

THE IMPACT OF THE PUBLIC SECTOR IN
EXTERNAL IMBALANCES:
THE NETHERLANDS ANTILLEAN EXPERIENCE

by

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Nassau, Bahamas
October 26 - 29, 1992

1. Introduction¹⁾

I am honored to have this opportunity to appear before you today to discuss Netherlands Antillean experiences regarding the impact of fiscal deficits on the external accounts. Thus I will deal with the balance of payments implications of fiscal imbalances in a small open economy with a fixed exchange rate regime vis-à-vis the U.S. dollar and a low rate of inflation.

Recently the public finances in the Netherlands Antilles has been cause for concern. It is increasingly asserted that the current balance of payments deficits in the Netherlands Antilles are partly due to the persistence of the fiscal imbalances. It is self evident that the continuous deterioration in the foreign exchange reserves position of the Netherlands Antilles, if allowed to continue, will eventually erode investors confidence in the economy and hence impair the prospects for sustained economic growth. The purpose of this paper therefore, is to examine the role of the public sector in the imbalances on the external accounts of the Netherlands Antilles. The second section of this paper gives a brief summary of the monetary approach to the balance of payments, which is the conceptual framework that underlies the analysis. Section three provides an overview of economic performance in the Netherlands Antilles during the second half of the 1980s. That is followed by section four, which focuses on the analysis of the relationship between the public finances and the balance of payments outcome during that period. The concluding sections discuss the implications of the analysis for the future course of domestic macro economic policy.

1) An earlier version of this paper was presented at the LV meeting of Central Bank Governors of Latin America and Spain held in Curacao, Netherlands Antilles on September 14 - 16, 1992.

2. The conceptual framework; the monetary approach to the balance of payments

The basis of the monetary approach to the balance of payments, is the definition of the money supply (Ms) as being equal to the domestic assets of the banking system (DAB) plus the country's foreign exchange holdings (NFA).

$$(1) Ms = DAB + NFA$$

This means that changes in the money supply results from changes in commercial banks domestic credit extension and changes in the foreign exchange reserves position.

$$(2) d Ms = d DAB + d NFA$$

The approach is based on two very important postulates. First, the real demand for money is a stable function of a few variables such as real income and an interest rate. In the case of the Netherlands Antilles the role of interest rates in determining the real demand for money may be marginal, hence income may be the single most important factor in this context¹⁾. Second, the domestic component of the nominal money supply (d DAB) is exogenously controlled by the monetary authorities. This is important because it implies that equilibrium on the balance of payments can be achieved by maintaining a fixed relationship between the various components of monetary expansion.

The essence of the monetary approach is that an excess of expenditure over income can only occur if financed with bank credit and/or activation of money. If the source of the credit and/or activation of money is domestic this will result in an

1) A stable function implies a constant proportional relationship between national income and money stock.

As shown in table 1, these shocks had significant adverse social economic repercussions for the Netherlands Antilles. The economy contracted by about 7% on average during the period 1986-1987, while unemployment rose to more than 25%.

Table 1 Selected economic indicators

	1986-1987	1988-1991
GDP growth (percent per annum)	-7.4	5.4
Unemployment rate ^{1/}	NA	20.4
Inflation rate (percent per annum)	2.6	3.4
Fiscal balance (as percent of GDP)	0.2	-3.2
Current account (as percent of exports)	-0.1	-2.3
Official external debt (as percent of exports)	28.8	24.4
Official reserves (as percent of imports)	22.8	16.9

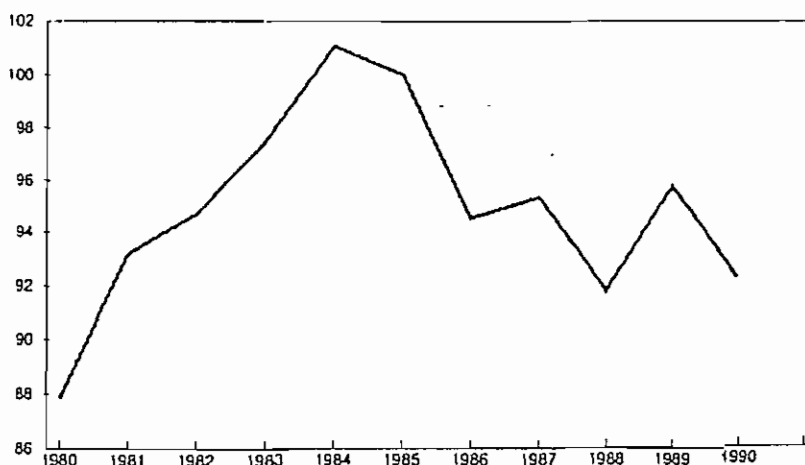
1/ In 1988 the unemployment rate (i.e., of Curacao) amounted to 24.4% while in 1991 it amounted to 16.4%.

