The Netherlands Antilles and the global economy: challenging times for policy makers

Introductory remarks on the presentation of Mr. Henk Brouwer, executive Director of De Nederlandsche Bank by Dr. Emsley D. Tromp, on the occasion of the closing ceremonies related to 175 years of central banking in the Netherlands Antilles.

Ladies and gentlemen,
It is for me a great pleasure to introduce to you Mr. Henk Brouwer, executive director of De Nederlandsche Bank, who is our keynote speaker today. Mr. Brouwer will share with us his views and experiences on some of the defiant global issues which, given the extreme openness and vulnerability of our economy, represent a real challenge for policy makers in the Netherlands Antilles.

Mr. Henk Brouwer is a good friend of the Netherlands Antilles. Our working relation with Henk dates back from the time he was Treasurer General at the Ministry of Finance in the Netherlands. Before joining De Nederlandsche Bank, Mr. Brouwer was also a member of the executive board of the ”Nederlandse Phillipsbedrijven”. He combines experiences in both the private and the public sector and is therefore an excellent speaker to address us on how global changes are likely to impact our economy.

Ladies and gentlemen, it is well-known that a flexible open economy is better able to withstand or benefit from global developments. Anticipating on the presentation of Mr. Brouwer let me briefly mention some of the daunting issues on the domestic front. There are strong indications that the economic recovery that started last year, will continue in 2003 and the year ahead. The main factors underlying the positive economic growth are net foreign demand and domestic demand. Mr. Brouwer will shed some light on global issues that can affect the developments in net foreign demand. Domestic demand will continue to be fueled by increased consumer spending and an expansionary fiscal policy, whereas investment spending is lagging behind. Obviously, this kind of economic growth is not sustainable over the medium and longer term. It is in this context that the “Debt Commission” formulated (six months ago) a set of recommendations to address some of the domestic imbalances that weaken our capacity to withstand or benefit from global developments.

To fully benefit from global opportunities or to be able to face global challenges, the Netherlands Antilles must continue on the path directed at restoring order in its public finances. The government already started to take steps to implement some of the recommendations of the “Debt Commission”. The recently adopted budget of the island government of Curacao and the draft budget of the central government, for example, are in line with the recommendations. I like to reaffirm, however, that the full implementation of the recommendations of the “Debt Commission” is a necessary condition to restore confidence in public finances and, consequently, promote sustainable economic recovery.

There are also some other issues at stake that weakens our position in the global economic environment. We must continue on the road of flexibilization of the labor market, privatization of government- owned enterprises, and the liberalization of the local goods market, that is, the elimination of market protection. In addition, considerable efforts must be directed at strengthening our educational system and our social policies. The agreement reached between the Dutch and Antillean governments in that respect is an important first step in the right direction.

If we manage to solve these domestic imbalances and market distortions, our economy will be in a better position to face some of the global threats and opportunities awaiting us. These global threats and opportunities will be addressed by Mr. Brouwer. Henk, I am sure that your views and experiences will help us in the design and implementation of the correct policies in this increasingly integrating global market.

Ladies and gentlemen, I would like now to invite Mr. Brouwer to deliver his address.

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Speech by Mr. Brouwer, Executive Director De Nederlandsche Bank NV at the closing of celebrations of the 175th anniversary of the Bank van de Nederlandse Antillen.

Introduction
Bon dia. It is a pleasure to be here and to deliver a speech on the big world economy and the perspective of a small group of beautiful islands. Moreover it is an honour to do so at this special occasion. Some 175 years ago, King William I also had his mind on the global economy. He foresaw the importance of international developments for these islands and initiated the foundation of the Antillean Central Bank to promote trade and reform the prevailing currency system. Now, so many years later, we can see that the Antilles have lived up to this challenge. With its extensive transport links, open economy, and many foreign visitors, the Antilles are highly integrated in the global economic system.

