FOR
AGENDA

SM/85/21

CONTAINS CONFIDENTIAL
INFORMATION

January 22, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Kingdom of the Netherlands - Netherlands Antilles - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with the Netherlands Antilles.

This subject has been tentatively scheduled for discussion on Friday, February 15, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Leipold, ext. 573743.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS - NETHERLANDS ANTILLES

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984
Consultation with the Netherlands Antilles

Approved by L. A. Whittome and J. T. Boorman

January 18, 1985

Article IV consultation discussions were held in Willemstad and Oranjestad from November 19 to December 3, 1984. The staff team included Messrs. P. Dhonte, A. Leipold, P. Nyberg (all EUR), V. Marie (BUR), and Ms. K. Pettie (EUR) as secretary. Meetings were held with the Minister of Finance, the Commissioner for Finance of the island Government of Aruba, and the Governor of the Bank of the Netherlands Antilles. The mission also met with representatives of the business and banking communities.

The Netherlands Antilles comprise six islands, which form part of the Kingdom of the Netherlands. Fiscal authority is in the hands of a Central Government and of the Governments of the two largest islands, Aruba and Curaçao; these accounted respectively for 34 percent, 20 percent, and 46 percent of public expenditure in 1983. Protracted negotiations resulted in March 1983 in an agreement in principle which will give the island of Aruba, in 1986, a separate status within the Kingdom of the Netherlands.

The economy is widely open, with exports being equivalent to over three quarters of GNP. Approximately one half of external transactions are with the U.S. dollar area. The currency of the Netherlands Antilles is the Netherlands Antillean guilder which since 1971 has been pegged to the U.S. dollar at a rate of NA f. 1.79 per U.S. dollar. The Kingdom of the Netherlands accepted the obligations of Article VIII as of February 15, 1961. The last consultation discussions were concluded at EBM/83/158 (November 21, 1983).

I. Background

The early 1980s were years of affluence for the Netherlands Antilles: GNP per capita was estimated at around US$7,000 in 1983, and compensation per government employee at US$25,000. Two separate developments were influential. The oil shock of 1979 initiated a period of high profitability for the two large refineries which operate on the islands, and at the same time indirectly stimulated tourism originating in Venezuela. Simultaneously, there was a great increase in the number of finance companies making use of the favorable provisions in the tax treaty between the Netherlands Antilles and the United States.

In 1983, however, an abrupt decline in tourist arrivals from Venezuela signaled that this period of buoyant activity was coming to an end. In concluding the consultation at EBM/83/158, the Executive Board noted signs of weakness in the economy which it related to changes in foreign demand but also to an emerging uncompetitiveness. The Executive Board accordingly commended the authorities for their attempts to restore wage competitiveness, and warned of the risk of rapidly rising financial imbalances.

In the intervening year, the deterioration in external conditions has developed along the lines of a "worst case scenario," increasing the perceived uncompetitiveness of the islands, and the risks of a serious financial imbalance.

1. The external shocks

As mentioned above, the first in a succession of adverse external shocks in the past two years came from neighboring Venezuela, whose residents had long patronized the tourist industry in Aruba and Curaçao. Tourist arrivals from Venezuela substantially declined following the devaluation of the bolivar in February 1983 and 1984. Fortunately, the recovery in the United States provided an alternative and expanding market which the islands were quick to tap; nevertheless tourism earnings were down by nearly 30 percent in 1984 compared with 1982 and were only expected to recover slowly in the coming years.

A second shock was the repeal, in July 1984, of the United States withholding tax on investment income accruing to nonresidents. Preferential treatment under this tax was the main point in the tax treaty between the United States and the Netherlands Antilles. The tax and the tax treaty had been the justification for the creation in the Netherlands Antilles, and specifically in Curaçao, of a large number of finance companies which generated a substantial amount of tax revenues and indirectly, some local employment. Following the repeal of the withholding tax, new loan activity virtually stopped and offshore activity was limited to those operations which are unrelated to the tax treaty and which were hitherto estimated to yield between a fourth and a third of tax revenues paid by the offshore financial sector.

