CENTRALE BANK VAN
CURAÇAO EN SINT MAARTEN

Balance of payments vulnerabilities caused by a widening current account deficit: a way forward. Is dollarization the right approach?

February 8, 2011

The unfamiliar, however simple, is often hard to understand because it requires a slightly different way of thinking. Official dollarization is a case in point. On the occasion of the presentation of the Annual Report of the Central Bank in 2009, I renewed discussion of dollarization as a policy option for the newly to be formed countries Curacao and Sint Maarten. It is hard to conceive of a simpler monetary system than using somebody else's currency. There is no central bank, no independent exchange rate, and more generally no independent monetary policy. Yet precisely because most countries have central banks, people often think about dollarization by using a frame of reference derived from central banking. Today, I will attempt to make a few points about why dollarization may be the right policy response for Sint Maarten and Curacao. I hope I will be able to provide you with a better understanding of the underlying causes that is the basic tenet of my policy proposal.

Discussions about the appropriate exchange rate regime have been going on for a long time. John Stuart Mills once referred to the existence of multiple currencies as barbarian. There is a rationale why countries choose to abandon their own currencies and adopt another currency as their legal tender. By replacing their domestic currencies with the U.S. dollar, countries considering dollarization hope to achieve economic stability and growth. However, dollarization is not a prescription to resolve structural and institutional problems which, in many cases, give rise to crisis conditions in the first place. These problems must be addressed in order for countries to achieve long-term economic stability and growth. Nonetheless, I will argue that as a small open economy in an ever globalizing world economy, we have become increasingly vulnerable to external shocks. To insulate our economy from risks emanating from global crises, the best policy response is full dollarization.

Outline presentation

- Background
- Why dollarize:
  - Vulnerabilities
  - Development balance of payments
- The definition of dollarization
- Benefits and costs of dollarization
- Requirements for successful dollarization
- Implications of dollarization for the tasks of the central bank
- Conclusion

Background (1)

- Constitutional changes within the Dutch Kingdom:
  - Bonaire, Saba and St. Eustatius introduced the US dollar as legal tender on January 1st, 2011.
  - Curaçao and St. Maarten currently form a monetary union with one central bank and a common currency.

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•As you know, on 10 October 2010 the Netherlands Antilles was dismantled. Bonaire, Saba & St.Eustatius became special municipalities of the Netherlands, whereas Curaçao and St.Maarten became autonomous countries within the Dutch Kingdom.

•These changes also affected our monetary system:

-The BES islands introduced the US dollar as legal tender on January 1st 2011.

-Curaçao and St.Maarten form a monetary union with one central bank and a common currency (the NAf. / Caribbean Guilder).

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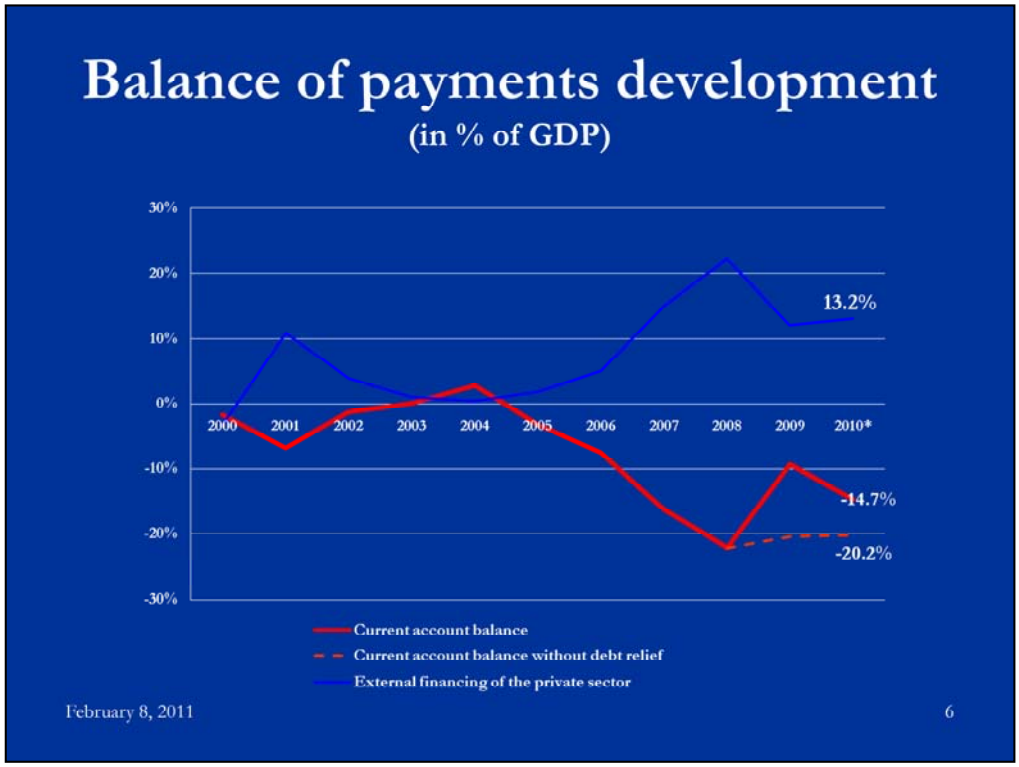
The dismantling of the Netherlands Antilles has increased our vulnerability to external shocks, because of diminishing economies of scale.

•The widening deficit on the current account of our balance of payments also increases our vulnerability, since this deficit is mainly being financed by capital inflows from abroad. A reversal in these capital flows could lead to a balance of payments crisis.

•The last international financial crisis has shown that the ability of small open countries to deal with external shocks is very limited. The demise of Icesave in Iceland has underscored the fact that when small countries are confronted with financial crises, a successful response is greatly dependent on external assistance



•The current account of our balance of payments is traditionally in deficit as the trade deficit cannot be offset by the services, income and current transfer balances. Between 2006 and 2008 the current account deficit expanded rapidly, reaching -22.0% of GDP in 2008.