The independent Antillean Central Bank has played an important role in promoting this international integration. It has successfully preserved the external stability of the Antillean guilder, thereby greatly reducing uncertainty for trade and investment with the rest of the world. In addition, it has promoted the efficient functioning of the financial sector, which is an important part of the Antillean economy. By competently administering these tasks, it has supported a stable economic environment that is necessary for an economy to prosper. Finally, the Bank has an important advisory role in economic policy discussions. By offering a professional and independent view on the economy, free from political bias, I believe that the Bank is of great value for the Antilles.

Today I will focus on a number of key issues that policymakers in both large and small economies are facing. For a small open economy like the Antilles, international economic developments have a great influence on domestic economic conditions. First, I will discuss developments in the US and their likely impact on the Antillean economy. Next, I will turn to economic developments in Japan and the current European policy discussions, which are also relevant for those in the Antilles. Subsequently and finally, I will focus specifically on developments in the Antilles. The vulnerability of this small open economy has triggered a debate on the extent to which closer integration with other economies is beneficial. These debates focus in particular on the relationship of the Antilles with the Netherlands and the European Union.

Economic Developments United States
But first, I would like to discuss the latest developments in the United States, which are crucial to the near term outlook of the global economy. The outlook is good... and better than it has been in quite a while. Indeed, there are promising signs of a firm upturn in the United States. Third quarter growth figures have been very impressive, and reflect the resilience and dynamism of American economic activity. This bodes well for the economic prospects of the world and indeed for the Antilles. Tourism will benefit from America's greater purchasing power and willingness to spend. Furthermore, the Latin American and Caribbean regions will benefit from greater demand in the US.

However, the recovery has been achieved through unprecedented policy stimulus. The Federal Reserve has aggressively lowered interest rates, while the Bush administration has sharply reduced taxes and sharply raised spending. The response of policy makers was timely and forceful, preventing a sharp downturn. But the strong policy reaction also entails risks. We are not out of the woods yet. Two issues clearly stand out: the deterioration of public finances and the large current account deficit.

First, the deterioration of government finances. Tax cuts and increased spending have turned a surplus of 1S% GDP in 2000, into a deficit of 5% GDP this year. Forecasts for 2004 by the OECD indicate that the deficit will remain at this level, while the structural deficit will also amount to 5% GDP. Such a fast deterioration of government finances is unprecedented in modern American history. In light of future expenditures on pensions and health care, this public deficit needs to be reduced. Such a policy would also serve to limit the current account deficit. By casting this adjustment in a medium term fiscal consolidation framework, the authorities can attain this in an even-handed way. It is self-evident that this entails difficult choices for US policy makers. Due to the rising costs for defence, ageing and social security, priorities have to be set. After the booming nineties, this is a sobering experience. Moreover, it is an experience shared with policy makers in Europe and the Antilles.

The second issue is the current account deficit. Currently, the United States is borrowing from abroad to finance its expenditures on consumption and investment. With the deficit now at 5% of GDP, it is substantially higher than the previous peak at 3.5% of GDP in 1987. As with public finances, this deficit has surged in recent years. In 1998, the current account deficit was less than a third of what it is now. And, given that the US is again leading the global economic cycle, the external deficit is likely to continue to grow. Both economic theory and history tell us that this is not sustainable. We do not know precisely when a correction will occur, just that it will. The challenge for policy makers is to promote a smooth adjustment.

In the 1980s, a gradual reduction of the deficit was achieved through policy co-ordination with Japan and Germany. These countries used fiscal and monetary tools to complement exchange rate changes with domestic demand stimulus, so that the imbalance could be wound down in an orderly fashion. But due to their own financial constraints there is currently no scope for budgetary stimulus in Europe and Japan, even if we would still want to do so. Indeed, historical experience has taught us that the stimulus led to a structural deterioration of government finances. Afterwards, these deficits could only be reduced with great difficulty. Thus, on the basis of the large US need for foreign financing and the limited scope for demand stimulus elsewhere, the risks of a sudden correction may now be judged to be higher. Such a scenario could trigger a downward spiral of dollar depreciation, capital outflows, higher risk premia and lower stock prices. This would not only be a problem for the US, but also for other economies, including the Antilles. The Antillean guilder has been fixed to the dollar since 1971. Any volatility of the dollar therefore also translates to volatility of the guilder, causing uncertainty for trade and investment. Furthermore, bond rate increases in the US would be passed on to the Antilles further aggravating the current debt problem. And this could come at a time when, unfortunately, growth performance is already weak.