Sources:

Bank van de Nederlandse Antillen
Central Bureau of Statistics

The depressed economic conditions were, however, not solely of external origin. Growing prosperity in the late 1970s and early 1980s induced upward pressure on wages, hence adding to the negative impact of the strong U.S. dollar on the international competitiveness of the Netherlands Antilles. Between 1980 and 1985, the competitive position, as measured by the real effective exchange rate, deteriorated by almost 15%.

Graph 1 The development in the real effective exchange rate of the Netherlands Antilles 1980 - 1991



The government, in an attempt to contain the deterioration of the economy and to maintain employment, reacted by increasing expenditure. The main increases occurred as a result of:

- the support of financially trouble enterprises through subsidies and capital transfers; and
- the expansion of employment in the public sector.

In 1988, the economy recovered, due to a more favorable international climate and an improvement in international competitiveness. The then prevailing international economic growth and strong demand in the main trading partners of the Netherlands Antilles bolstered Netherlands Antillean exports. The buoyancy in exports were promoted further by the weakening of the U.S. dollar and the reduction in domestic production cost, through nominal wage cuts, in key industries. The cut in nominal wages, as opposed to exchange rate adjustment, played a crucial role in the economic recovery and should be viewed against the background of the characteristics of the domestic economy¹⁾.

1) Given the small open nature of the economy it is crucial that the bulk of the international payments are conducted in a stable payments environment. Exchange rates adjustments has the potential to erode the confidence in mentioned stability and hence to induce further destabilizing influences.

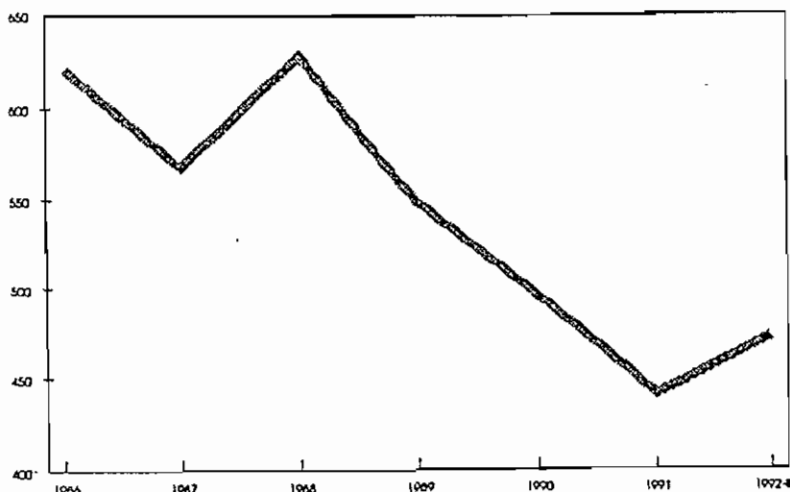
Government investments in, among others, tourist infrastructure also played an important role in the economic recovery. During 1988-1991 real GNP increased by about 5.4% on average. The growth was mainly fueled by a marked increase in exports primarily as a result of:

- an increase in stay-over tourism,
- a reactivation of oil refining capacities;
- a considerable strengthening of ship repair operations; and
- the expansion of non-traditional international financial and business services operations.

The economic expansion had positive effects on the labor market as it resulted in an improvement in the unemployment situation. Unemployment in Curacao dropped from 24.4% in 1988 to just over 16% in 1991. Notwithstanding this significant improvement, the rate of unemployment continue to be high and therefore an area of concern. In addressing this issue two factors should be taken into consideration; the existence of a natural rate of unemployment due to social and cultural factors and the mismatch between the demand for and supply of labor. To address the unemployment issue the focus should be on the reduction of this mismatch through, e.g., the implementation of a rescholing, training and upgrading program.

The growth was accompanied by a more than proportionate rise (averaging almost 8% during the period 1988-1991) in domestic expenditure, owing to the strong increase in commercial banks domestic credit extension. The ensuing sharp increase in imports, owing to the openness of the Netherlands Antillean economy, has notwithstanding the buoyancy in exports led to a worsening of the external position.

Graph 2 The development in the net international reserves position of the Netherlands Antilles (in millions NAf.)