•In line with the worsening of the current account during this period, net foreign indebtedness of the private sector increased, indicating a drop in net foreign wealth. As shown in this graph, external financing of the private sector peaked at 22.3% of GDP in 2008.

•In 2009, the current account balance improved considerably due largely to the inflow of grants related to the implementation of the debt relief program in the Netherlands Antilles. In addition, net exports of goods and services rose as a decline in imports offset a drop in exports. As a consequence, net foreign indebtedness of the private sector also shrank.

•In 2010, the deficit on the current account rose reflecting largely less inflow of grants related to the debt relief program. Consequently, external financing to the private sector also grew.

•The developments on our balance of payments in 2009 and 2010 were basically masked by the implementation of the debt relief program. Without debt relief, the current account deficit as share of GDP would have reached -20.2% in 2010.

Increased vulnerabilities

(in mln Naf.)

	GDP
CURACAO	5,300
SINT MAARTEN	1,500
TOTAL	6,800

	Total assets
MCB	5,600
GIRO	1,100
RBTT	3,900
BDC	1,400
APNA	4,200
FATUM	900
ENNIA	1,100

OFFICIAL RESERVES (EXCL. GOLD)	1,900

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Our increased vulnerabilities are shown in the following table. Some financial institutions are almost as large as the economies of Curacao and Sint Maarten together. So the question is whether the government and / or the Central Bank can guarantee the repayment of these institution's debt in the case of a crisis.

The development of our balance of payments increases our vulnerabilities…

- Exchange rate adjustment and inflation resulting from a sudden reversal of capital inflows.
- Inability to meet foreign obligations.
- Loss of credit worthiness.

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•A sudden reversal of capital flows would cause our foreign exchange reserves to deplete rapidly, undermining the confidence in our currency.

•An exchange rate adjustment would lead to a surge in inflation as a result of higher import prices.

•The loss of confidence in our currency would also lower the inflow of capital from abroad, while investors would demand higher returns on domestic investments.

•Therefore, the balance of payments vulnerability compels us to consider alternatives, one of which is dollarization.

Our vulnerabilities have been mitigated by the implementation of the investment rule (40% -60%) and the recent implementation of the debt relief.

Scenario without debt relief

	WITH DEBT RELIEF			WITHOUT DEBT RELIEF	
	2009	2010		2009	2010*
Current account	-669.3	-1,080.7		-1,456.9	-1,487.5
Capital account	200.6	90.7		200.6	90.7
External Financing	873.4	970.5		1,373.8	1,301.6
Direct investments	-196.2	198.5		196.2	90.7
Loans and credits	706.3	1,263.2		1,116.1	1,168.7
Portfolio investments	-188.9	-215.6		61.3	-65.6
Change in reserves	-538.9	-116.3		-252.0	-41.3

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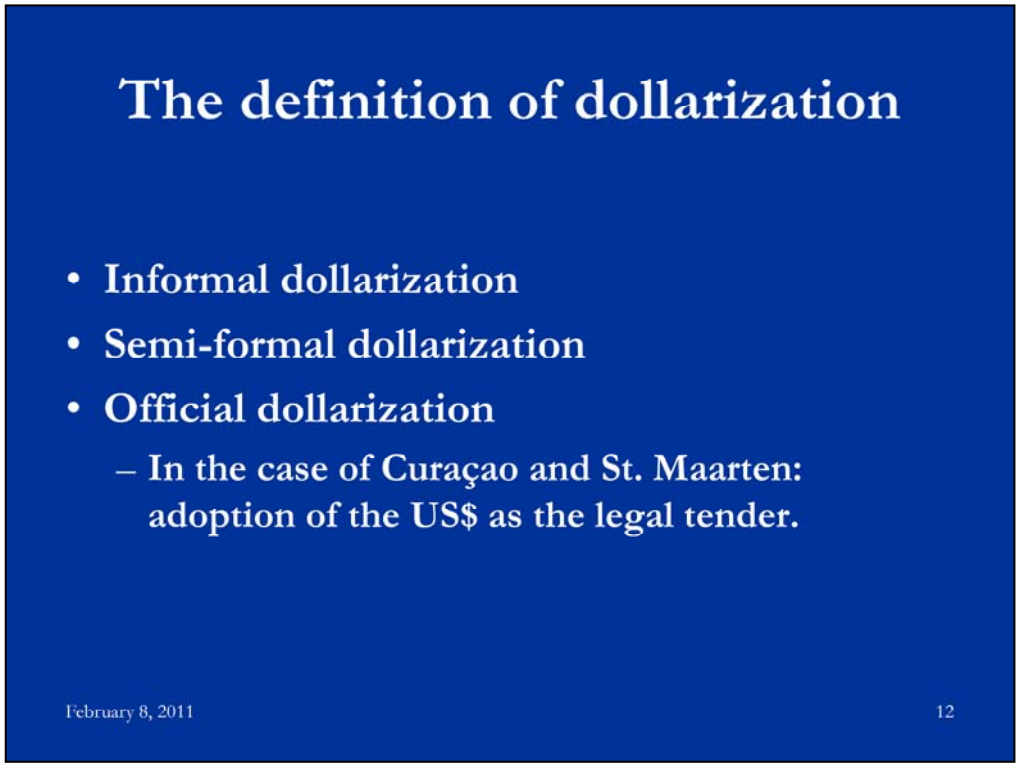
- This table clearly shows the effects of the debt relief program on our balance of payments. Without the debt relief, the deficit on the current account would have been much higher in both 2009 and 2010. In line with the current account, external indebtedness would have increased much stronger without the debt relief. Consequently, the surplus on the balance of payments would have been lower.

Dollarization

Dollarization is recommended in order to:

- Reduce vulnerabilities
- Make economic growth the overriding objective



Dollarization is a fixed exchange rate regime.

