

## Kingdom of the Netherlands—2014 Article IV Consultation with Curaçao and Sint Maarten: Preliminary Mission Conclusions

May 20, 2014

*Difficult but necessary reforms have put public finances on a more sustainable footing and, together with a more restrictive monetary policy, helped reduce external imbalances. But growth remains weak, especially in Curaçao, and unemployment high. While the improving global outlook should help rekindle economic activity, urgent action is needed on various priority areas for a more sustained increase in growth and jobs.*

1. **Important reforms since the 2011 consultation have put fiscal policy on a more sustainable path.** Curaçao, in particular, has tackled serious imbalances in the old age pension system, reduced the size of the public apparatus, and lowered health care costs, which were running at twice the regional average. Sint Maarten has kept public wage costs in check as well as improved the financing of the health insurance and the budget process.
2. **Monetary policy has also been appropriately tightened to stem pressures on the current account and international reserves.** Funneled by abundant domestic liquidity, until recently rapid growth in private sector credit—especially in Curaçao—permitted an increase in consumption and investment despite broadly stagnant incomes, widening the union’s current account deficit. To slow down credit expansion, the Central Bank of Curaçao and Sint Maarten (CBCS) has raised reserve requirements significantly in several steps since 2011 and imposed, beginning in early 2012, bank-level credit ceilings.
3. **These policies have helped reduce external imbalances, but these remain large.** The union’s current account deficit has declined steadily from its 21 percent of GDP peak in 2010 to an estimated 18 percent of GDP in 2013. Available data suggest that this deficit stems mostly from Curaçao, but these data are likely incomplete and thus should be interpreted with caution. External deficits of this order are a source of long-term economic vulnerability.
4. **The slow global recovery from the Great Recession has depressed economic activity.** Estimated average growth over 2011-13 has been negative in Curaçao (-½ percent), only partly because of the fiscal adjustment, and ¾ percent in Sint Maarten, which has lost some market share in stay-over tourism and some competitiveness vis-à-vis the US due to higher inflation.
5. **This has compounded pre-existing challenges:**
  - a. **Curaçao’s growth and job creation have been chronically weak, owing in part to a dysfunctional labor market and stifling red tape.** Generous sick leave, welfare payments unlimited in duration (reportedly worth more than the minimum wage when housing and other subsidies are factored in), and weak controls discourage labor supply. Lengthy and cumbersome license procedures (e.g. for work permits) and very restrictive dismissal laws limit labor demand. Pervasive indexation can weaken the link between wages and productivity, hurting competitiveness. These rigidities contributed to subpar growth (½ percent per year on average since 2001) and kept unemployment high (13 percent).

- b. The newly established administration of Sint Maarten needs to build capacity.** This is needed to attend to the many basic functions (e.g., law enforcement, police, tax administration) previously carried out by the government of the Netherlands Antilles, while also addressing similar challenges to the business environment as in Curaçao (dismissal law, license procedures, etc.). Despite positive economic growth, tax revenues have not kept up, possibly due to declining compliance. This is detrimental from an equity perspective as well with regard to the sustainability of public finances.
6. **The improving global outlook should support a pick-up in tourism.** This would boost activity in both countries, and especially in Sint Maarten, which we expect to grow by around 2 percent, given the much larger share of tourism in its GDP. Curaçao may revert to positive growth of about ½ percent this year if construction of the hospital begins without further delay. Stronger external demand, combined with slightly declining oil and food prices and still subdued private domestic demand, should enable a further reduction in the union's current account deficit.
7. **Growth could accelerate in the medium-term if the reforms mentioned below are implemented:**
- Curaçao could grow between 1 and 1½ percent if it improves its business environment and competitiveness in support of net exports and implements planned large public infrastructure projects. In the long run, however, sustained growth can only come from a more agile and competitive private sector (see #13-14).
  - Sint Maarten could grow by around 2½ percent in the medium term based on current projections for growth in the demand of the tourist origin countries but it must overcome its institutional gaps.
8. **But risks remain tilted to the downside.** The volatile situation in Venezuela, already hurting Curaçao's tourism and transportation sectors, could deteriorate further and complicate negotiations to upgrade the refinery in time for the expiry of the current lease to PDVSA in 2019. Planned public investment could face delays or stall altogether due to weak implementation capacity. Weather-related or other disruptions to tourism are a risk for Sint Maarten. Lower than expected growth in the US or in Europe, including as a result of geopolitical tensions, would negatively affect tourism and growth prospect in both countries.

