IMMEDIATE ATTENTION

SM/14/211
Correction 1

July 25, 2014

To: Members of the Executive Board

From: The Secretary

Subject: **Kingdom of the Netherlands—Curaçao and Sint Maarten—Staff Report for the 2014 Article IV Consultation**

The attached corrections to SM/14/211 (7/14/14) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 11, para. 21, line 4: for "tax burden" read "direct tax burden"

Comment: The authorities have informed staff that the statement that efficiency-enhancing reforms might provide scope for a reduction of the tax burden does not clearly underscore their intention to reduce *direct* taxes specifically. This, they argue, would achieve the recommended further rebalancing of the tax burden from direct taxes to indirect taxes.

Evident Ambiguity

Page 4, para. 1, line 6 and Page 34, first paragraph of the draft press release, line 2: for "independent countries" read "autonomous countries"

Comment: The original formulation could be misinterpreted as suggesting that the two countries have gained independence.

Questions may be referred to Mr. Lombardo, EUR (ext. 39937) and Mr. Quayyum, FIN (ext. 30578).

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

Att: (3)

Other Distribution:
Department Heads

ANNEXES

APPENDICES

INTRODUCTION

1. **Curaçao and Sint Maarten share many similarities but also important differences.** Both are small open island economies but, while Sint Maarten's economy is essentially tourism-based, Curaçao's is more diversified, featuring also an international financial center (IFC), a transshipment port, a dry dock, and the oil refinery. Trading partners are also different: Sint Maarten relies mostly on tourists from the US and Europe, while Curaçao has important trade and tourism links also with close-by Venezuela and Latin America. Having been established as autonomous countries (out of the dissolution of the Netherlands Antilles) as recently as late 2010, both need to right-size and increase the effectiveness of their administrations. But while Curaçao needs to extract efficiency gains from merging the two pre-existing levels of governments (the Netherlands Antilles' central government and Curaçao's island government), Sint Maarten needs to *expand* its capacity to perform some of the functions previously carried out by the Netherlands Antilles' central government.

2. **Both countries face many of the challenges of other Caribbean islands** (Figure 1), especially in terms of boosting growth while safeguarding external stability. This is particularly the case for Curaçao, which has trailed its regional peers at least since the early 2000s. Sint Maarten has done better, benefiting from a boom in cruise tourism which, however, may face diminishing returns and could also adversely impact the quality and appeal of stay-over tourism. On the plus side, both countries' public debt is low, thanks to the 2010 debt relief, whereby the Netherlands took over all the Netherlands Antilles' outstanding public debt in exchange for a significantly smaller amount of very long-term/low-cost debt issued by the two new countries.

3. **Against these challenges, staff's advice is predicated on an analytical framework based on the fixed exchange rate.** Curaçao and Sint Maarten form a currency union, whose currency—the Netherlands Antilles Florin, or *guilder* (NA.f)—has been pegged to the US dollar at 1.79 since 1971. Since the dissolution of the Netherlands Antilles, there has been some debate whether the two countries should keep the currency union (the two island nations are far apart—over 550 miles—and trade between them is limited). This debate, partly economic and partly political, appears to have subsided of late in favor of the *status quo*. But even if, in consideration of their economic differences and geographic distance, the two countries were in the future to decide to adopt separate monetary arrangements, they would still be best served by a fixed exchange rate regime, given their small open economies. Such a regime helps by preventing unnecessary exchange rate uncertainty, but it also affords very limited scope for active monetary policy. It thus puts a premium on creating and keeping fiscal buffers, and requires maintaining competitiveness and flexibility primarily via structural reforms.

4. **Major data gaps hamper effective macro-economic analysis and surveillance**. National account data are produced only with very long lags. In Curaçao, there is no official breakdown for

21. **Both authorities also agreed in principle with the merits of shifting the tax burden towards consumption and away from income.** In Curaçao, however, they indicated that they intend to fully pursue their efficiency-enhancing reforms first, as these might provide scope for an overall reduction of the direct tax burden over time. In Sint Maarten they noted that it is essential to proceed with care, and as much as possible in close coordination with the French side, to avoid any revenue loss from implementation pitfalls, lack of reliable data, and/or tax arbitrage.