A third blow, in October 1984, was the announcement that the Lago oil refinery on the island of Aruba would cease operations as of March 31, 1985. Closure of the refinery, long one of the world's largest, meant a major loss in foreign exchange revenues, and was estimated to wipe out directly and indirectly a third of the island's GNP. The decision to close the Lago refinery was mainly related to world market conditions for oil products, which because of different technical constraints did not threaten quite as directly the Shell refinery in Curaçao. However, it became more apparent in the wake of that decision that the Shell refinery was also facing an adverse market environment and, in particular, uncompetitive wage costs.

Finally, in a more diffused manner, changes in shipping conditions sharply reduced the demand for harbor services, transshipment facilities, and ship repair and maintenance which were an important sector of the activity of Curaçao.

All in all, foreign exchange earnings, which had peaked at NA f. 2,679 million in 1982 (Table 1) and declined to an estimated NA f. 2,233 million in 1984, could be projected to fall further in the following two years. In the mission's central estimate, they would fall by 20 percent between 1983 and 1986.

Table 1. Netherlands Antilles: Current Foreign Exchange Earnings

(In millions of NA guilders)

	1981	1982	1983	1984 1/	1985 2/
Total 3/ 4/	2,631	2,679	2,333	2,233	2,050
Of which:					
Tourism	786	759	577	560	580
Oil sector 4/	637	779	693	565	430
Offshore financial sector (net)	257	332	439	478	480
Other	954	809	625	630	560
Memorandum items (percent changes)					
Total foreign exchange earnings	12.2	1.8	-12.9	-4.3	-8.2
CPI (year averages)	12.2	6.1	2.8	2.0	...
Real effective exchange rate 5/	11.1	5.2	3.2	4.2	...

Source: Data provided by the Netherlands Antillean authorities and staff esimates and forecasts.
1/ Staff estimates.
2/ Staff forecasts.
3/ Including investment income and private remittances; excluding development aid.
4/ Including oil deliveries for local use.
5/ CPI basis.

2. The domestic repercussions

Not surprisingly, the prospective fall in foreign exchange earnings is paralleled by a drop in government revenue. At their peak in 1983, taxes paid by the offshore and the oil sectors represented over 40 percent of total revenues of the three governments; even so, the three governments together recorded a small deficit in that year (Table 2). Within a few years, most of this source of income is likely to disappear, and public expenditure, of which about one half (equivalent to around 20 percent of GNP) consists of wages and salaries, must be severely reduced.

At the same time, the uncompetitiveness of the islands has become increasingly evident. While the peg of the currency to the U.S. dollar has been instrumental in achieving a remarkable deceleration of the rate of inflation (consumer prices only rose by 2 percent in 1984), it has also entailed a 25 1/2 percent real effective appreciation of the guilder, based on relative CPIs, between 1980 and 1984. Available indicators suggest that, in terms of wage costs, the differential over that period may have been around 30 percent. This is also the order of magnitude by which several of the large firms on the islands claim that they must trim wage costs in order to recover their competitiveness.

Table 2. Netherlands Antilles: Public Finance Indicators 1/

(In millions of NA guilders)

	1981	1982	1983	1984 2/	1985 3/
Total revenue	907	1,055	1,126	1,100	990
Of which:					
Offshore and oil profit taxes	256	376	457	435	387
(Percent of total revenue)	(28)	(36)	(41)	(40)	(39)
Total expenditure	897	1,014	1,142	1,173	...
Of which:					
Wages and salaries	453	526	573	583	...
Balance	10	41	-16	-73	...
(As percent of expenditure)	(1)	(4)	(-1)	(6)	...
Growth rate of expenditure	(17)	(13)	(12)	(3)	...
CPI percentage change	(12.2)	(6.1)	(2.8)	(2.0)	...

Sources: Data provided by the Netherlands Antillean authorities; and staff estimates and forecasts.

