View on the EURO from a Netherlands Antillean perspective. The Euro, a window of opportunity

Speech presented by Drs. A.G. Romero, Director of Financial and Economic Affairs, at the ABN AMRO conference
May 27, 1998

Opening remarks
Commissioner of Finance of the island of Curaзao, Mr. Ys, captains of industry, distinguished guests, ladies and gentlemen, good afternoon. I would like to start by thanking the ABN AMRO Bank for organizing this seminar. I am convinced it will provide some answers to questions many of you may have with respect to the use and implications of the EURO. The first speaker gave an overview of the new currency and the opportunities it will provide. I will present to you my thoughts on the effects of the introduction of the EURO, and in particular, its effects for the Netherlands Antilles. I am very pleased to have this opportunity, since it will enable me to clarify some issues surrounding the EURO.

First, I will give a very brief overview of the start and various stages of development of the Economic and Monetary Union and the EURO, being the ultimate stage of the European economic and monetary integration process over the past 40 years.

Next, I will discuss with you the determinants which make a currency (in fact: any currency) weak or strong. In the design of the soon-to-be established European Central Bank (ECB) and the European System of Central Banks (ESCB), European policymakers have tried to institutionalize several aspects of central banking. They did this to minimize the possibilities of creating a weak currency because of institutional flaws such as political dependence, incompatible fiscal policies or multiple goals. However, market forces are expected to be much more influential in establishing the strength or weakness of the new currency. As a result, the strength or weakness of the EURO is something that will prove itself in day-to-day practice.

In perhaps the most appealing part of my presentation, I will finally describe the effects of the introduction of the EURO for the Netherlands Antilles. I will present two scenarios: one based on the assumption of a strong EURO, the other on the assumption of a weak EURO.

The making of EMU and EURO
The process that led to the EMU and the EURO began in 1952, when six European countries -- Belgium, France, Germany, Italy, Luxembourg, and the Netherlands -- joined to form the European Coal and Steel Community. In 1957, these countries established the European Economic Community (EEC) by signing the Treaty of Rome. This treaty, which entailed a customs union and a common agricultural policy as main elements, is generally regarded as the starting point of what is now known as the European Union. The EEC was later abbreviated to the European Community (EC), when other European institutions (like Euratom and the ECSC) were incorporated.

With the passing of time, the EC increased both in size, as measured by the number of Member States, and in depth, as measured by the growing influence of European directives within the community. By 1986 the EC consisted of 12 member countries. These 12 countries convened in Maastricht (1991) to sign the treaty on the European Union. This treaty extended the powers of European institutions, formulated criteria for common policies, and included an agreement on the concept of a monetary union (EMU) and a common currency.

This latter aspect of the so-called Maastricht Treaty defined three stages to reach a European Monetary Union. Stage one had already started in 1990 with the liberalization of European capital markets and capital flows. This action was aimed at establishing free movement of capital across the EU. The second stage started in 1994 with the creation of the European Monetary Institute (EMI). This institution had the primary goal of preparing the EU countries for the EMU and a common currency. The EMI also worked towards harmonization of monetary policy, prepared for the introduction of a European Central Bank and the European System of Central Banks, which were to conduct monetary policy in the EMU.

In this stage, the focus also was on achieving greater economic integration of the member states. Integration is measured by a set of convergence criteria, which included the following:

Inflation should not exceed the average of the three countries with the lowest inflation rate plus 1.5 percentage points;

Government debt should not exceed 60% of GDP, or should be steadily falling towards this target;

Budget deficits should not exceed 3% of GDP;

Long-term interest rates should not exceed the average of the three countries with the lowest inflation plus 2 percentage points;

The exchange rate should be part of the EMS for at least two years, without realignment.

Furthermore, an agreement was reached on a timeframe for the start of the third stage of EMU. It was agreed that the third stage would commence at the earliest on January 1, 1997, or at the latest, on January 1, 1999, and that it would take place with the member states that had qualified for participation at that time.

The next important stop on the route to the EMU was Madrid 1996. During this European top, the countries agreed upon naming the new common currency "EURO." Furthermore an agreement was reached on the timetable for specific target dates within the third stage. The third stage would start on January 1, 1999. The participating countries would be those that met the convergence criteria in the first weekend of May 1998. This, of course, has just recently been done; the third stage of EMU will start with 11 qualifying countries (Denmark and the UK made use of their option out, Sweden and Greece did not qualify for participating in the first group). As of the start of the EMU, the EURO will be used in financial markets and interbank payments. Furthermore, it was decided to start with the process of replacing local banknotes with EURO banknotes on January 1, 2002, with the objective of finalizing this exchange within six months.