B. Financial Sector Policies

Background

22. **Ample bank liquidity has continued to fuel rapid credit expansion, especially in Curaçao, until late 2013** (Figure 3). Absence of government bonds to invest in, low interest rates prevailing abroad, and continued large inflows from the debt relief operation have resulted in ample and growing liquidity for domestic banks, fueling rapid credit growth. When this started to exert pressures on international reserves, the CBCS attempted to induce banks to reduce lending by raising reserve requirements multiple times (to 17.5 percent as of May 2014) and, as from February 2012, by imposing temporary bank-level credit ceilings, which have since been recalibrated and renewed every six months. These measures notwithstanding, credit growth continued unabated in Curaçao until late 2013, when it abruptly turned negative. Since banks kept excess reserves throughout and the ceilings were first not observed and then undershot, it would appear that the slowdown in credit reflects not CBCS measures per se but a reduction in credit demand (likely triggered by the reduction in disposable income from the fiscal adjustment) and a more cautious supply of loans by banks (including because of the acceleration in non-performing loans, NPLs, see below).

23. **Banks still have relatively healthy capital levels, but NPLs are on the rise.** At end-2013, NPLs jumped to 11.9 percent, from 8.6 percent in 2010, and there is a growing concern about asset quality in general. So far, NPLs seem to be concentrated in certain sectors (tourism and air transportation), but there is anecdotal evidence—no hard data—that the sustained growth in mortgages, combined with steady inflows of Dutch retirees and IFC professionals, may have created froth in some segments of the real estate market in Curaçao. As of end 2013, banks report adequate capital (12 percent tier-1 capital ratio) and liquidity (30 percent liquid asset ratio), but one bank has been intervened (reportedly because of the stress caused by a defaulting airline). The situation warrants continued close monitoring by the CBCS.

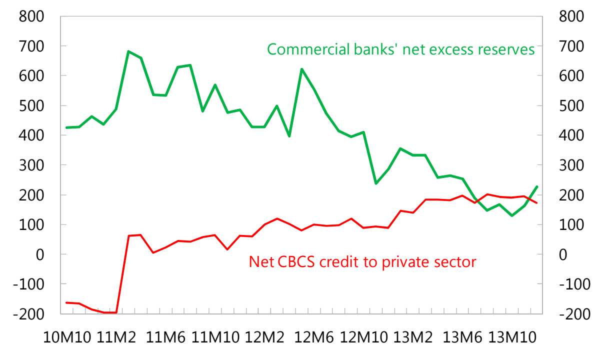
Staff's Views

24. **The CBCS is appropriately trying to slow down credit growth, but should do so more consistently and rely on more standard sterilization tools:**

- **Dealing with excess liquidity:** The CBCS should be prepared to pay a higher interest rate on its certificates of deposits even though this would lower its profits. It could also raise reserve requirements further, while simultaneously increasing the interest it charges banks for liquidity. Finally, it could use macro-prudential tools to contain growth of specific types of loans, e.g. reducing maximum loan-to-value ratios to slow down the growth in mortgages. Over time, it should gradually eliminate remaining limits on outward investments by pension funds. This would allow the excess liquidity to flow out of the system gradually, removing distortions on domestic interest rates.

- **Refraining from direct financing of non-financial companies:** While raising reserve requirements and imposing bank-by-bank credit ceilings, the CBCS has continued to provide funding to private corporations and SOEs (the liquidity thus created is now bigger than the banks' excess liquidity which the CBCS is trying to control—chart to the right). This funding is not part of a standard central bank toolkit and moreover is not justified in a situation where the central bank is concerned with *excess* liquidity resulting in overall excessive and subpar lending.

Credit extended by the CBCS created additional liquidity
(NA.f Million)



Sources: CBCS and Fund staff calculations.