1/ Central government and island Governments of Aruba and Curaçao.

2/ Preliminary estimates.

3/ Staff forecast.

The external developments have a direct adverse impact on domestic employment; they also severely restrict the scope for employment subsidization. Subsidies to the public utilities have been a longstanding feature of the fiscal system in the islands, as a result of high utility costs (all water is obtained by desalination) and of poor user fee collection. More recently, there has been a sharp increase in public support to ailing enterprises in the public sector, including hotels, the ship repair company and the national airline. Such subsidies, which absorb an estimated 4 to 5 percent of GNP, will be increasingly difficult to sustain in a period of declining revenues. A consequence of the squeeze on public sector revenues is therefore to expose fully the uncompetitiveness of the islands.

3. Some qualifications

In facing these difficulties, the islands are endowed with an enviable human and financial heritage. A population of 230,000 inhabitants has maintained two of the world's largest refineries, a world-class drydock, a sophisticated offshore financial sector, and an attractive tourist business. The Netherlands Antilles have no external public debt of a commercial nature and can rely on continuing foreign aid of around NA f. 100 million a year mainly from the Netherlands. At the end of 1983, the governments were together net creditors of the banking system; net foreign assets were equivalent to about 10 percent of GNP; and, at 2 percent, the rate of consumer price inflation in 1984 was one of the lowest worldwide.

Secondly, the decline in foreign exchange revenues will be spread out over several years. Severance payments by the Lago refinery in Aruba are expected to keep the foreign exchange income of the island at a high level in 1985; the drop in 1986 could be abrupt, although expenditure to clean up the site after 1985 could perhaps offer some further reprieve. A seven-year grandfather clause in the U.S. withholding tax repeal law implies that most loans presently booked with Netherlands Antilles finance corporations will remain subject to Netherlands Antilles taxation until they are paid off; however, the benefit of this provision would be sharply reduced if international interest rates were to fall significantly, for many existing loans would then be refinanced.

On the other hand, the uneven distribution of the loss of foreign exchange among the islands, together with the prospects of a separate status of Aruba, may handicap the formulation of a coordinated strategy. The closure of the Lago refinery is a major blow to the economy of Aruba, which is deprived of the bulk of its foreign exchange revenues. The other islands, although seriously affected by the repeal of the U.S. withholding tax, benefit from a more diversified economic base and a more gradual decline in foreign income.

II. The Policy Discussions

At the time of the mission, the Central Government authorities and those of the island Government of Aruba were attempting to keep the Lago refinery in operation; and there were some prospects that exploration rights to oil deposits off the shores of Aruba could be sold to interested oil companies. While any of these developments would greatly ease the situation of the islands, neither could be considered very probable. The most likely scenario was therefore seen to be one in which a lasting fall in foreign exchange earnings and public revenues of the Netherlands Antilles made necessary a significant reduction in domestic demand, especially government expenditure, and simultaneously required an improvement in competitiveness and other measures to encourage new employment and production in the Netherlands Antilles in the near future.

1. Development policies

Despite programs for temporary work and substantial public financial support to unprofitable enterprises, unemployment continued to rise in 1984. This was partly the result of substantial reductions in employment in the oil sector, but also of labor shakeouts in the retail trade sector. During 1985 unemployment was expected to rise sharply, due mainly to the effects of the closure of the Lago refinery and to possible further reductions in overstaffing in other sectors of the economy. Altogether, it was feared that the rate of unemployment would rise to around 30 percent of the labor force in the islands of Aruba and Curaçao in the course of 1985.