Finally, I would like to mention the European top held in Amsterdam in 1997. During this top, the EU member states signed the "Pact for Stability and Growth." This pact determines, among other things, that each member state will aim at achieving a budget surplus or a deficit close to zero over the course of the business cycle. This objective is intended to keep every participating state within the 3%-budget-deficit-criteria in times of economic turmoil. If a member state fails to stay within the 3% limit, a penalty system will go into force. One exemption has been made: for cases where the economic growth slows down very rapidly, a temporary budget deficit of more then 3% can be allowed.

Determinants for a strong currency

Why, one could ask, did European leaders set these convergence criteria, construct an independent central bank, specify the policy objectives, and agree on a stability pact. The answer is quite simple: it was all done to ensure that the institutional structure would provide a stable basis for a strong EURO. But a currency will only be strong as long as the market believes it will be. So, to ensure a strong EURO, the right signals had to be sent to gain market confidence.

One of the indicators that financial markets observe when dealing with currency valuation is the compatibility of fiscal policies with monetary policy. This is important because economic theory teaches that monetary policy will eventually have to follow fiscal policy. The implication is that an expansionary fiscal policy will result in a loose monetary policy to finance the budget deficits. Whenever this is the case, inflation will soar, and the currency in question will lose its value.

The 3% budget deficit target set in the Maastricht Treaty should be seen against this background, but it also serves another goal. By making sure that government spending stays within a certain bandwidth with EMU countries, artificial differences in the momentum of the business cycle will become less probable . On the other hand, the 3% deficit limit does give enough flexibility for local governments to counteract country-specific macroeconomic shocks. Local governments need this flexibility, since an interregional redistribution of funds -- other than for agricultural purposes -- is not present in the EU.

The institutional setting of the monetary authorities in the currency area is another important indicator for the strength of a currency. This monetary authority -- in the case of the EMU, the ECB and the ESCB -- will have to be politically independent. Politicians, in general, have a short electoral time horizon, so there is an incentive for them to create short-term inflation leading to economic expansion in the short run, without bothering about the long-term consequences of their decisions. Monetary authorities have to be independent so that they can stay focused on the long-term consequences. Within the ECB this has been arranged by appointing the directors for 8 years, a longer term than politicians normally serve.

Furthermore, financial markets look at the objectives set by the monetary authorities. Especially, they are concerned with the trade-off being made between price stability and full employment. If the goals are ambiguously set, higher inflation rates will generally result, because both goals cannot be met simultaneously. The most important factor is to create an environment of price stability that will ultimately lead to the achievement of full employment.

The Maastricht Treaty states that the number one policy objective of the ECB is to maintain price stability. The ECB also has to support economic policies in the EMU, but only as far as this is possible without jeopardizing the price stability goal. To reach this goal, the ECB is free to choose its instruments. For the exchange rate instrument, however, the politicians will have the ultimate responsibility.

Consequences for the Netherlands Antilles

Introduction
Whenever nominal exchange rate movements are not compensated for by changes in prices, the relative prices of local and foreign goods and products will be altered. In periods when a currency is appreciating without an offsetting inflation differential, the products of the country with the appreciating currency will become relatively more expensive. In our example of the EURO, this means the following. Whenever changes in the EURO/US$ exchange rate are not compensated for by differences between US and European inflation, the relative competitiveness of European goods compared to US goods will change.

This seems a whole mouthful of economics, but the principles are quite simple. In fact, it is happening all the time: nominal exchange rates change very rapidly, while international prices change only with a long lag, leading to changes in relative prices. Prices change only after a certain lapse of time, because of the existence of long-term trade contracts, because exporters are willing to give up part of their profit margin to maintain competitive prices, and because re-pricing also means additional advertising/marketing costs.

So what do we know by now? We know that changes in nominal exchange rates are likely to affect the relative attractiveness of internationally traded goods and services. It will, off course, also affect the value of your assets and liabilities denominated in other currencies. In the rest of my presentation, I will discuss both issues from a Netherlands Antilles standpoint. First, I will focus on the effects of exchange rate changes for the trade of goods and services between Europe and the Netherlands Antilles. Next, I will show the importance of the EURO with respect to our international investment position. After this economically flavored analysis, I will make some remarks on several operational and legal aspects of the introduction of the EURO.