Economic developments Japan

Meanwhile in Japan, the economy is showing signs of growth. In the third quarter the economy expanded by 0.6%. For the first time since 2000, investment growth has turned positive. This signals a renewed confidence of Japanese businesses in the future. Although this is promising, some caution is necessary as we have seen false dawns before in Japan. The Japanese economy still suffers from a complex mixture of problems. It is an economy plagued by overcapacity, weak banks and deflation. Since these problems can not be resolved with macroeconomic policy tools, a solution will be time consuming. Thus, it is difficult for me to be overly optimistic about the Japanese economic outlook. And hiccups are likely to occur along the way. As an example, last month the Japanese authorities rescued a big regional bank to prevent it from collapsing. Such is the fragility of the financial system that banks are generously nursed in order to avoid triggering banking runs and financial instability.

Recapitalising banks is costly however, which brings me to another problem that has been plaguing Japan since the mid nineties. Due to the low economic growth, tax revenues have consistently been lower than projected. Unfortunately, government expenditures have not been cut accordingly. As a consequence, Japan now has one of the highest government debts of all industrialised nations at more than 150% of GDP. Such levels of public debt are usually associated with war periods. If we take into account the possible expenditures on recapitalising the financial sector, as well as those related to population ageing, which is more advanced in Japan than anywhere else in the world, the picture becomes even more disturbing. Future projections for government debt show an increasingly fast deterioration of Japan's public finances. According to the OECD, government debt will rise to 194% of GDP in 2008. Clearly, this trend is unsustainable.

Policy makers in Japan should seize the current window of opportunity that has been given to them by the economic upturn. Encouragingly, the re-elected Koizumi government has outlined bold plans for privatizations. Furthermore, it seems more willing to sort out the weak banking system. Hopefully, it will also draw up a medium term fiscal sustainability framework. So far, the Japanese government has not met any difficulties in financing its debt. Interest rates are low and domestic investors are eager to buy government bonds. But time is running out for Japan. If domestic investors would lose confidence in the value of government bonds, pressures would become acute. As long as government debt keeps rising, the risk of such an event increases. By drawing up a plan for fiscal consolidation, and implementing it, the government can safeguard the confidence of its creditors. This is a point that also holds for the Antilles, particularly considering the weaknesses in the past on the implementation of fiscal consolidation plans. I will return later in my speech to this.

Economic developments Europe

Turning to economic developments in Europe, we are still looking for more definite signs of economic recovery. Structural rigidities, especially inflexible labour markets and high tax burdens, are frustrating growth. These clouds have a silver lining to the extent that there is now recognition that reforms are necessary. For example, both France and Germany are tackling underlying weaknesses in their economies. After a fierce public debate, legislation for pension reform and flexibilisation of labour markets has been enacted. In the Netherlands, structural reforms also dominate the political agenda. From one of the fastest growing economies in Europe, the Netherlands has turned into a laggard. In a typically Dutch manner, the government, employers and labour unions have agreed to freeze nominal wages for two years. Furthermore, deep spending cuts have been decided on to keep public finances in order. Needless to say, this has required painful decisions. But in light of future government liabilities, it is prudent to act now rather than later.

Regarding the acceding countries, the prospect of ten new member states joining the European Union next year poses interesting policy challenges. To join EMU, these countries need to adhere to the well-known Maastricht criteria. Here, two issues stand out. The first issue is the criterion of participation in the exchange rate mechanism ERM-II, which requires countries to keep their exchange rates within a band of 2.25% around a central euro rate. This is a useful requirement ahead of euro introduction. Maintaining a stable exchange rate will stimulate these countries to implement appropriate stabilisation policies and should promote economic convergence towards the euro area. Moreover, it will help to assess whether each individual country is ready for a permanently fixed exchange rate regime. After a successful term of at least two years inside ERM-II, they should be ready for the euro. In the coming years, it will be interesting to see how the acceding countries will approach this issue. Some may want to join ERM-II immediately; others may want to wait to allow their economies more time to adjust.

