentlemen, so far, the Bank's monetary policy has produced the intended results by moderating credit growth, improving the current account deficit on the balance of payments, and stemming the decline in reserves in the monetary union. In 2013, the deficit on the current account of the balance of payments dropped further, primarily because the growth in exports of goods and services exceeded the rise in imports. Export growth was driven largely by the tourism and transportation sectors, mitigated by a decline in the re-export activities by the free-zone companies in Curaçao. Imports rose as a result of more merchandise imports to meet tourism demand and the import of construction materials related to investment projects, including the Simpson Bay Causeway. However, a decline in merchandise imports by the free-zone companies in Curaçao combined with a decline in domestic demand in Curaçao moderated import growth. Also, the lower international oil and food prices contained the increase in the import bill.

The deficit on the current account was financed primarily by external financing to the private sector, as reflected by a worsening of the direct investment, portfolio investment, and loans and credit balances. As the inflow of capital during 2013 exceeded the current account deficit, the balance of payments of the monetary union recorded a surplus as reflected by an increase of approximately NAf.77 million in the gross official reserves.

We should not consider the improved situation on the balance of payments in 2013 as a reason to lessen our efforts to address the imbalances on the current account. After all, the current account deficit as a percentage of GDP is still too high. In this context, we must realize that the deployment of monetary tools can bring only a short-term solution to a structural problem. The situation on the balance of payments can be structurally improved only if both Curaçao and Sint Maarten take the necessary actions.

An analysis of the developments on the current account of the balance of payments over the period 2007–2012 reveals that the current account deficit was the result of imbalances in both Curaçao and Sint Maarten. However, the deficit in Sint Maarten has been declining during recent years while the deficit in Curacao has remained well above the benchmark of 4–5 % of GDP. Even though the center of gravity of the problem seems to be in Curaçao, both countries bear responsibility for addressing the situation of the balance of payments in the monetary union.

In this regard, regular consultations and coordination of policy actions between the two countries are imperative. However, since 2010, the focus of the discussion has been on the political wisdom of a monetary union between Curaçao and Sint Maarten rather than on how this current situation should be addressed through coordinated actions.

The balance of payments can be structurally improved if both countries strengthen their competitiveness vis-à-vis their main trading partners. Over the past years, the international competitiveness of Curaçao and Sint Maarten, as measured by the real effective exchange rate (REER), has deteriorated. The REER, which assesses a country's international price competitiveness, has been deteriorating in Curaçao since 2009 and in Sint Maarten since 2008. The reduced competitiveness of both countries has contributed to the widening of the current account deficit. Gains in competitiveness can be achieved through more wage and price flexibility, increased labor productivity, and an improvement of the overall investment climate. Therefore, the governments of Curaçao and Sint Maarten should embark on a policy path of structural economic reforms to strengthen the balance of payments in a sustainable way.

Ladies and gentlemen, as we celebrate the inauguration of this causeway, I would like to address the reasons why the Bank facilitated the financing of the Simpson Bay Causeway of Sint Maarten Harbour Group. As I mentioned on several occasions, we live in a period of Unconventional Monetary Policy. In a speech during the National Economic Forum in

Curaçao on October 14, 2013, I quoted Jean-Claude Trichet[1], the former president of the European Central Bank: "…we all have had, since mid-2007, the great privilege to experience extraordinary demanding and difficult times…" He went on to say: "The widespread introduction of so-called non-standard monetary policy measures by major central banks has been a defining characteristic of the global financial crisis." These unprecedented monetary policy measures included the intervention in specific market segments to support market functioning through actions such as the introduction and expansion of asset purchase programs for commercial paper, corporate bonds, and government debt. The main purpose of these measures, conducted by, for example, the Bank of England, and the Federal Reserves of the United States and the Bank of Japan, was to counteract market dysfunction and restore confidence.

Ladies and gentlemen, advances in understanding entail thinking in a somewhat different way. Sometimes even a highly educated and broadly read person can feel resistance when new knowledge takes us into areas we did not know were even there-spaces that are hard to assimilate into the comfortable world we feel we know. Therefore, I would not be surprised if several years hence, when students of monetary economics reading the history of this period may be as dumbfounded regarding the resistance to innovation as we are now regarding the seventeenth-century resistance to the discovery that the heart is a meat pump. Let us not forget that it took the Catholic church 400 years after Galileo's arrest to concede what every moderately well-educated person knew to be true: earth is not the center of the universe.