General overview
How important is Europe for the Netherlands Antilles? Or, how important are European currencies for the Netherlands Antilles? The following graphs will give the answers to these questions. The first graph indicates that roughly 20% of all international payments of Netherlands Antillean residents, that is, NAf. 950 million involves a European counterpart, of which 16% is Dutch. The second graph shows which currencies are used by Netherlands Antillean residents to make international payments. You can see that 13% of all international payments are made in Dutch Guilders. Other European currencies, notably the British Pound and the Deutsche Mark, together account for less then 2% of total payments. Furthermore, European currencies are barely used in transactions not involving European counter parties. The dominance of the US$ is clearly visible in the graph. Both graphs indicate that Europe and European currencies play only a marginal role in international payments for the Netherlands Antilles.

The third graph divides all Antillean transactions with Europe into several categories. As can be seen from this graph, the major part involves the import of merchandise. Other important categories include private remittances, other services, and the capital account. The latter includes both government capital, consisting of the repayment of Multi-annual Plan-loans, and private capital. Private Capital consists mainly of changes in foreign accounts and the repayment of loans. In the following part, each of the categories mentioned in this graph will be analyzed further.

To quantify the effects of the introduction of the EURO, it is important to know which currencies are used to pay for these European imports. Graph four relates the first graph with the second one and shows that the Dutch Guilder is clearly the most important currency for European-bound transactions, accounting for 66% of the total. Overall, the currencies that will be succeeded by the EURO are responsible for 69% of the transactions to Europe. Furthermore, it follows from the graph that the US$ and NAf. account for approximately 24% of these transactions.

Trade balance
The single most important kind of transactions with Europe is related to merchandise imports. These imports are concentrated heavily towards Holland, which accounts for just over two-thirds of total merchandise imports stemming from Europe. As I explained before, EMU currencies are the most important means of payment in transactions with Europe. However, a significant part, is still denominated in US$. In my opinion, it is likely that the share of US$ payments to European exporters will decline in favor of the EURO. This means that the EURO will take center stage in our financial relationships with Europe. I even expect the share of the British Pound to drop, as UK exporters may opt to bill in EURO also. In short, the exchange rate sensitivity of the trade balance will expand, since the US$, with

which we have maintained a fixed exchange rate for almost three decades, will be used in fewer transactions in favor of the EURO, which will float against the US$ and consequently the NAf.

I explained before that a change in the nominal exchange rate generally alters relative prices. Now I will explain what will happen if EURO becomes a strong or a weak currency. If the EURO becomes a strong international currency, and I expect it will, the EURO will appreciate against the US$. This means that, with given price levels in the short run, European merchandise goods will become more expensive for Antillean residents, compared to US goods. This, in turn, might lead to a change in the import pattern.

However, since international business often makes use of long-term trade contracts, it is unlikely that these relative price changes will result in fewer European goods and more US goods being bought. Furthermore, there are strong indications that the import of European goods is related to special consumer preferences in the Netherlands Antilles. This results in a low price elasticity of demand, indicating little or no reaction in quantity demanded to changes in relative prices.

Overall this means that a strong EURO will lead to a deterioration of the trade balance, as larger amounts of Antillean Guilders have to be offered for the same quantity of European goods. A 10% appreciation of the EURO for example (from NAf. 2,00 per EURO to NAf. 2,20 per EURO) will lead to approximately NAf. 40 million more expenses on European imports.

If, in contrast, the EURO is not be as strong as expected, the story will go the other way. European goods will develop a relative price advantage over US goods. If we again assume that the price level is given in the short run, and quantities are fixed as a result of consumer preferences and long-term trade contracts, this will mean fewer Antillean Guilders have to be paid for the same European imports. Consequently, the trade balance will improve slightly, leading to more international reserves.

In the long run, the assumptions of fixed prices, given quantities, and consumer preferences might not hold. This means that if an appreciation or depreciation of the EURO vis-a-vis the US$ holds for a long period of time, this might indeed lead to a change in the import pattern. In this case, an appreciation of the EURO might shift imports away from Europe in favor of the US, and vice versa.

Until now, I discussed only the Antillean imports without bothering about exports. I had a specific reason for doing so. The Netherlands Antilles are not in a position to influence the pricing of their exports, so our prices will follow international market prices. Since the largest part of foreign exchange income is generated through tourism, the composition of foreign exchange income over the various currencies is not expected to change: it will stay largely (80%+) in US$. This composition can only alter significantly when European tourism expands and if these tourists are able to pay with EURO just as easily as with US$. I personally do not see both of these happening at the same time. What may happen to tourism is my next topic.