The second issue is the ceiling on budgetary deficits of 3% of GDP. For the larger acceding nations, Poland, the Czech Republic, Slovakia and Hungary, this is a big challenge. Currently, all have budget deficits of around 5% of GDP. Since these countries are in a process of transition, there is a high demand for expenditures on infrastructure and human capital. At the same time, however, they need to bring their finances in order. Again, spending priorities will have to be tightly set, to set the stage for euro entry and to put public finances on a sustainable path. Indeed, the requirement for sound budgetary policies does not stop after EMU entry.

This brings me to the debate about the Stability and Growth pact. Let me restate here that this pact is vital to a proper functioning of the European Monetary Union. It increases the credibility of our common currency and facilitates a balanced development of the euro area economy. Therefore, it is regrettable that the excessive deficit procedure has been discontinued for Germany and France. The difficulties we now see in containing budget deficits cannot be simply attributed to the economic downturn. Prudent budgetary policy requires discipline in both good times and bad times. As the saying goes: “you should repair your roof when the sun is shining”. However, many EU countries were hesitant to put their finances in order during the good times. Owing to this, problems now materialise at a time when the economy is going through a difficult patch. This reaffirms the time-honoured wisdom that postponing a necessary measure generally only serves to increase its pain. Prudent budgetary policies are required during all stages of the economic cycle. This also holds for the Antilles to which I will now turn.

Economic Developments in the Antilles

The Antillean economy has struggled for some time now. In part, this reflects the weak global business cycle. Its geographical location in a region of the world where political turmoil is nearby, such as in Venezuela, serves as an extra obstacle to growth. Recent economic developments have been more favourable though. With the upturn in the United States and presumably Europe, the Antilles can hopefully consolidate the nascent economic growth in the coming years. It has to be clear that economic growth is a function of structural adjustment efforts and the current upturn in the economy is still too fragile. Therefore, the challenges that face the Netherlands Antilles are no smaller than those elsewhere.

As in Europe, structural weaknesses stand in the way of a truly robust economic recovery. Liberalisation of labour markets and consolidation of public finances are necessary prerequisites to lift the economy towards higher growth. As in Europe, opposition to such measures is fierce. Public debate focuses on the urgency and necessity of spending cuts. As in Europe, this tends to be a drawn out process. But recognition has grown among policy makers and the wider public that corrective measures are necessary.

Apart from the parallels, there are also some important differences. As a small and open island economy, the Antilles are vulnerable to external shocks. This is because its small economic size limits the scope for diversification. Moreover, the benefits from economies of scale are limited. This vulnerability increases the importance of economic flexibility, including in terms of macroeconomic policies. Apart from these economic characteristics, another difference stands out. As I said earlier: “you should repair your roof when the sun is shining”. Given weather conditions here, it would seem there is ample opportunity to fix the roof. Nevertheless, the necessary construction work has not progressed in recent years, to put it mildly, even though the urgency for budgetary reform is arguably greater on the Antilles than elsewhere. Public debt is already nearing 100% of GDP. Though public finances have not yet deteriorated as far as in Japan, the debt dynamics are at least as worrisome, given the Antilles’ lower savings rate, less diversified economy and its less-developed financial sector. The report of the commissie schuldenproblematiek estimated that in absence of corrective action, public debt will rise to 250% of GDP in 2010. This is unsustainable and would lead to financial instability. I would echo the warning given by the report of the commission on debt difficulties in the Antilles and urge the authorities to draw up -- and implement -- a plan on fiscal consolidation.

