Developmental Challenges in a Small Economy: The Case of St. Maarten

Speech by Dr. E. Tromp on the occasion of The State of the Economy Presentation, Philipsburg, St. Maarten March 20, 2008

Ladies and gentlemen, good evening,

With pleasure I accepted the invitation from Commissioner Buncamper-Molanus to speak to you on the relevant theme "Developmental Challenges in a Small Economy" at this event surrounding the presentation of the Economic Outlook 2008. St. Maarten is a very small economy, but a highly successful one as I shall demonstrate later. I shall begin my address this evening with an analysis of St. Maarten's economy, which is growing at an impressive speed. In the second part of my address, I shall discuss with you some of the challenges of the constitutional changes that are ahead for the island. If managed well, these changes create enormous opportunities for high sustainable growth in the coming years.

St. Maarten is the second largest economy of the Netherlands Antilles with a 20% share of total Gross Domestic Product, approximately 1.2 billion guilders. Although Curacao's 70% share is considerably bigger, St. Maarten's economy has performed much better. Since the end of the economic recession in 2001, the economy of St. Maarten has grown by an annual average rate of 3.8% in real terms, compared to 1.8% for Bonaire, and a marginal 0.3% for Curacao. A preliminary estimate by the Central Bureau of Statistics indicates a real growth rate of 4.5% for St. Maarten for 2007. The island's strong economic growth has been accompanied by a moderate rate of inflation, averaging 1.8%, but increasing to 2.3% in 2007. The higher- than- average inflation rate can be explained mainly by the impact of rising world oil prices.

St. Maarten's robust economic growth contributed to a decline in the unemployment rate, which reached 10.6% in 2007. This rate is better than the 12.0% in Curacao, but Bonaire's unemployment rate was even lower at 7.8%. Youth unemployment still contrasted sharply with overall unemployment. With 26.0% of St. Maarten's labor force in the age group of 15-24 unemployed, the island has the highest rate in the Netherlands Antilles; this figure compares to 24.2% in Curacao and 20.5% in Bonaire.

Tourism is the dominant sector in St. Maarten's economy and can be illustrated in various ways. In the National Accounts, tourism activities encompass the following sectors: Trade; Hotels & Restaurants; Transport, Storage & Communication; and Real Estate, Renting & Business Activities. Gross value added by these sectors comprises 56% of total business activities and 42% of Gross Domestic Product for the island. St. Maarten welcomes an impressive number of visitors each year. The number of stay-over visitors is approaching the 500,000 limit, and the number of cruise passengers has exceeded 1.4 million. In 2007, St. Maarten accounted for 56% of stay-over tourism and 76% of cruise tourism in the Netherlands Antilles. Tourism activities in St. Maarten generate approximately 1.2 billion guilders in foreign exchange revenues annually, representing 64% of total foreign exchange revenues from tourism in the Netherlands Antilles.

However, these impressive figures are somewhat overshadowed by the disappointing visitor growth rates during the last two years. The number of stay-over visitors has remained about the same since 2005, while the number of cruise passengers declined in 2006 and remained almost unchanged in 2007. I think the main explanation for this development is that St. Maarten's utilization of its tourism infrastructure has reached full capacity. Therefore, further growth can be attained only by expanding the tourism infrastructure. Investors seem to believe in the potential for further growth, as evidenced by the continued robust growth in construction activities indicated in a press release from the Central Bureau of Statistics and the Department of Economic Affairs of St. Maarten last month. Hotel room and time share capacity as well as cruise pier capacity are expanding, creating prospects for the resumption of growth in the number of visitors in the near future. Another explanation for the weak growth in tourism may be the weakening economy of the United States, from which more than half of St. Maarten's tourists originate.