Tourism
The tourism industry will react a lot faster to relative price changes, as the use of long-term contracts is not as widespread in this sector as it is in others. However, the phenomenon of ‘packages’ may act the same way as a long-term contract; the consumer may not be affected by relative price changes until after a certain period of time (e.g., one tourism season). If we assume that consumers/tourists are confronted with relative price changes, the impact on tourism income can be estimated.

Another assumption that I need to make is that European tourists will spend the same amount, measured in their own currency in both scenarios. An appreciation of the EURO will lead to more tourism inflows from Europe. This effect may be re-enforced because a vacation in other parts of the world will become relatively less expensive compared to European destinations. However, since the Netherlands Antilles will have to compete with the rest of the world, the latter effect is expected to be negligible. The estimated increase in tourism inflows is thus fully attributable to exchange rate changes. An appreciation of the EURO by 10% will, in this case, lead, for example, to a 10% increase in tourism inflows stemming from Europe or an additional NAf. 25 million a year. In the event of a depreciation, just the opposite is true: foreign exchange income resulting from European tourists will drop.

Private remittances
A significant part of all payments to Europe consists of private remittances, largely scholarships and payments for pension beneficiaries. Since these payments are generally linked to equivalent payments in Dutch Guilders (or EURO), the costs of these transfers measured in Antillean Guilders will change with the exchange rate. Consequently, this will lead to higher outflows (expressed in NAf.) in the case of a strong EURO, and fewer transfers in the case of a weak EURO. If I once again take a 10% appreciation as an example, it follows that local expenses on

private remittances to Europe will increase by approximately NAf. 10 million. Again, the opposite will hold for a 10% depreciation.

Other services
This category is used to classify the several services, of which the operational income/expenditures of the international financial and business services sector is the most important. In this subcategory, the operational expenditures of offshore companies with European parties explain the international payments to Europe. These expenditures consist of payments for services provided by European parties, and are income (US$) related. In addition, transfers by offshore companies from local accounts to accounts with commercial banks in Europe are classified in this subcategory. These facts do indicate that a change in the exchange rate does not affect the magnitude of these payments, measured in Antillean Guilders.

Foreign position
For the next part of my presentation, I will concentrate on the payments to Europe as a result of the international financial position of the Netherlands Antilles. I would like to define the net foreign assets position as the difference between foreign assets and foreign liabilities. If we look at the General Government of the Netherlands Antilles, we see that the General Government does not have foreign assets and that all foreign liabilities are denominated in European currencies. Graph five shows that the General Government has a foreign debt of approximately NAf. 575 million, denominated in Dutch Guilders and in other EMU currencies. As a result, this debt will be converted to EURO as of January 1, 1999.

For a debtor, it is favorable when the currency in which the debt is denominated depreciates, since the debtor will have to pay less in local currencies to offset the foreign debt. So a weak EURO will lead to significant budgetary relief for the Antillean Government. Our example with a 10% depreciation in the exchange rate means that approximately NAf. 5 million less per year is needed for interest and principal repayments. The opposite is true for a strong EURO, since in that case more local currency is needed to repay the foreign debt. These swings in local currency payments are not new. Graph five shows that the floating exchange rate against the Dutch Guilder gave similar results. So the EURO will make a difference to the extent that this new currency will be significantly stronger or weaker then the Dutch Guilder.

There is one thing we should bear in mind though. Contrary to this reduction in interest and principal payments, we also will experience a reduction in funds coming from the Dutch Government (assuming constant Dutch Guilder or EURO budgets). The Dutch funds are especially related to the Multi-annual Plan funds, the KABNA budget, and Dutch co-financing of, for example, 'Sociaal Vangnet' and 'Capriles Kliniek.' The loss on these transactions -- 10% of NAf. 100 million -- will exceed the mentioned NAf. 5 million in budgetary relief. So at first glance, it looks like a depreciation of the EURO would benefit the Antillean Government; however, a closer look leads to the conclusion that the Netherlands Antilles would, in contrast, benefit form a strong EURO.