I would also like to echo the message from the first president of the European Central Bank, Mr. Duisenberg. In his speech earlier this year, he also stressed the need for budgetary reforms. In doing so, he also emphasised the importance of doing so in a medium term fiscal framework. This should smooth the fiscal impact of measures to restore sustainability of public finances. It would prevent a re-occurrence of the damaging impact of past stop-and-go fiscal adjustment policies. Moreover, it would inspire confidence in the debt servicing capabilities of the government. Needless to say, this is a difficult challenge as it limits the policy options available to politicians. The recent difficulties regarding the implementation of the Stability and Growth pact in Europe provide ample illustration of this.

The Antilles and the European Union

Given these challenges, it is perhaps inevitable that discussions have flared up about the political and financial relationship between the Antilles and the Netherlands. On both sides of the Atlantic, there is a willingness to review the current relationship and to work towards a different association of the members of the Kingdom. Currently, there is a feeling that we are drifting apart. While the Netherlands is moving towards ever-closer integration with Europe, the Antilles wonder about their place in the world and within the Kingdom.

It is not surprising then, that among the proposals for reform is the possible entry of the Antilles to the European Union. This could be achieved through the so-called, ultra periphery area status for the islands. In short: the UPG-status. Current examples of extra-European areas that have such a status are: the Azores, Madeira, the Canary Islands and the French overseas departments. To review the options and issues concerning EU-entry of the Antilles, it is perhaps enlightening first to explain the present institutional arrangement.
Currently, the relationship between the Antilles and the Netherlands is governed by the so-called Statuut. The Statuut covers all common responsibilities and competencies for the members of the Kingdom of the Netherlands. The three countries or constituent parts of the Kingdom -- the Antilles, Aruba and the Netherlands -- are of equal status. This gives the Antillean islands a fair amount of autonomy. In light of its distinct geographical location, and the distinct set of policy issues and challenges it faces, such policy autonomy is desirable. To give just an example: there is an independent central bank for these islands, the Bank Nederlandse Antillen. The Antilles consequently have their own currency and banking supervision.

However, this contrasts sharply with the current UPG-members of the European Union. Their status also brings with it many obligations. All UPG-members have ceded considerable autonomy to their capitals or Brussels. In this sense, the UPG-entry of the Antilles would be unique, as it is without precedent that such an autonomous region would enter under this regime. In principle, the entire body of European law would have to be incorporated in the Antilles. Exemptions from this principle would have to be negotiated between the Antilles, the Netherlands and the other member states. Consequently, it remains to be seen whether and how policy authority has to be shared between the Antilles, the Netherlands and Brussels in case of EU entry. In all, much is still uncertain regarding the terms and policy consequences of a possible formal closer relationship to the European Union. It is for politicians and ultimately the people of the Antilles to decide whether and how they would like to proceed with EU-integration and whether this is feasible in the existing frameworks.

Nevertheless, I can highlight some issues that are relevant for the context of this discussion. First, there are clear benefits attached to closer relations with the EU. It would allow the Antilles better access to European markets, and would upgrade legislation concerning a wide range of topics. Furthermore, EU-entry would allow for peer pressure and reviews on economic issues, promoting responsible government. That said, apart from the discussions regarding policy autonomy, it is important to also highlight the possible monetary consequences. For example, all present UPG-members now have the euro as their currency. It is therefore uncertain whether the Antilles would be able to keep their current monetary arrangement after EU-entry. In light of the theory of optimal currency areas, it is not self-evident that pegging to the euro is optimal for the Antilles. This depends on the present and future trade relations with euro or dollar-oriented economies. Therefore, the benefits and drawbacks of switching to the euro would have to be weighed carefully.

Conclusion

Ladies and gentlemen, let me conclude. I have offered you a broad picture of the global economic environment. As you have seen, these broad global developments touch us all. Furthermore, policy challenges are not very different for many countries. In the Antilles, as well as in the US, Japan and Europe, the common thread is the deterioration of public finances in a difficult economic climate. Finally, I have touched upon the issue of the closer links with the European Union for the Antilles. I am confident that the Antilles will find a comfortable and suitable new framework within the Kingdom and possibly also in the EU. I thank you all for your attention.