There are three forms of dollarization:

1. Informal dollarization: monetary system in which the majority of deposits are held in a foreign currency even though this currency is not legal tender.
2. Semi-formal dollarization: bi-monetary system in which a foreign currency is legal tender but plays a secondary role in everyday payments.
3. Official dollarization: a system in which a country officially abandons its own currency and adopts the currency of another country (anchor country) as its legal tender. The foreign currency is used in all transactions. Under full dollarization , the monetary base changes strictly in accord with changes in market demand for it.

In the case of Curaçao and Sint Maarten full dollarization would entail adoption of the US$ as our legal tender. It should be noted that up to 1954 the islands were in fact dollarized. The choice for the US$ is based on the fact that the United States is our main trading partner and the US dollar is used extensively for international transactions. 82% of our external cash flow is in US$ while 75% of our international transactions are with US$ countries.

Why did countries dollarize?

International experience learns that countries dollarize to promote policy credibility:

- Reduce inflation and bring macro-economic stability (e.g. Ecuador)
- Promote integration with international markets (e.g. El Salvador)

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Countries initiating full dollarization seek policy credibility. Full dollarization requires a serious commitment to maintaining consistent economic policy, and governments must introduce a series of institutional and structural reforms. In the case of Ecuador, full dollarization helped to reduce inflation (and expectations of inflation) and to bring economic stability.
In El Salvador, in contrast, the implementation of full dollarization was part of the process that included stabilization and structural reforms. Authorities there expected that full dollarization will promote foreign investment and integration with international markets.

Characteristics dollarized economies

- The size of the economy is small.
- The economy has a high degree of openness.
- The economy suffered from monetary instability and rapidly expanding inflation.
- The economy was already de facto dollarized.

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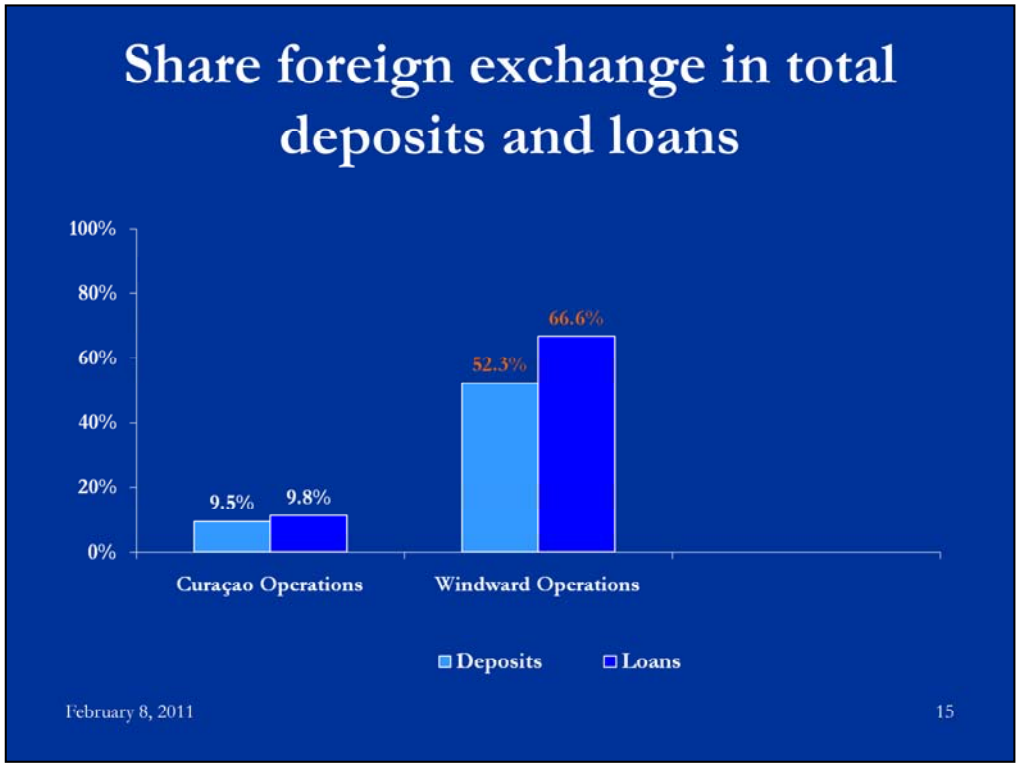
•The first two characteristics are the most applicable to our case.

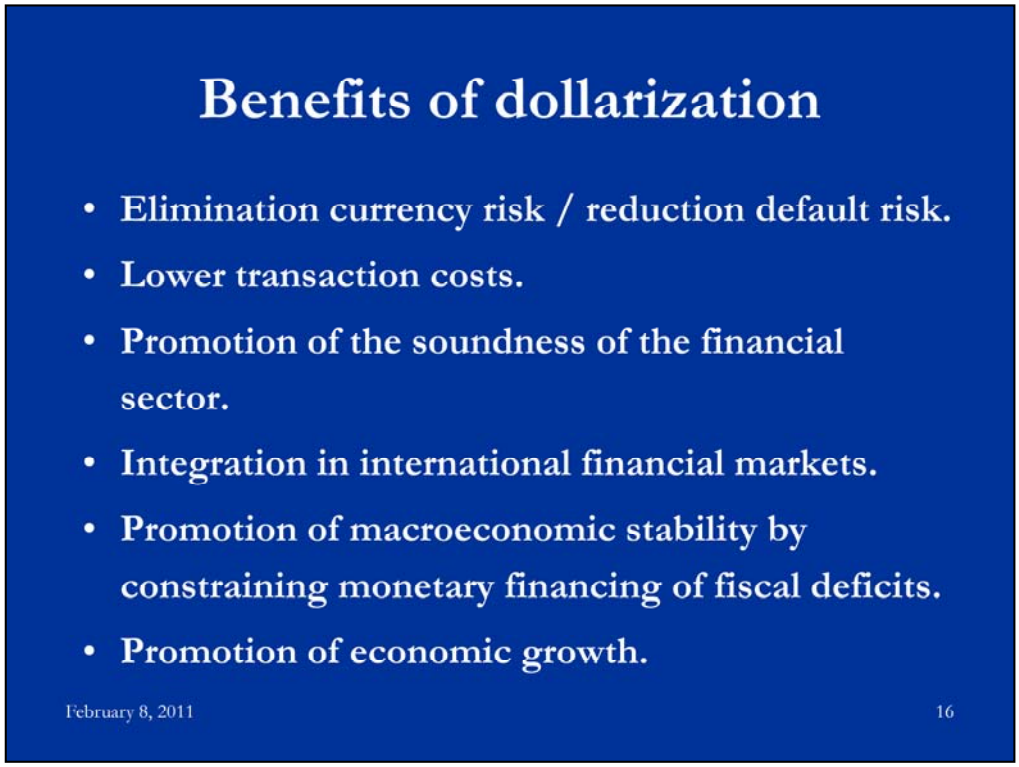
•The third characteristic is not applicable to us yet, but in case of a balance of payments crisis and an exchange rate adjustment, we would find ourselves confronted with monetary instability and soaring inflation.