The net foreign position of the private sector -- particularly insurance companies and pension funds -- is not exactly known. I used the investment income account, the account on the balance of payments where the return on investments is registered, to estimate the total stock of foreign investments. Since this investment account provides net figures, I was able to use them to directly estimate the net foreign position of the private sector. It turns out that the private sector has a significant net foreign position of NAf. 1.4 billion. This position however, is very heavily concentrated in US$, the result of the fixed exchange rate. Even if there is an exchange rate risk, investors will see it as a possibly higher NAf. return on their investments. Due to this concentration, the consequences of the introduction of the EURO for the private sector, based on the current portfolio, will remain very modest.

The EURO might, however, have implications for the composition of the private sector's investment portfolio. The introduction of the EURO will generate an investment opportunity in a large and liquid market. There will remain a large exchange rate risk (perhaps even larger then before the introduction) since the EURO is expected to float more heavily against the US$ and consequently, the NAf. Investors will demand high real rates of return to compensate for this risk, although the reshuffling of the investment portfolio also is believed to generate significant risk reductions.

In short, I expect the local investors to wait and see what is going to happen with the EURO. As soon as the EURO has gained market confidence, local investors might consider a transfer of funds from US$ to EURO as a matter of return enhancement and risk reduction.

Operational aspects
The operational aspects of the EURO in the Netherlands Antilles will not be much different from the ones in other non-EMU countries. As a result of the special relationship with the Dutch, the use of the EURO might be more widespread in the Netherlands Antillean then in other non-EMU countries. In addition, the fact that the Netherlands

Antilles have an important international financial business services industry also will also contribute to more use of the EURO as well as a better preparation needed. The banking sector has to prepare for the EURO, in order to be able to participate in the inter-bank payment system. For this goal, not only the accounts denominated in EMU currencies will have to be redenominated using the fixed conversion factors with 6 significant figures, but also all automated processes will have to be redesigned. For example, the new SWIFT code of the EURO is EUR.

Furthermore, banks will have to consider if they want to offer EURO-denominated products to their clients, both in deposits and in loans plus securities. Again, due to the special position with the Dutch, banks in the Netherlands Antilles might more easily choose to offer these products. In addition, banks will have be able to change their treasury policy, since 12 currencies will cease to exist, with only one replacement. For banking supervision, this will probably mean less capital requirements for open foreign exchange positions, since long and short positions in each of the 11 EMU currencies will be automatically offset.

Next, I like to think about St. Maarten, our island in the north of the Caribbean, which we share with the French. As of January 1, 1999, the French side will switch to EURO as part of France. In my opinion, this will not change much on the island. Tourism will remain responsible for almost all foreign exchange income, and this will still be geared towards the US$ as a result of the origin of the visitors. Only if the EURO is as widely accepted on the island in 2002 as is the US$ today, and only if tourism from Europe gains in relative importance, will the EURO replace part of the US$ in circulation. As may be clear from the formulation of this last sentence, I do not see this happening: St. Maarten will remain an island where dollar transactions will predominate.

The legal aspects form one specific set of operational issues. The introduction of the EURO also will result in the ending of 12 other currencies and various indices related to these currencies. As of January 1, 1999, each contract referring to such quantities will have to use a new reference value. For contracts in the European Union, the law has taken care of this by stating that in cases where both parties did not agree on how to deal with the EURO beforehand, the contract will be redenominated automatically to EURO and its related indices.

For the Netherlands Antilles, no legislation exists on this issue, and as far as I know, there is no intention to prepare one before the conversion date. This means that both parties will have to agree on the conversion themselves. An example is a contract in which individuals are seeking cheap funds in Europe to finance their homes. These individuals will have to pay EURO much in the same way as the government does. But because the individual does not receive a flow of funds coming from Europe -- like the government does -- an appreciation of the EURO will increase their payments to Europe.

Concluding Remarks

As of January 1, 1999, the world will know a new currency. For a lot of countries, especially in Europe, this means a significant change from the past. It will increase inter-European competition, as transaction costs are diminished, and one currency will provide more market transparency. The EURO opens up a window of opportunities. For non-EMU countries, these opportunities are in fact the same as existed prior to the EURO, but it depends on the country in question if economic gains can be made. The Netherlands Antilles will probably have to deal more with the EURO than other Caribbean countries, due to our special position within the Kingdom and due to our extensive offshore financial relations. If the EURO is going to be a strong currency, this will temporarily lead to a NAf. 20 million effect on our Balance of Payments. This effect is comparable to a current depreciation of the dollar against the EMS currencies. The influence of a strong EURO in the long run can be different, as trade patterns will have to be adapted -- towards the USA -- indicating that the EURO’s share in total payments will drop further. I thank you very much for your attention.