In line with the weak tourism performance, the airport and the harbor of St. Maarten also showed weak growth in 2007. Nevertheless, the Princess Juliana International Airport remained the busiest of the Netherlands Antilles airports, with 1.7 million passengers handled, half of all passengers handled in the Netherlands Antilles. With the recent modernization and expansion of St. Maarten's airport, its capacity has increased to 2.5 million passengers per year. Thus, this part of St. Maarten's infrastructure is capable of absorbing the anticipated recovery in tourism growth without any problems.

Harbor growth is expected to resume once the expansion of the cruise pier and the container and freight handling facilities have been completed. I support the vision behind the expansion of the container and freight handling facilities to develop the harbor as a transit point for the distribution of goods to the neighboring islands. This is a step towards the necessary diversification of the economy.

Ladies and gentlemen, I am an optimist who worries a lot. Therefore, allow me now to draw your attention to some of the weaknesses of St. Maarten's economy. The most obvious weakness is the heavy reliance on one principal economic activity, namely, tourism. This characteristic is typical of most small island economies. However, such heavy reliance on a single activity enhances the business cycle and makes the economy more susceptible to external shocks.

Reducing reliance on one main economic activity requires diversification. A small island economy like St. Maarten has, of course, only limited possibilities for diversifying its economy given, among other things, its lack of natural resources, scarcity of land, and small domestic market. This situation should not, however, prevent its policymakers and the business sector from coming up with creative ideas. Enhancing the regional distribution function of St. Maarten is a viable policy to pursue. The current expansion of the harbor and the recent expansion of the airport fully support this policy. I also note the idea of developing an international financial and business services sector on the island, an activity worth further exploration. However, a word of caution is at order: the daunting list of challenges that surround the creation of a world class international financial and business services sector requires a world class regulatory infrastructure and the institutional capacity to implement it, which may prove to be overly ambitious given your resource constraints.

Another major weakness in St. Maarten's economy is that the public infrastructure has not kept up with the expansion of the economy, either physically or socially. The physical dimension can be illustrated by the insufficient capacity of the road infrastructure, which has resulted in structural congestion most of the day. Electricity and water production cannot keep up with demand, causing frequent power outages and water shortages. The increasing amount of solid and liquid waste generated by businesses and the public cannot be processed effectively, which has created a growing burden for the environment. Some examples of the social dimension are shortages of schools, daycare facilities, and social housing, an understaffed police force, and an inadequate penitentiary system. These shortcomings have resulted in a rising crime rate and increasing social imbalances, aggravated by the illegal immigration issue.

Ladies and gentlemen, I mention these weaknesses since they are a good starting point for discussing with you the challenges of the constitutional changes for the future country of St. Maarten. One of the many tasks in preparing the island for its new constitutional status is addressing effectively the observed economic and social imbalances to create a sound social-economic basis for durable balanced growth in the years ahead. With the new status comes the responsibility to govern the new country with a population anxious to reap the benefits of the new status. It is not a question of survival, but a challenge of leadership. Like inheritance, success can be invested productively or not. The question therefore to be answered is whether you are investing in what it takes to continue to build on the existing foundation while using the new status to meet the challenges that will await you as a new country within the Kingdom.

According to the current thinking, St. Maarten is scheduled to become a country on December 15 of this year. However, almost all stakeholders realize that this date is not attainable. I strongly believe that a thorough preparation with all the laws and institutions in place is crucial for a viable start as a country. Until this process is completed, assumption of the new constitutional status is bound to create more issues than it solves for Sint Maarten.

The number of issues that must be addressed before St. Maarten can become a country are quite overwhelming, but they also create unique opportunities to correct the administrative, economic, and social ills on the island with broad technical and financial support from the Dutch government. Given the time constraint, I have selected a few to discuss with you in more detail. These are the design of an effective and efficient government apparatus, sound government finances, and the future of the monetary system and financial supervision.