I have spent most of my professional life thinking and practicing monetary policy. The basic tenet of my thesis was and is that in a small open economy such as ours, fiscal consolidation is an indispensible condition for monetary stability. The debt relief program in the context of the constitutional changes was the fulfillment of that expectation. However, suddenly in the blink of an eye, the market for government bonds dried up, depriving the Bank of an important policy instrument, namely, the ability to conduct monetary policy through open market operations. At the same time, because of the conditions of the debt relief program, more specifically the interest burden rule and the standing subscription, high yield investment instruments for our local institutional investors on the local market became very limited. To fill that vacuum, we embarked on the development of the corporate bond market.

Ladies and gentlemen, the development of a well-functioning corporate bond market in Curaçao and Sint Maarten is an important, albeit not sufficient precondition for business creation, investment, and economic growth. Along with equity financing and bank lending, corporate bonds are one of the ways companies fund their investments, and they are considered a stable and reliable source of finance. A well-functioning corporate bond market enhances the efficiency of the financial system as companies compete with each other for finance, and it expands the financial sector and promotes the use of cost-effective financing instruments. However, while the corporate bond market has been gaining new momentum elsewhere, the development is being viewed with apprehension here.

We embarked on this policy to develop a corporate bond market in 2009 when we acquired the so-called Aqualectra bonds. In 2012, we participated in the bond issue of the Sint Maarten Harbour Company. The case of Sint Maarten is a special one. Contrary to the Aqualectra bond, the Sint Maarten Harbour bonds have a much wider and broader participation as more market participants acquired the bonds. This increased participation is also thanks to the standby arrangement according to which the Central Bank stands ready to buy or sell bonds at all times as dictated by the monetary conditions of the union. However, a necessary condition for this arrangement to be successful is that our public enterprises have

1 *Unconventional Monetary Policy Measures: Principles-Conditions-Raison d'être.* Speech delivered at the IJCB conference "Central Banking: Before, During, and After the Crisis" held on March 23–24, 2012, at the Board of Governors of the Federal Reserve System in Washington, DC.

to be well managed and sound. In this regard, I concur with dr. Age Bakker[2], chairman of the *Board of Financial Supervision – CFT –* who last November during the Kingdom Conference stated that, "The Sint Maarten economy has been performing well during the past decade. The budgetary challenges in Sint Maarten are less pronounced than in Curacao, the Netherlands, and Aruba. The main reasons are that Sint Maarten has a younger population, well capitalized social funds, and sound public enterprises." That the Sint Maarten Harbour Company is well managed, was another important consideration for the Bank to facilitate the bond issue of the Sint Maarten Harbour Company.

Ladies and gentlemen, with a much broader set of policy instruments, we hope that the Bank can continue to promote the stability of the guilder, thereby creating an environment conducive to more growth and prosperity. As recent policy measures of the Bank demonstrated, we were able to reduce the current account deficit and turn the balance of payments deficit into a surplus. However, for these results to be sustainable, we have to strengthen our export-generating capacity by making Sint Maarten a welcome place to invest. That means that we have to bring our immigration, tax, investment, and labor and product market policies in line with our objective to make Sint Maarten the preeminent place to do business.

We also must realize that as long as a monetary union exists, efforts that benefit growth in one of the countries of the union benefit the union as a whole. I am convinced that the positive spin-off of the Simpson Bay Causeway for the economy of Sint Maarten and thereby also the monetary union of Curaçao and Sint Maarten will prove that the actions of the central bank were right.

Looking ahead, for the further development of the corporate bond market, it is imperative that the government continues to ensure the sound management of public enterprises by strengthening corporate governance, including transparency and accountability. After all, sound and well-managed enterprises imply a lower risk premium and, consequently, a lower interest rate. This condition will lead to more investment and higher economic growth.

Ladies and gentlemen, times have changed and so has our monetary policy. Since 2010, Curaçao and Sint Maarten have comprised a monetary union and this union is facing some challenges with the balance of payments. To effectively deal with those challenges, we need to take coordinated actions. Recent policy actions in the union, both in the monetary and fiscal fields, indicate that concerted action to address our economic challenges is possible. However, we should remain always cognizant that these measures are taken ultimately to improve the welfare of the citizens. Therefore, in the design and implementation of these policy measures, due regard should be given to their social costs.

Thank you for your attention.

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[2] *Gezonde overheidsfinanciën. Een solide basis voor duurzame groei in het Caribisch Koninkrijk.* Speech delivered at the "Congres Koninkrijk en duurzaamheid" held on November 28, 2013, in the Hague, the Netherlands.