•The fourth characteristic is the most applicable for St. Maarten since this island economy is already de facto dollarized.



•The island of St. Maarten is already de facto dollarized.

•Meanwhile, the US dollar is widely accepted in Curaçao.



•Dollarization promises a way of avoiding currency and balance of payments crises.

Without a domestic currency there is no possibility of an exchange rate adjustment against the anchor currency and sudden capital outflows triggered by fears of exchange rate adjustments are ruled out. An immediate benefit from the elimination of currency crises would be a reduction of country risk premium, consequently lowering interest rates. In other words, the spread between the interest rates of the dollarized economy and the United States is reduced. Lower interest rates benefit growth by reducing the cost of credit, encouraging investments.

•As a result of dollarization, transaction costs (related to the conversion into foreign currency) are lowered. This would benefit trade including tourism and foreign direct investments.

•Due to the perceived currency risk, local financial institutions might be more inclined to invest in foreign assets. In the absence of currency risk, financial institutions would be more inclined to invest capital locally.

•By adopting the US dollar, the financial system also opens to capital flows. Capital mobility promotes financial intermediation, competition and efficiency among institutions, and helps restore confidence in the financial system. It also encourages integration of the financial system with the rest of the world.

•Although the public finances of Curacao and Sint Maarten are currently closely monitored by the budget supervisor CFT, dollarization would provide an extra long-term constraint for fiscal policy as it eliminates the possibility of printing money to finance fiscal deficits (i.e., the monetization of debt). Hence, the restrictions on changing the money supply can improve policy credibility given our long history of troubled adjustment programs and fiscal deficits.

Costs of dollarization (1)

- No possibility of autonomous monetary and exchange rate policy
  - Limited possibility given the current peg.
  - More dependent on fiscal policies and structural measures.

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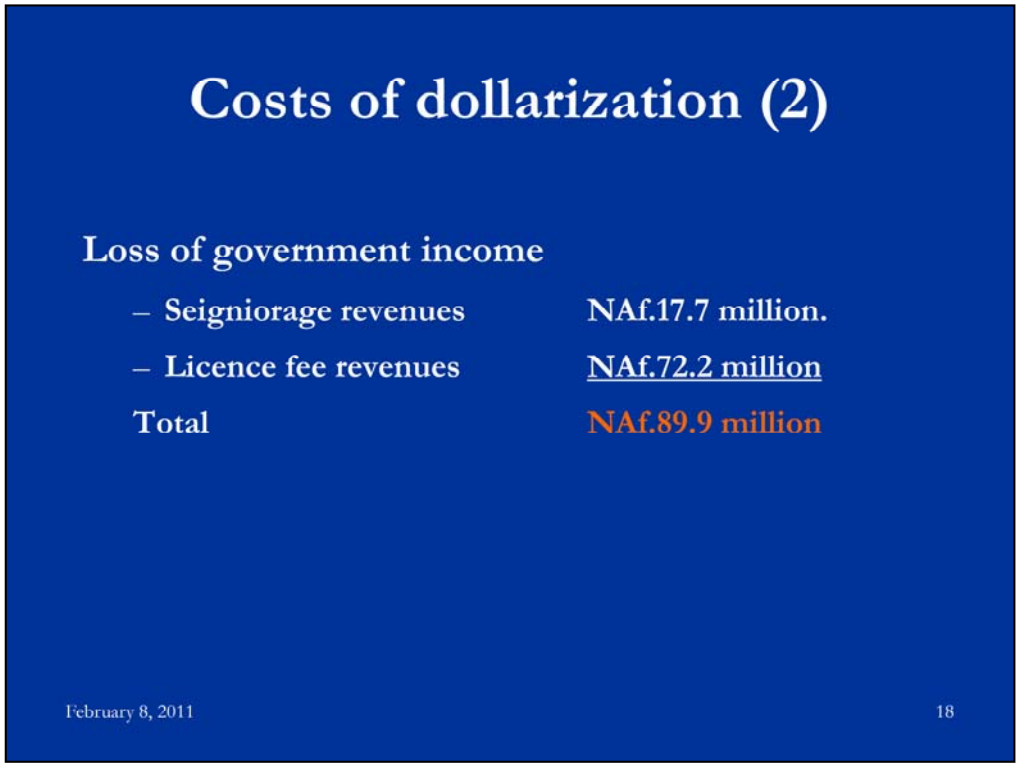
•A dollarized country loses the possibility of having an autonomous monetary and exchange rate policy. However, given our the current peg to the US-dollar, this loss of autonomy is likely to be limited. The recent adjustment periods have indicated that small open economies like ours are limited to fiscal policies and structural measures to remain competitive and promote investments and growth.



