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FOR AGENDA

SM/08/269
Correction 1

September 5, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Kingdom of the Netherlands—Netherlands Antilles—Staff Report for the 2008 Article IV Consultation**

The attached corrections to SM/08/269 (8/18/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 4, box 1, line 18: for "with investments" read "with loans for investments"
line 28: for "central bank (BNA) in charge" read "central bank in charge"

Page 6, para. 4, line 1: for "in the civil service and spending on goods and services, and low wage increases,"
read "in the wage bill and spending on goods and services, "

Typographical Errors

Page 5, figure 1, panel 4: left axis changed.

Questions may be referred to Ms. Banerji (ext. 34780), Mr. Daal (ext. 39047), and Mr. Moore (ext. 39391) in EUR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (3)

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Department Heads

I. Recent Economic Developments

1. **The promise of large-scale debt relief and fiscal responsibility under the dissolution agreement for the Netherlands Antilles has boosted investor confidence and ended a long period of stagnation** (Box 1, Table 1, Figure 1). Economic growth accelerated sharply in 2007 to 3.8 percent, driven by investments in infrastructure, housing[1] and tourism sectors, and increased private consumption, supported by income tax cuts and higher employment. The expansion was partly supported by credit growth, reflecting monetary easing in the United States. Preliminary indications are that the growth momentum is continuing in 2008.

2. **Inflation, historically low, jumped in 2008 due to an elimination of implicit oil subsidies**. Earlier in 2008, parliament approved a full pass-through of energy price increases to consumers, which it had delayed since 2006, forcing the budget to absorb the costs as lower dividends. As a result, inflation, which usually broadly tracks U.S. inflation due to the anchor of the exchange rate peg to the dollar, rose, reaching 4.2 percent in Curaçao in May 2008. Food price increases have had less impact, given a low weight in the CPI basket.

3. **The current account deficit increased sharply in 2007 in line with the surge in FDI flows related to large hotel projects**. Exports moderated temporarily due to fire-related damages in the free-trade zone. However, tourism was a bright spot; notwithstanding the U.S. slowdown,[2] competitiveness was boosted by prior investments in infrastructure, the euro appreciation, strong growth in the Netherlands, and downward pressures on costs from immigration. Imports surged in tandem with high oil prices and domestic demand, as could be expected given high import elasticities typical for small open economies with limited domestic agricultural and manufacturing production. The large current account deficit—16 percent of GDP in 2007—was more than financed by FDI, increased Dutch aid, and private sector trade credits. As a result, reserve coverage improved, fully covering short-term liabilities.

4. **The government retrenched its finances through 2007, mainly through controls on spending**. Notwithstanding income tax cuts in 2006, revenues held steady due to improvements in collections, including reductions in tax backlogs, and more recently, the introduction of modern techniques (container scanning) to prevent evasion of import and sales taxes. Spending cuts focused on curtailing current primary spending through reductions

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[1] The strong euro, longstanding tax rebates, and high Dutch house prices have fuelled demand for retirement and vacation homes in the Antilles.

[2] U.S. tourism, predominantly time-shares in St. Maarten, is less sensitive to economic fluctuations than hotel- or cruise-based tourism. Most Curaçao tourists are Europeans.

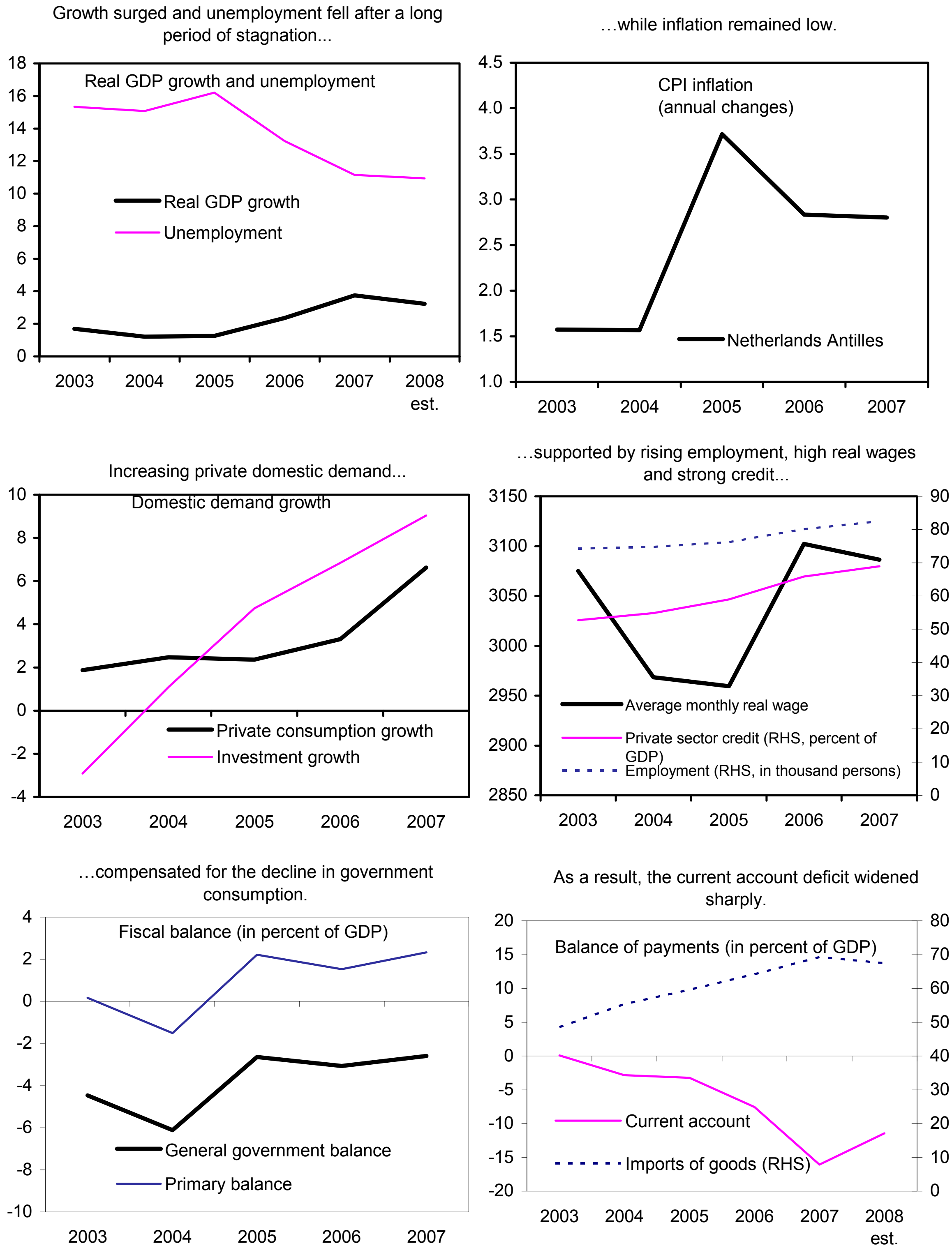
Box 1. Constitutional Changes and a New Fiscal Framework: The Key Elements