The authorities observed that the threat of rising unemployment had resulted in 1984 in increased awareness of the need for nominal reductions in wage costs. No uniform pattern had prevailed; negotiations had generally started when employers filed for a reduction in employment, and the resulting arrangements reflected the specific circumstances of the company. Such arrangements had recently been reached in the transportation, metalworking and hotel industries and had generally involved reductions in the wage bill, by reducing overstaffing, temporary suspension of indexation clauses, as well as cuts in hourly wage costs. In the view of the authorities, such cost reductions needed to be extended to all sectors of the economy, either because of competitiveness pressures as in the refining and metal-working industries, or because of budgetary pressures in the civil service. The alternative of an exchange rate devaluation was seen as highly undesirable; specifically, it carried the risk of initiating a devaluation-inflation spiral. An interdepartmental working group had already proposed a legal framework for nominal wage cuts of 10 to 15 percent, and had suggested in addition cuts in subsidies to the utilities and other government companies. This proposal was under review by the Government.

Discussions with various branches of government as well as the banking and business community indicated a widespread preference for an approach of this sort. The mission supported this strategy, as it would strengthen confidence in the currency and contribute to the good image of the islands abroad. It noted however that the need for cost reductions had already been evident for some time and that little effective adjustment seemed to have taken place. It therefore emphasized that the adjustment was urgently required, both because the viability of several large enterprises, at prevailing cost scales, was in doubt, and because of the long lead time between improved competitiveness and improved employment opportunities. The mission further observed that measures of the loss of competitiveness since 1980, as well as indications of the degree of uncompetitiveness of selected enterprises, and projections of the fiscal imbalance for the three governments, suggested a need for larger wage reductions in the order of 20 percent, is larger than those proposed by the working group.

No definite plans to promote alternative foreign exchange earning activities appeared to be available, though a number of private initiatives to expand the tourist sector on Aruba were at various stages of implementation. The interdepartmental working group's report emphasized the need for higher investment and the creation of new activities and recommended less government involvement in enterprises and greater flexibility in the implementation of labor regulations in new export industries. The mission noted that existing quantitative import protection extended to a diversity of small manufactures produced on the islands tended to perpetuate high costs and poor quality, and should be phased out as the competitive position of the islands improved. Exchange regulations, which require licensing for capital exports by nonbank residents, continued to be liberally administered. The mission strongly supported this policy, noting that a liberal approach was essential to continued public confidence in the guilder.

2. Fiscal policies

The authorities indicated that the fiscal balance of the three governments had deteriorated in 1984 despite a clear deceleration in the growth rate of real expenditure (Chart 1). Fiscal developments had continued to be relatively diverse for the three Governments in 1984. Existing revenue-sharing arrangements were functioning adequately, but there was still very little effective policy coordination among the Governments, while budget control remained almost inexistent.

The Central Government had introduced a number of measures in the second half of 1983 after experiencing difficulties in placing treasury paper at the same time as central bank advances reached their ceiling in the middle of the year. A hiring freeze was introduced, and the cost of living adjustment for civil service wages was suspended. Financial transfers to the smaller islands as well as locally financed capital outlays were to be restrained. Additional revenues were sought from an increase in various taxes and from adjustment of user fees. These measures were reflected in a nearly balanced initial central government budget for 1984. All the measures were not implemented however, and the central government deficit outturn for 1984 was estimated at about NA f. 30 million, or about half the estimated actual deficit for the previous year.

The Curaçao island Government's financial surplus in 1984 was expected to remain roughly at the same level as 1983, or about NA f. 30 million, mostly on account of an increase in tax payments by the offshore financial sector, which were buoyed by a catching up on a backlog in tax assessments.

In Aruba, on the other hand, the financial situation of the island Government was deteriorating sharply, mostly because of a large drop in profit tax payments by the Lago refinery from their record level in the previous year, but also due to an increase in transfers paid to households and public enterprises. As a result, a deficit of about NA f. 70 million was anticipated for 1984, following three years of financial surpluses.

Turning to the prospects for 1985 and beyond, the authorities indicated that revenues must be expected to fall sharply and that a major effort of expenditure restraint had therefore become necessary. Again, the situation would differ among the three Governments in 1985. As regards the island of Aruba, tax payments by the refinery, which had contributed almost half of revenues in 1983, could vanish altogether in 1985, as the refinery was likely to dispute its obligation to pay a minimum tax in that year. Running down the remaining deposits with the banking system would provide only a temporary solution. Therefore, following the announcement of the closure of the refinery, the island budget for 1985 had been revised; a new budget, incorporating major cuts in personnel expenditure is to be introduced in January 1985.