•The right to issue a country's currency provides its government with seigniorage revenues, because currency is noninterest-bearing debt. If dollarized, the country will lose its seigniorage revenues. In other words, the monetary authorities would give up future seigniorage earnings stemming from the flow of new currency printed every year to satisfy the increase in money demand. In the case of the Netherlands Antilles the average annual seigniorage revenues over the period 1990 – 2009 were NAf 17.7 million or 0.34 % of GDP.

•It should be noted that seigniorage revenues are expected to decline over time given the increasing use of electronic payment methods and higher costs of printing banknotes and making coins.

•Another important source of income for the government is the license fee revenues. The central bank collects license fee on all transactions between residents and nonresidents. If dollarized, the license fee would disappear. The license fee revenues amounted to NAf. 75.6 million in 2009. The total license fee collected in St. Maarten in 2009 was NAf. 23.1 million.

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However, in the absence of balance of payment constraints, the Central Bank's gold and capital & reserves will become investable funds. Moreover a "Transaction fee" can be charged on all transactions between residents and non residents.

Transaction fee	NAf. 122.2 mln
Return on capital and reserves investments	NAf. 20.6 mln
Return on gold investments	NAf. 30.0 mln
Total	NAf.172.9 mln

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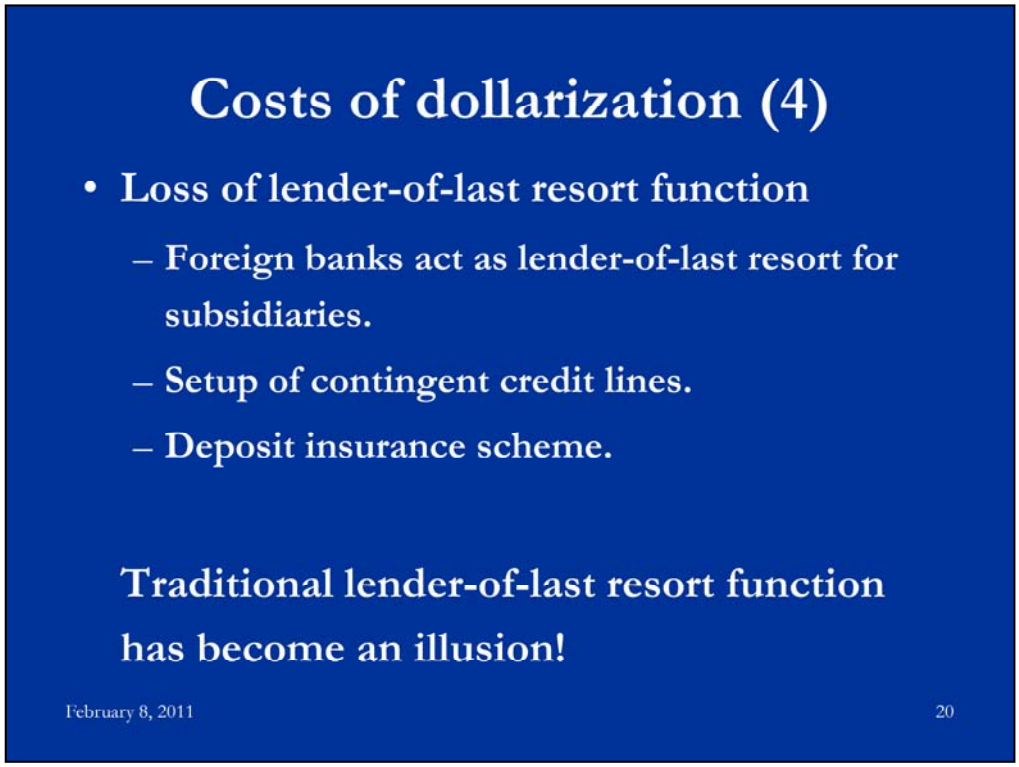
•The license fee could be replaced by a transaction fee on all transactions between residents and nonresidents. A transaction fee of 1% would have resulted in NAf.122.2 million income in 2009. St. Maarten's share in the transaction fee would be NAf.40.3 million.

•Since the balance of payments constraint is no longer binding, the need to hold foreign exchange reserves to maintain the peg no longer applies. Therefore, the Bank's capital and reserves will all become investable funds, thereby preserving the profitability of the Bank. Also the gold reserves which serve now to secure the currency peg can be invested.



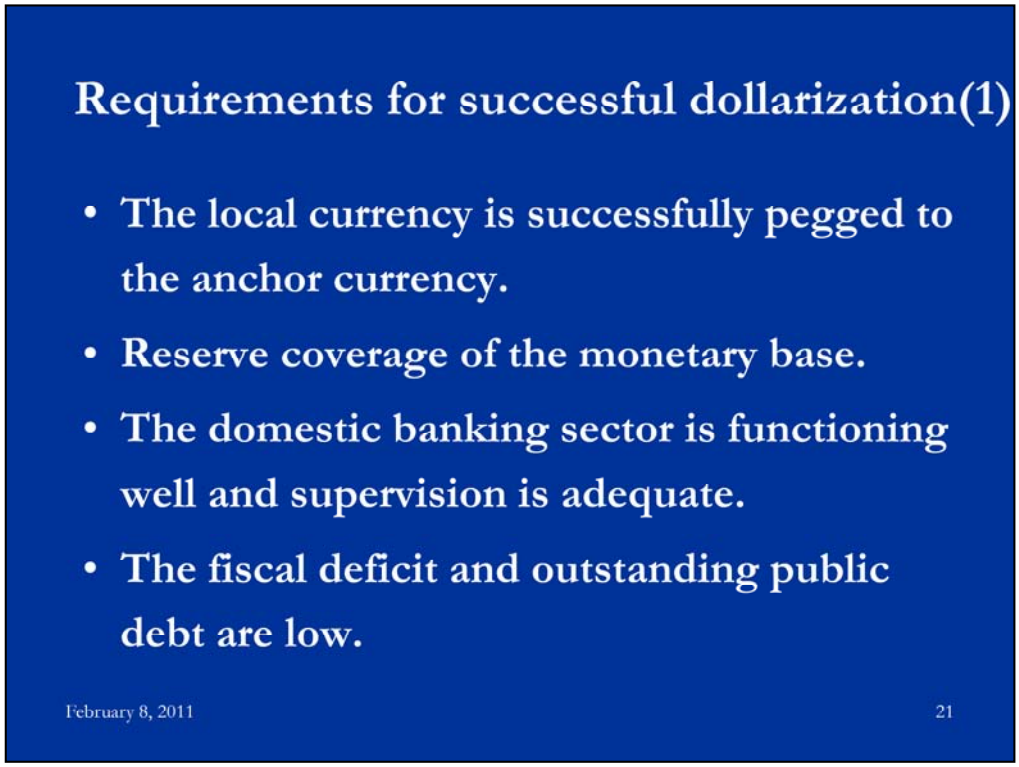
•The ability of a central bank to guarantee the payments system or to fully back bank deposits is known as the lender – of –last resort function. If dollarized, this function will be lost because the credibility of the lender- of- last resort function typically is linked to the ability to print money. In other words, the central bank will not be able to provide funds to financial institutions in trouble. The central bank's function instead will be to maintain the soundness and efficiency of the financial system.