### **Macro policies should be geared to support further external adjustment**

9. **Recent fiscal policy gains should be entrenched.** Curaçao needs to urgently address the imbalances in the civil servants' pension system, in line with the recent old age pension reform, and further increase the effectiveness and reduce the cost of the state apparatus. Sint Maarten should look to strengthen its tax collection capacity, including by exploiting synergies in collection efforts by social funds, and should gradually increase the retirement age to 65 well before population ageing sets in. Over time both countries should explore the scope to shift more of the tax burden from income to consumption and replace the existing turn-over with value-added taxes to underpin external competitiveness (in Sint Maarten, given the shared border, some of these reforms may need to be coordinated with the French side).
10. **Both governments should build fiscal buffers.** To keep debt ratios in safe territory (i.e., below 40 percent) a current balance of ¾-1 percent of GDP should be

maintained. This prudent policy would create fiscal space to respond to shocks, which is especially important given the limited room for active monetary policy in a fixed exchange rate regime. State companies should also contribute by paying dividends.

11. **Monetary policy should absorb the excess liquidity using more standard sterilization tools.** The CBCS has appropriately stopped financing state-owned companies and should divest its bond portfolio, as planned, as market conditions allow. Bank-level credit ceilings are a suboptimal tool to control bank behavior, and expose the CBCS to lobbying and pressure for exemptions. The CBCS should over time move to absorbing excess liquidity by further raising reserve requirements (and, if necessary, the interest at which it provides liquidity to banks) and offering slightly higher interest rates on its CDs. Gradually eliminating limits on outward investments would also contribute to a normalization of the domestic liquidity situation and enable pension funds to achieve better risk-reward trade-offs. Finally, the deterioration in bank asset quality (with the non-performing loan ratio at 12 percent as of end 2013) warrants close monitoring, although ample interest rate margins appear to have enabled most banks to build adequate capital buffers.

### **Structural reforms are needed to increase flexibility and competitiveness**

12. **Greater focus is needed on advancing structural reforms.** While macro policies have improved in recent years, limited progress has been made on the structural front. Yet this is essential to boost competitiveness, growth and job creation.
13. **The labor market must be rendered more flexible and dynamic, especially in Curaçao.** Welfare support for unemployed should be limited in time and eligibility requirements (including active job search) enforced vigorously, as Sint Maarten has sought to do. Dismissal laws should be made more conducive to cyclical shifts in labor demand in order to raise employment durably. Consideration might also be given to easing restrictions on hiring foreign workers while enforcing adequate labor conditions, to facilitate FDI and the associated financial resources and know-how.
14. **The costs of doing business need to be lowered.** In particular the business licensing and permit regimes should be substantially streamlined and the efficiency of public utilities and the governance of public enterprises improved. This would also help bringing more activity out of the shadow economy.

### **Data availability, quality, and timeliness must be improved**

15. **There remains an urgent need to upgrade the statistical infrastructure.** Substantial data gaps hinder effective macroeconomic diagnosis and surveillance and complicate policy-making in both countries. For example, national accounts data are incomplete and published only with very long lags, there are no data on GDP deflators or on the international investment position, and fiscal data do not adhere consistently to international classification standards and, in the case of Sint Maarten, are released only with long delays. Curaçao's CPI basket needs to be updated. More resources/investment are needed to progress in this critical area.

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*The mission is grateful for both islands' warm hospitality, for the authorities' cooperation both in the run-up and during the visit, and for open, frank and constructive discussions.*