Let me start with the design of the government apparatus. The present dual layer of government has created numerous inefficiencies, promoted tensions between the central and island administrations, and frequently undermined the effective implementation of policies. Now that St. Maarten is becoming a country and the central government is being dismantled, a unique opportunity is created for the design of a new effective and efficient government apparatus. First, the government tasks must be defined, including the tasks that are taken over from the central government. Second, legislation on which to base the implementation of the government tasks must be prepared and approved. I think current legislation will generally be adequate, complemented with the necessary amendments. Third, the government apparatus must be adequately staffed in accordance with the requirements in the job description of each position. The positions can be filled from the current pool of civil servants of the island as well as from the central government, if necessary complemented with additional training. Positions that remain open should be advertised and filled with external candidates. Current civil servants who do not meet the job requirements and cannot be properly retrained should seek employment in the private sector after receiving adequate redundancy payments. Finally, the principles of good governance should be embedded in the new government apparatus to guarantee effective and responsible spending of the citizens' tax money, efficient high quality services to the public, and effective sanctions for misconduct and abuse.

The second issue that must be addressed and about which I would like to share my views with you is sound public finances. Based on the relatively few occasions that St. Maarten has approached the central government for financial assistance, it appears that it has been able to bring expenditures in line with revenues. However, its budgetary process has been rather murky. The government has operated quite a few times without an approved budget for part of the year. Regular progress reports on the implementation of the budget have been absent. Budget audits have been delayed for years. Although the government is legally not allowed to borrow, St. Maarten has built up a considerable debt, sometimes created because of creative financing constructions. I do not want to suggest that St. Maarten has a monopoly on weak fiscal discipline and deviation from the budget legislation. The other islands and even the central government also have failed in this area. I only mention it as an illustration that a drastic change is necessary in how we approach the public finances in preparing for the island's future status as a country.

In the agreement between the central government, the governments of Curacao and St. Maarten, and the Dutch government of November 2, 2006, better known as the "Slotverklaring", the parties explicitly underscored the importance of starting the new constitutional status with a financially sound position. To arrive at this position, the Dutch government is prepared to take over a substantial part of the debt of the entities. In the new situation, St. Maarten will be granted the long desired authority to borrow but within strict limits. The maximum allowed outstanding debt will be bound to an interest burden rule, prescribing that the interest expenses in the budget may not exceed 5% of the average revenues of the preceding three years. It is still not very clear what this means for St. Maarten. First, the interest burden must be calculated from an estimated revenue base of the country of St. Maarten. Second, the room for borrowing depends also on the loans that remain the responsibility of St. Maarten after the debt relief. But I think it is safe to conclude that there will be some opportunity to borrow.

The debt relief and authority to borrow are bound by strict conditions and control that will substantially enhance fiscal discipline and transparency. First, the current account of the budget may not have a deficit and must be presented in a multi-annual framework. Second, interest expenses may not exceed the 5% rule. Third, the recommendations of the Financial Position working group on improvement of the financial management and control must be implemented as planned. Fourth, the entire budgetary process from preparation of the draft budget to the accountability of its implementation is subject to supervision by an autonomous supervisory authority that will monitor whether the budget rules and other agreements are met, suggest corrective actions in case of deviations, and report its findings on a regular basis.

I can imagine that this new approach to the public finances will be a culture shock for the island. In the beginning, it will create frequent tensions with the supervisory authority; the recent experiences of Bonaire, Saba, and St. Eustatius serve as an example here. It is for this reason that I have always been a strong proponent of a complete debt relief with the simultaneous elimination of the authority to borrow. But be as it may, we have to go through this period of adaptation to arrive at lasting sound public finances, a conditio sine qua non for building up a viable country with a prosperous future for its citizens.