•Foreign banks that own commercial banks in Curacao and / or St. Maarten could act as lender- of- last resort for their subsidiaries on the islands.

•Furthermore, the central bank could set up contingent credit lines with private banks where the funds would be earmarked to remedy bank runs.

•We also need to accelerate the deposit insurance scheme. Aside from providing depositors with added security, the funds of such a scheme, some of which can come from the current reserve requirements, will meet the function of lender-of-last resort.

•However, the international financial crisis has shown us that the traditional lender- of- last resort function has become an illusion as financial institutions have become more integrated internationally and have in many cases liabilities that go way beyond a country's Gross Domestic Product.



•A successful experience with a credibly fixed exchange rate signals that a country has already shown its commitment to a stable currency and has proven its willingness to pay any costs associated with fixed exchange rate regimes. Although Curaçao and St. Maarten do not have a track record regarding monetary policy, the Bank van de Nederlandse Antillen had a good reputation regarding its monetary policy to preserve the external value of the guilder.

•The foreign exchange reserves of the dollarizing country should at least cover the monetary base. This is the case in the Netherlands Antilles where the domestic currency in circulation over the period January – September 2010 was on average NAf.364 million or US$202 million. Meanwhile, the net official reserves (including gold) were over the period January-September 2010 on average NAf 2.2 billion or US$1.2 billion.

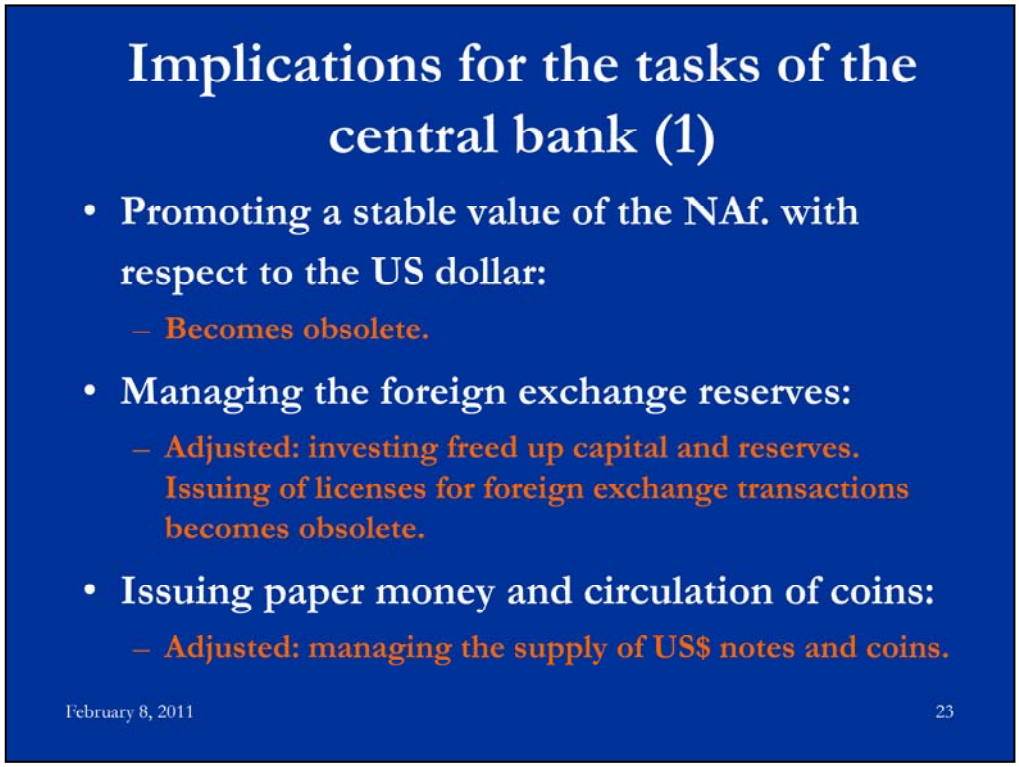
•A weak banking system may experience systemic crises that are fiscally costly and may in the absence of a strong lender of last resort facility lead to financial panic and serious economic distress. Therefore, the existence of a sound, competitive, well-supervised and well-regulated banking system is an important condition for a successful dollarization. This is the case in Curaçao and St. Maarten.

•The sustainability of a fully dollarized economy will depend upon how successfully the government implements fiscal discipline, including tax and expenditure reforms. The smaller the budget deficit and the stock of public debt, the smaller is the risk that dollarization might fail. Given the debt relief program coupled with the enhanced monitoring system through the budget supervisor, CFT, in the context of the constitutional changes, it appears that we have finally set a solid foundation for sustainable sound public finances, which is an important precondition for successful dollarization.