Authorities' Views

25. **The authorities agreed with the thrust of the staff advice.** They reported that they do plan to increase reserve requirements further and raise interest rates on their CDs, as needed, as well as to further alleviate over time the restrictions on outward investments by pension funds. On the financing of SOEs, CBCS management indicated that this policy was initially conceived as a way to facilitate the development of a corporate debt market, but that it has since been discontinued and that they intend to divest their holdings of non-financial companies' debt as soon as market conditions allow.

INCREASING FLEXIBILITY, COMPETITIVENESS, AND GROWTH

Increasing growth and resilience to shock requires dealing with long-standing structural bottlenecks, including stifling red tape and inflexible and dysfunctional labor markets.

Background

26. **Both countries suffer from a rigid labor market and high costs of doing business.** Labor laws are very rigid. For example, laying off workers requires the approval of the labor ministry, even for bankrupt companies. Welfare support for the unemployed is quite generous (for example, in Curaçao it is reportedly roughly equivalent to what one would earn from a minimum wage job once free medical insurance, rent and other subsidies are factored in, and can be received for an

Annex 1: The authorities' response to Past IMF Policy Recommendations

IMF 2011 Article IV Recommendations	Authorities' Response
Fiscal Policy I	
Tighten fiscal policy in the order of 2-3 percentage point of GDP to mitigate external vulnerabilities.	Progress is ongoing, particularly in Curaçao where the need for adjustment was greatest.
Fiscal Policy II	
Shift tax burden from direct to indirect taxation.	Still being considered but details have yet to be worked out.
Fiscal Policy III	
Tax compliance in Sint Maarten needs to be enhanced.	Progress is ongoing.
Fiscal Policy IV	
Curaçao needs to review the generosity of unemployment benefits, particularly with regards to the duration.	No action taken.
Structural Reforms I	
Enhance labor market flexibility, liberalize the administered price regime and reduce red tape.	No action taken.
Structural Reforms II	
Implement measures to increase the efficiency and governance of public utilities and public enterprises,	Remained broadly unchanged though the pass-through of input costs to retail prices has been improved.
Monetary Policy I	
Strengthen financial crisis resolution mechanisms.	Plans for deposit insurance scheme are currently being reviewed in cooperation with the FDIC.
Monetary Policy II	
Use monetary and macroprudential tools to reduce credit growth below that of nominal GDP.	Reserve requirements have been gradually increased and bank level credit ceilings introduced.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Appendix I. Draft Press Release

Press Release No. 14/xx
FOR IMMEDIATE RELEASE
[Month, dd, yyyy]

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes Article IV Consultation Discussions with the Kingdom of the Netherlands—Curaçao and Sint Maarten

On August 1, 2014, the Executive Board of the International Monetary Fund concluded the 2014 Article IV consultation discussions with Curaçao and Sint Maarten, two autonomous countries within the Kingdom of the Netherlands, and considered and endorsed the staff appraisal without a meeting.[1,2]

After some initial slippages, both countries have brought their fiscal policies in compliance with the fiscal rules that had been agreed with the Netherlands in 2010 in exchange for significant debt relief. Curaçao in particular has decisively addressed the spending pressures related to its aging population, which were especially acute. This supported a gradual but steady reduction in the union's current account deficit—the key economic vulnerability flagged by the 2011 Article IV Consultation discussions—though this remains large.

Curaçao's real GDP contracted by an estimated ½ percent in both 2012 and 2013 due to the needed fiscal adjustment, a continued decline in the international financial sector, and the slow global recovery, all combined with long-standing structural weaknesses. Sint Maarten has been recovering, growing by about 1 percent on average over 2012-13, thanks to the ongoing recovery in the United States (the source of 60 percent of its tourists) and the construction of the Simpson Bay causeway.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] Article IV consultations are concluded without a Board meeting when the following conditions apply: (i) there are no acute or significant risks, or general policy issues requiring Board discussion; (ii) policies or circumstances are unlikely to have significant regional or global impact; (iii) in the event a parallel program review is being completed, it is also being completed on a lapse-of-time basis; and (iv) the use of Fund resources is not under discussion or anticipated.

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