Revenues of the island Government of Curaçao, by contrast were expected to remain high in 1985, as collection of the backlog of offshore taxes would continue. In the longer run however the island would be deeply affected by the decline of this source of income which, in 1984, represented over half of its revenues. It was thus a source of concern that no major attempt at reducing public expenditure on the island Government appeared to be under way. In fact the island Government was heavily committed to the support of public enterprises, and was not taking any action to cut its own wage costs.

Finally, the Central Government was facing a difficult situation already in 1985 and was accordingly considering a proposal of the interdepartmental working group to sharply reduce wages and subsidy payments.

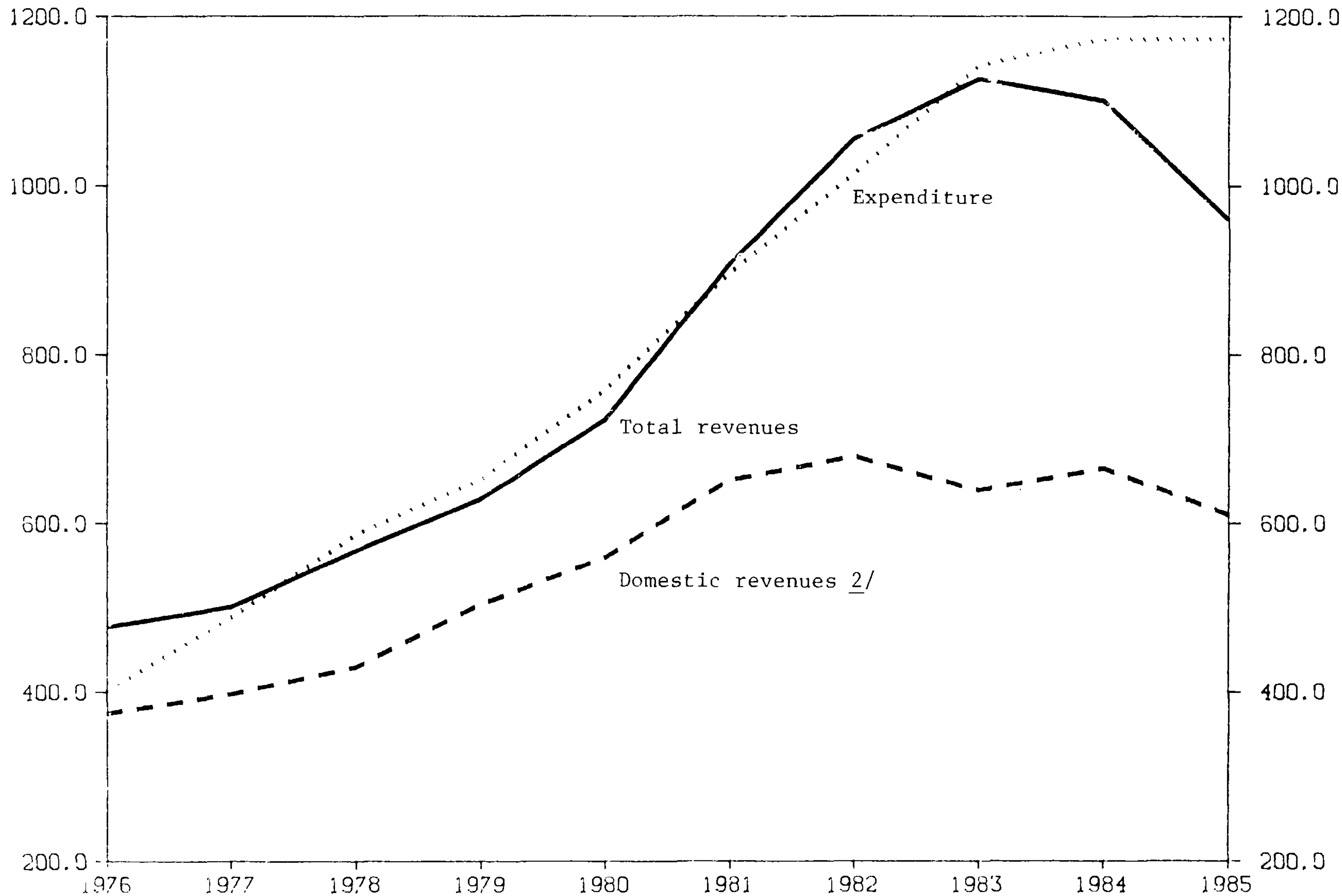
The mission observed that the fall in revenues was not of a temporary and reversible nature and therefore required a permanent adjustment of expenditures. Indeed, projections of the monetary survey confirmed that monetary financing of the public sector would result in a