•Dollarization does not stand alone as a remedy for economic maladies. It must be accompanied by a series of structural reforms in order to achieve economic growth and development in the long term. In the absence of monetary policy instruments, external shocks that require a change in real wages will not have lasting effects on the rate of unemployment if the labor market is not flexible. This flexibility may need to take form of downward flexibility of nominal wages, and low hiring and firing costs. This is an area that still needs to be addressed in Curacao and St. Maarten.

•A high degree of capital mobility in a dollarizing economy, as measured by the flows of inward foreign direct investment, increases the likelihood that dollarization will be successful. Both Curacao and St. Maarten have experienced a considerable increase in foreign direct investments recently. However, several aspects of our investment climate (including red tape) need to be addressed in order to make it more attractive to foreign investors.

•Finally, successful dollarization requires a high level of public support.



•Dollarization has many implications for a country's central bank, the main one being the elimination of autonomous monetary and exchange rate policy. Countries can opt to completely abolish the central bank (as was the case in Panama) and create separate agencies to take care of the supervisory and regulatory tasks previously carried out by the central bank. Another alternative is to maintain the central bank with all its traditional tasks, except for monetary supervision. The latter alternative has been chosen by the majority of dollarized countries.

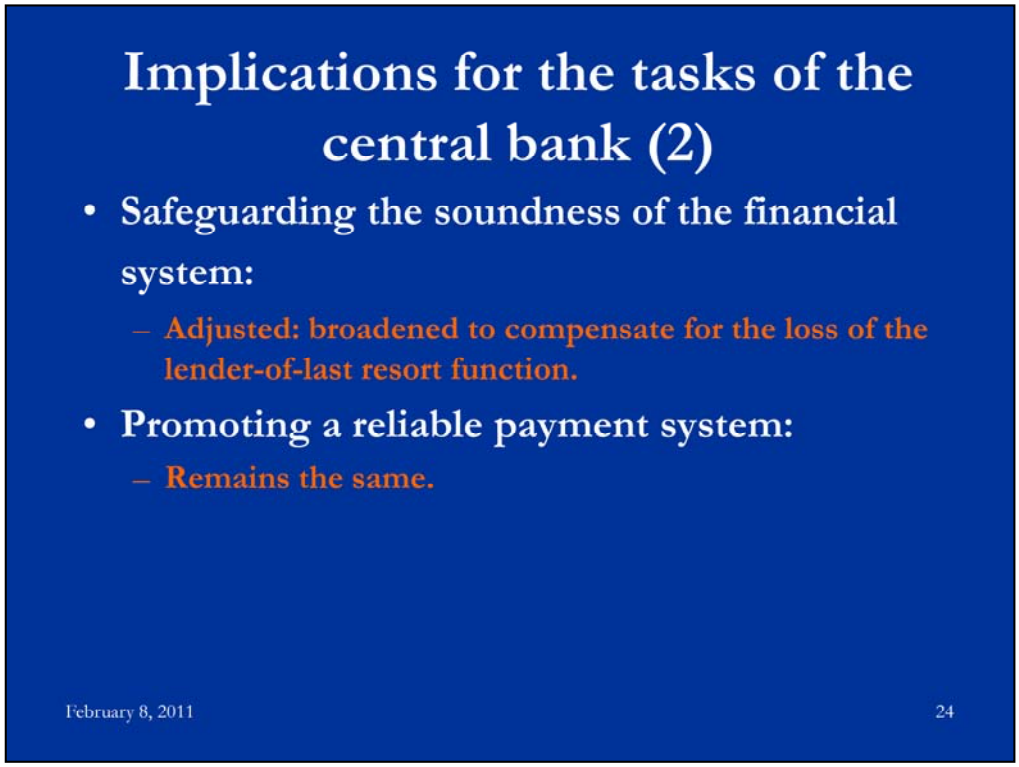
•In the case of Curaçao and St.Maarten, it is recommended that the central bank is maintained. This would ensure that the loss of economies of scale is minimized, while the expertise and good reputation that have been built up over the years are safeguarded. The implications for the different tasks of the central bank would be as follows:

-Promoting a stable value of the NAf. / Caribbean guilder with respect to the US dollar: this function would become obsolete as the peg to the US dollar seizes to exist.

-Managing the foreign exchange reserves of Curacao and Sint Maarten: this function would be adjusted. Without the requirement of maintaining a minimum amount of foreign exchange at low / neglectable risks, the bank will have more flexibility to invest its capital and reserves. The issuing of licenses for capital transactions between residents and nonresidents becomes obsolete.

-The issue of paper money and the circulation of coins: this function would be adjusted.

Instead of issuing NAf. / Caribbean guilders, the bank would be in charge of guaranteeing the ample and timely supply of US dollar notes and coins.



-Safeguarding the soundness of the financial system in Curacao and Sint Maarten: the bank would continue its supervision of financial institutions in order to guarantee the funds of depositors and other creditors with these institutions, and the soundness of the financial sector in general. In addition, the supervisory task would be broadened to compensate for the loss of the lender-of-last-resort function.
-Promoting a reliable and efficient payment system: this function would remain the same.

Implications for the tasks of the central bank (3)

- Acting as the government's banker
  - Remains the same.
- Serving as one of the government's main advisors on financial and economic affairs
  - Adjusted: broadened as fiscal policy and structural measures will become crucial.