The third issue I'd like to bring forward, and one which I keep particularly close at heart as a central banker, is the future of our monetary system and financial sector supervision in the new constitutional arrangement. The

“Slotverklaring” explicitly states that there will be one central bank for Curacao and St. Maarten responsible for monetary, financial, and integrity supervision based on one set of laws. Rationally considered, I fully subscribe to this statement. It means that the current central bank will be broadly maintained, continuing its good reputation and credibility in safeguarding the stability of the monetary and financial system. I believe this is very important in light of the uncertainties surrounding the numerous changes that will take place on the road toward the new constitutional status of the islands. In addition, with a common central bank, economies of scale can be maintained with regard to the high costs of highly educated staff and modern information and communication infrastructure. Moreover, a common central bank will provide a larger common economic area with broader economic diversification, which may dampen the impact of a shock occurring on one of the islands.

If Curacao and St. Maarten as autonomous countries share a common central bank and currency, they join a monetary union. Since autonomous countries have their own policy responsibilities, a monetary union requires a high degree of policy coordination and harmony to ensure a balanced and effective monetary policy. In addition, a well functioning monetary union requires free movement of goods, services, capital, and labor between the countries. These requirements may be difficult to reconcile with the desire for more autonomy by Curacao and St. Maarten since this desire was the main driving force behind opting for country status. Ladies and gentlemen, I do not like to sound like the rooster who claims credit for the sunrise. We must begin however, with the understanding that strong political commitment is required to give up some of the newly won policy autonomy in the interest of a stable and effective monetary union. If we fail to comprehend this, we will not be able to create a stable monetary environment conducive to growth and stability. We will need to work well together because we have a great challenge before us. It is our own incredible success that we face.

As mentioned, like inheritance the new found opportunities can be exploited successfully or be squandered. Though not far from inconceivable, the inevitable question becomes; if the politicians cannot come to an agreement on a common central bank, what will be the next best alternative? Given the current financial architecture, Curacao will likely continue the current central bank, although its revenue base will shrink as a result of the division of the foreign exchange reserves with St. Maarten and the omission of income from the issuance of banknotes and currency transactions with banks in St. Maarten.

With respect to St. Maarten, it is the question whether it will be able to sustain a full- fledged central bank in a profitable way. The smallness of the economy simply hampers the generation of enough income to cover the operational costs. This means that the central bank will become dependent on government financing, which will undermine its independence and, hence, credibility. In general, a central bank contributes to government revenues, not the other way around.

Actually, St. Maarten does not need its own monetary policy. An own monetary policy and consequently an own central bank is needed only if you have your own currency. Because the US dollar is used so widely, official dollarization is an efficient and feasible alternative. Hence, dollarization eliminates the need for a central bank. In effect, you will elect to distribute the seignorage profit to the public at large rather than having it accrued to the central bank.

The other question which we cannot deflect is:

What about the supervision of the financial sector? Since most financial institutions in St. Maarten are subsidiaries or branches of foreign-based institutions, the central bank of the respective parent company continues to include them in its supervision. Instead of setting up its own supervisory authority, which will suffer from large diseconomies of scale, it would be much more efficient and effective for St. Maarten to outsource the supervision of the financial sector to the central bank of the parent institution.

Ladies and gentlemen, St. Maarten’s economic development can be considered a success story. However, it is accompanied by increasing imbalances in the public domain, which will eventually undermine the sustainability of the current growth. The preparations for the new constitutional status provide a unique opportunity to address these imbalances effectively, helped by financial and technical support from the Dutch government. An efficient and effective government apparatus, sound public finances, a stable monetary system, good governance, and adequate financial sector supervision are essential elements for building a viable and prosperous country. The road towards this goal is marred with obstacles and setbacks.

You have to be careful not to devote too much energy to achieve the new status while neglecting to strengthen the foundation and creating the institutional capacity to govern the new country. Our history is too simple and the facts, as they are commonly understood, not so clear. Governing a country is a matter of no little importance. It requires skills different than those for governing an island territory. Dismissing this may prove to be more disruptive than helpful. You will be leading a nation in a world riven with economic, financial and environmental challenges. What happens anywhere can matter everywhere. But, the people of St. Maarten have proven resilient when the going gets tough, and I am convinced that they are tough enough to get going.

Thank you for your attention.