Chart 1

NETHERLANDS ANTILLES

Public Finance Developments 1/

(In millions of NA guilders)



Source: Data provided by the Netherlands Antillean authorities; and staff estimates and projections.

1/ Central and island Governments combined; projections for 1985 assume a freeze in expenditure.

2/ Total revenues excluding tax payments by the oil and the offshore financial sector.

Netherlands Antilles - Statistical Issues

1. Coverage, Currentness, and Reporting of data for IFS

		Latest Data in December 1984 IFS
Real Sector	- National Accounts	n.a.
	- Prices	Aug. 1984
	- Production (refined petroleum)	1979
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1979
	- Financing	1979
	- Debt	1979
Monetary Accounts	- Monetary Authorities	Sept. 1984
	- Deposit Money Banks	Aug. 1984
	- Other Financial Institutions	
External Sector	- Merchandise Trade: Values	1980
	- Merchandise Trade: Prices	n.a.
	- Balance of Payments	1980
	- International Reserves	Oct. 1984
	- Exchange Rates	Oct. 1984

During the past year, the reporting of data for inclusion in IFS has been sporadic; series remain uncurrent in several areas of statistics.

2. Outstanding Statistical Issues:

Balance of Payments

1980 is the last year for which balance of payments data are available for publication in IFS. Data for 1981 and 1982 are to be provided shortly and should include data on service transactions on a gross basis, as requested.

Government Finance

The latest year for which data are published in the Government Finance Statistics Yearbook is 1979. The authorities have indicated that there little prospect of providing more current data.

General economic data

On petroleum products, monthly data for 1980 and subsequent years are not expected to be available for some time due to lack of reporting by one refinery.

Fund Relations with the Kingdom of the Netherlands - Netherlands Antilles

The Netherlands Antilles is part of the Kingdom of the Netherlands, which consists of the Netherlands Antilles and the Netherlands itself. The Kingdom of the Netherlands is an original member of the Fund. On February 15, 1961, the Kingdom formally accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement for all territories. The initial par value of the Netherlands Antillean guilder--NA f. 1.88585 = US$1--was established with the Fund on December 18, 1946. The authorities communicated to the Fund a rate of NA f. 1.79000 per US$1 to take effect as a central rate on December 23, 1971. Since then, the Netherlands Antillean guilder has been pegged to the U.S. dollar at this rate.

The Executive Board conducted the last Article IV consultation on the basis of staff reports SM/83/222 (10/31/83) and SM/83/226 (11/4/83).