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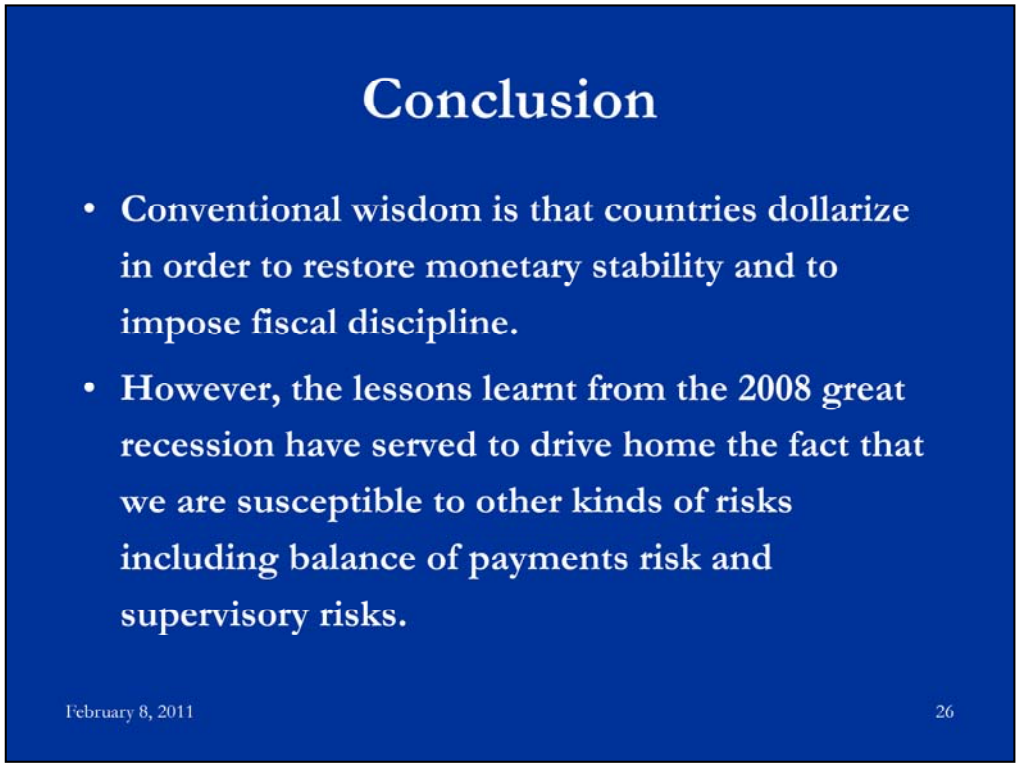
-Acting as the government's banker: the bank facilitates payments between the government and to the public, acts as the government's borrowing agent, and provides the government with cash advances (if necessary). This function would remain unchanged after dollarization.

-Serving as one of the government's main advisors on financial and economic affairs: this task would be broadened after dollarization because the loss of autonomous monetary policy increases the importance of adequate fiscal policy and structural measures to steer the economy.

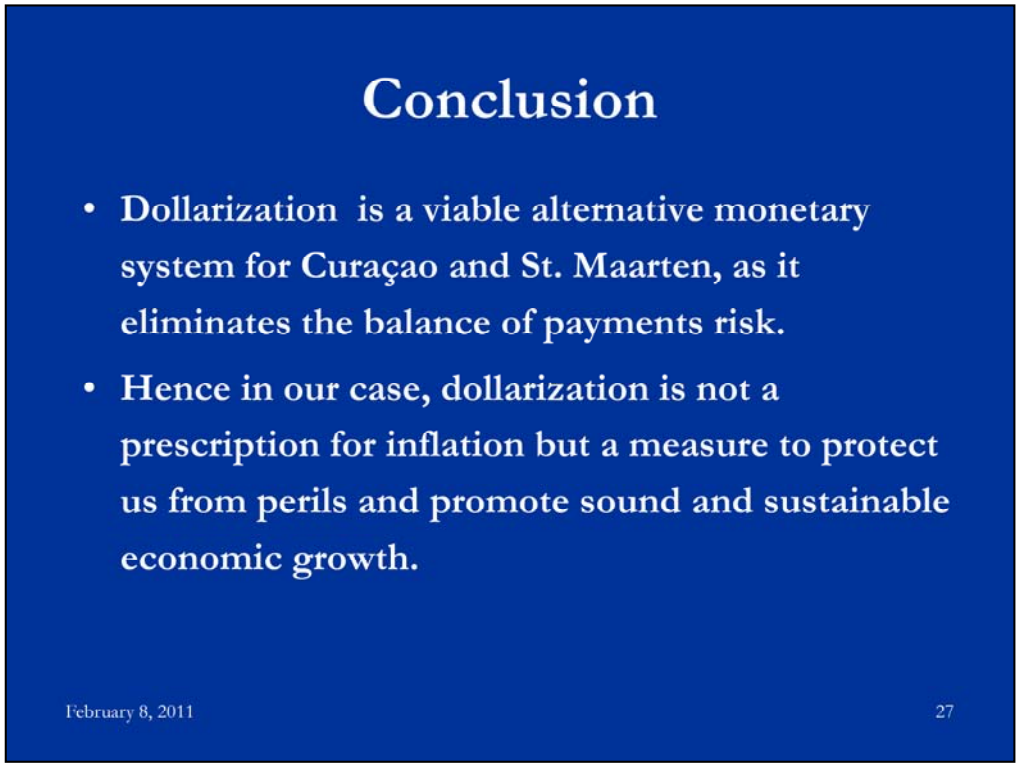


Countries tend to dollarize in order to restore monetary stability and impose fiscal discipline. Due to globalization, small open economies have become increasingly vulnerable to external shocks.

The 2008 global economic crises has shown us that countries are very susceptible to other kinds of risks including balance of payments risk and supervisory risk.

In our case, it should be noted that the investment rule insulated our economy from the crisis in 2008. Also the implementation of the debt relief program masked the situation on the current account of the balance of payments.

Our commercial banks' balance sheets are larger than our own economy. As a consequence, a banking problem (as a result of for example cross border transactions) could become a macroeconomic problem.



Due to globalization, small open economies have become increasingly vulnerable to external shocks. The past twin crises (commodity and financial) have compelled us to look for ways and means to insulate our economy from external shocks or at least to smooth out of the amplitude of the economic cycles emanating from abroad. Dollarization might be the right response.

So much of barbarism still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own.

John Stuart Mill (1848)

Thank you for your attention

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