According to the December 2005 agreement to dissolve the Netherlands Antilles federation, Curaçao and St. Maarten will gain *status aparte* (as did Aruba in 1986), while the BES islands will become part of the Netherlands. While some specific details remain to be finalized, key elements of the dissolution agreement are:

- Debt cancellation of about 80 percent of total public debt as of December 31, 2005 by the Netherlands. Details of the coverage, schedule, and modality of debt relief remain to be finalized, and the actual operations have been delayed. Debt relief will be conditional on the establishment of a fiscal framework, applicable to the local government of each island, and including:
    - The introduction of medium-term budgeting;
    - The establishment of a fiscal supervisor (chaired by a Dutch appointee) to supervise borrowing decisions, ensure that the fiscal rule (see below) is fully implemented, and advise responsible ministers.
    - A balanced current budget rule, with borrowing restricted to within-year cash management needs. Deviations will be allowed only in case of a disaster, with disaster relief subject to the approval of the fiscal supervisor.
    - Borrowing caps for capital expenditure, limiting annual interest payments to five percent of the average total revenue of the preceding three years, with loans for investments to be approved by the fiscal supervisor only if budget implementation is in line with the fiscal rule.
- A common central bank for Curaçao and St. Maarten responsible for monetary policy and financial sector supervision for both islands.
- A socio-economic initiative (SEI) to tackle social and economic problems.

The implementation of the dissolution agreement has already started, although the technical changes in the islands' status (the "constitutional changes") have now been postponed until January 2010. The BES islands have already introduced the fiscal framework, which Curaçao and St. Maarten are scheduled to begin implementing as from 2009. They have also agreed in principle to remain in a currency union, with the central bank in charge of monetary and exchange rate policies and financial sector supervision in both islands. The BNA's charter is being modified accordingly, with agreement on the Board's composition still pending.

Figure 1. Netherlands Antilles: Recent Economic Developments



Sources: National authorities and Fund staff estimates.

in the wage bill and spending on goods and services, though, in 2007, some arrears to APNA (the civil service pension fund) were incurred. However, total spending has remained high because of interest payments. Public debt remains close to 80 percent of GDP ahead of debt relief. All in all, the current budget balance has been held at 2⅓ percent of GDP during 2005–07.

5. **The Bank of the Netherlands Antilles (BNA) tightened monetary policy, restraining credit growth**. To offset the reduction in its benchmark pledging rate following cuts in the target U.S. federal funds rate, and to mop up excess liquidity, the BNA raised reserve requirements—its main policy instrument, besides CD auctions—from 12¼ to 13¼ percent in several steps since 2005. Credit to the private sector has grown steadily (12 percent year-on-year in May 2008), reflecting increased investor confidence and lower lending rates associated with intensified competition. Meanwhile, with inflows strong, the BNA has exceeded its target for reserve coverage (three months of imports).

6. **The financial sector seems broadly healthy and compares favorably with the region** (Table 2, Figure 2). Financial soundness indicators show adequate capitalization and profitability. Nonperforming loans remain moderate by Caribbean standards, notwithstanding some increase recently. Banking sector assets remain concentrated in the top two banks, reflecting limited competition on the funding side due to capital controls on institutional investors (pension funds and insurance companies), and market segmentation. However, increasing competition from smaller banks has compressed lending spreads modestly. Following a loss of market share earlier in the decade, assets of the international financial sector[3] have since begun to recover (Table 3). Neither the domestic nor the international financial sectors have been affected by the global financial turbulence. Supervision and AML/CFT efforts have been strengthened (Informational Annex I, including implementation of Fund policy recommendations).

[3] IMF Country Report No. 04/271.