	1979	1980	1981	1982	1983	1984 1/
	(In millions of NA guilders)					
Public finance						
(Central Government and Island Governments of Aruba and Curaçao combined)						
Expenditure	656	759	897	1,014	1,142	1,173
Revenue	612	722	907	1,055	1,126	1,100
Financial balance	-44	-37	10	41	-16	-73
(as percent of expenditure)	(-7)	(-5)	(1)	(4)	(-1)	(-6)
	(Changes in millions of NA guilders)					
Monetary data						
Money and quasi-money (M2)	72.9	87.3	120.9	146.5	61.4	51.0
(Percent growth)	(9.3)	(10.2)	(12.8)	(13.7)	(5.1)	(4.0)
Counterparts to M2						
Net foreign assets	12.5	52.2	96.4	90.7	-47.2	-2.0
Domestic credit	81.7	48.9	71.6	83.8	107.9	63.0
(Percent change)	(11.3)	(6.1)	(8.4)	(9.1)	(10.7)	(5.7)
Claims on government, net	56.2	-26.7	-72.5	-11.1	-26.7	52.0
Central government	-18.2	-3.4	-5.0	50.8	-11.5	12.0
Island governments	74.4	-23.3	-67.5	-61.9	-15.2	40.0
Claims on the private sector	25.5	75.6	144.1	94.9	134.7	11.0
(Percent change)	(4.1)	(11.8)	(20.0)	(11.0)	(14.1)	(1.0)
Miscellaneous other	-21.2	-13.9	-47.2	-27.9	0.6	-10.0
Exchange Rates						
Central rate: NA f. 1.79 = US$1						
NA guilder per SDR (period average)	2.313	2.330	2.111	1.976	1.914	1.846
Real effective rate (annual percentage change; period average) 3/	-1.3	1.3	11.1	5.2	3.2	4.2

1/ Staff estimates.
2/ Figures may not add up due to rounding.
3/ Corrected for changes in consumer prices.

Basic Data

Population (1981)	231,932
Of which:	
Curaçao	147,388
Aruba	60,312
Bonaire	8,753
Windward Islands	15,479
Population density	234 inhabitants per square kilometer
Average annual population increase (1972-81)	0.4 percent

	1979	1980	1981	1982	1983	1984 1/
Consumer price index (Leeward Islands)						
Percent increase:						
December to December	12.2	16.0	8.6	4.7	2.2	2.0
Period average	11.4	14.6	12.2	6.1	2.8	2.0
	(Annual percentage change)					
Selected indices of economic activity						
Refining output	-8.0	-1.1	-3.3	-11.4	-2.6	-4.3
Electricity production	4.3	1.7	0.8	-0.8	3.3	-7.6
Shipping activity	7.8	-10.6	6.6	-24.1	-27.1	-35.9
Stayover tourism (arrivals)	9.3	0.1	2.2	3.6	-6.9	13.4
Cruise tourism (arrivals)	6.8	-10.4	-13.9	-11.9	-18.7	-7.5
	(In millions of NA guilders)					
Balance of payments (cash basis) 2/						
Non-oil trade balance	-1,092	-1,364	-1,299	-1,450	-1,407	-1,207
Services	1,234	1,445	1,569	1,674	1,439	1,314
Private transfers and investment income	-147	-186	-176	-118	-119	-107
Current account	-5	-105	94	106	-86	--
Official capital	73	151	111	62	111)	
Private capital	-79	-18	-130	-95	-123)	-2
Errors and omissions	24	24	20	18	50)	
Change in net foreign assets, increase (-)	-13	-52	-96	-91	47	2
Memorandum item:						
Net foreign assets	194	246	342	433	386	384
(in months of imports)	(1.8)	(1.8)	(2.6)	(3.1)	(3.1)	(3.2)

coordination. In this context, careful control of all forms of accumulation of external debt is of particular importance. The staff would also wish to caution against the use of any form of exchange or import restriction; indeed, the effort to restore competitiveness provides an opportunity to dismantle existing import restrictions.

It is recommended that the next Article IV consultation with the Netherlands Antilles be held on the standard 12-month cycle.

unchanged policies, could not be financed without an excessive monetary expansion or an unprecedented recourse to foreign borrowing. The deficit of the public sector must be eliminated to achieve external balance without putting an excessive squeeze on credit to the private sector.

The second manifestation of the external shocks is a large loss of employment opportunities, either as a direct result of the external developments or indirectly as a result of the fall in domestic demand. Other employment opportunities in the export sector are threatened and must be preserved, while new activities must be established. It is not possible to meet this challenge at the present uncompetitive level of domestic costs. An important consideration in addressing this issue is the existence of a widely shared preference in the Netherlands Antilles to achieve the necessary improvement of competitiveness by reducing nominal costs. This approach has the merit of sustaining the present exchange rate and of building upon the successful inflation performance of recent years. Its practical implementation can draw on the fact that employment is heavily concentrated in the public sector and in a few large enterprises.

In the staff's opinion three adjustments are thus required. Firstly, a reduction of nominal wages of the order of 20 percent is necessary to restore competitiveness and to contribute to the reduction of domestic demand which is required for external balance. This measure will reduce the wage bill of the public sector, but substantial additional expenditure cuts are needed to eliminate the government deficit. It must therefore be supplemented with a sharp reduction in subsidies to public utilities and public enterprises. Thirdly, there must be a tight control of domestic credit, which is likely to require the enforcement of limits on credit to the private sector.

These measures must be implemented early and fully to prevent any loss of confidence that would put unbearable pressure on the currency and to take an early start in restoring employment prospects. While the full impact of the external shocks will not be felt for another year, this grace period must be accepted as an opportunity to implement a more orderly adjustment, not a cause for delay in taking necessary action. Present policies must rest on a realistic evaluation of economic conditions in 1986 and beyond, and action cannot be delayed on the basis of fragile hopes.

Unavoidably, the adjustment effort must be graduated among islands and among economic sectors. However, unless its burden is shared by all, there is a great risk that adjustment may not be achieved in an orderly fashion. In this respect, and from a strictly economic point of view, the six islands together offer a broader economic base and therefore better prospects for successful adjustment. It is therefore desirable to strengthen the process of intergovernmental and interdepartmental

Following a 5 percent increase in 1983, the demand for money was expected to rise by around 4 percent in 1984 despite the weakness of activity and the slowdown of inflation. The mission observed that this increase suggested continued confidence in the currency. However, there were reports of an increased demand for U.S. dollars in Aruba, prompted by the announcement of the closure of the Lago refinery. The mission observed in this respect that demand for foreign currencies was also stimulated by interest rate differentials in favor of U.S. dollar deposits, as the maximum interest rate on liquid guilder deposits was unchanged at 5 percent since 1970. The mission suggested therefore that the remuneration of commercial bank excess reserves with the Bank of the Netherlands Antilles be raised to allow banks to offer more competitive rates, at least to large depositors. The authorities noted that special facilities to this effect existed for large deposits (in practice exceeding NA f. 200,000), and that the behavior of most small depositors did not suggest a great sensitivity to interest rates.

The authorities expected a further small increase in M2 in 1985, as the severance payments by the Lago refinery would compensate for the contraction of activity in that year. The mission observed however that the contraction of activity together with the policy induced reduction in real and nominal incomes would entail a fairly sharp reduction in M2 over a two-year period, although the path over the period was uncertain. Therefore, even with a limited increase in net credit to the public sector, the protection of the external position imposed a need to achieve a reduction in credit to the private sector. This reduction would be facilitated by an improvement in competitiveness.

III. Staff Appraisal

The external shocks of the past two years confront the Netherlands Antilles with a period of severe economic difficulties.

The first manifestation of these difficulties is likely to be a sharp decline in foreign exchange and government revenues. On present expectations, which assume the closure of the Lago refinery and a gradual decline in offshore tax revenues starting in 1986, foreign exchange earnings are likely to fall by around 20 percent between 1983 and 1986. It is not possible to mitigate the necessary adjustment by allowing a deficit in the balance of payments. The new situation is not temporary and readily reversible, but reflects a permanent change in the economic base of the islands. The satisfactory level of reserves and the low level and concessionary character of the external public debt are assets which must be invested in development expenditures, not in sustaining excess domestic consumption. Therefore, the fall in foreign exchange revenues cannot but lead to a commensurate reduction in domestic demand, for which a central condition is a reduction of public expenditure. Already in 1985 the government deficits, projected on the basis of