The official reserves as a percentage of exports declined to under 17% in the period 1988-1991 (see table 1). In anticipation of these adverse effects the Central Bank saw the need for a more moderate growth in the domestic component of monetary expansion to eliminate excess demand pressures, and hence tightened its monetary policy stance in June 1988. That was followed by a further tightening in September 1990. The latter entailed the introduction of a credit control measure, that allows a 5% per ~~year~~ penalty-free growth of bank lending to the private sector. Monetary policy alone, however, cannot address the deterioration in the foreign exchange reserves position of the Netherlands Antilles. It should be complemented by policies in other areas that are consistent with the objective of improving the external balance of the country. That fiscal policy has a role to play may be derived from the fact, that it is increasingly asserted that the current balance of payments deficits in the Netherlands Antilles are partly due to the persistence of the fiscal imbalances.

1) This percentage is based on the objective of containing domestically induced monetary expansion at a rate consistent with a sustainable level of economic growth.

The question therefore is; what is the role, if any, of the public sector in the worsening of the external position of the Netherlands Antilles?

4. The public sector and external imbalances

The depressed economic conditions in the mid 1980s were not immediately accompanied by the anticipated deterioration in the public finances. This was mainly due to two transitory factors. First, the acceleration in the payments of profit taxes by international finance companies following aforementioned repeal of the U.S. withholding tax in 1984¹⁾. This resulted in a peak in profit tax earnings in 1986. And second, the windfall in income tax revenues as a result of the redundancy payments by the Shell in 1986 to its former employees.

However, as the anticipated decline in profit tax receipts started to assume definite shape the general government budget turned into a deficit in 1987. Profit tax earnings from the international finance sector dropped to NAf.217 million in 1991, that is less than half the amount of the 1986 peak. Faced with this prospect and the increased level of expenditure for reasons mentioned earlier, the government saw the need for and hence introduced a fiscal adjustment program, ~~the~~ so-called "equilibrio program". The objective of this program was to realize a balance budget by 1992. Areas where budgetary savings were attained are personnel, through a voluntary lay-off scheme, and the privatization of government owned hotels. However, in other areas, such as the reorganization of government departments and agencies, the actual adjustment fell short of the targeted goals. As a result the actual and the targeted deficits in the equilibrio program deviated increasingly.

1) Mentioned acceleration can mainly be attributed to the payments of arrears in taxes.

In 1990, the critical situation of the public finances came under added pressure as a result of an increase in the wage bill. Consequently, as shown in table 2, the budget balance worsened.

Table 2 Public finance and external accounts indicators

	1988	1989	1990	1991
(level as percent of GNP)				
PUBLIC FINANCES				
Fiscal balance	-1.3	-3.9	-4.6	-3.1
The borrowing requirement of the government	1.3	3.9	4.6	3.1
sources:				
- Banking sector	-2.0	-0.8	0.6	1.1
- Non bank financial sector	0.4	0.8	1.0	0.5
- Other	2.9	3.9	3.0	1.5
EXTERNAL ACCOUNTS				
Balance of payments outcome	2.7	-3.4	-2.0	-1.9
Current account	4.6	-0.1	-3.3	-1.9
Induced net capital inflows	-1.9	-3.2	1.3	0.0
MEMORANDUM ITEMS:				
Official reserves (as percent of imports)	22.6	15.9	15.9	13.0
Net bank lending to the private sector (% of GNP)	6.6	10.1	6.8	5.0

Source:

Bank van de Nederlandse Antillen.

As a percent of GNP the fiscal deficit widened from 1.3% in 1988 to 4.6% in 1990. As a result of these developments the borrowing requirements of the government increased substantially during the period 1988-1991. Initially, that is in 1988 and 1989, the government took recourse to non bank sources of credit to finance its deficits. But by 1990 the imbalances were increasingly

financed with commercial bank credit. During the period 1990-1991 the net claims of the banking sector on the government rose by over 80%. That development was accompanied by a deterioration in the current account of the balance of payments and, as a result of the aforementioned credit control measure, by a declining growth in the claims of the commercial banks on the private sector. The latter is reflected in the decline of net domestic bank lending to the private sector as a percentage of GNP from 10.1% in 1989 to 5% in 1992. According to the monetary approach to the balance of payments, this suggest that the excessive demand emanating from the budget deficits, which has been largely monetized, is increasingly contributing to the imbalances on the external accounts of the Netherlands Antilles. That is mainly the case since 1990.

Furthermore, to the extent that the government continue to accumulate domestic debt this is bound to put pressure on the cost of funds and hence crowd out private sector investments.

These developments are of great concern because they have the potential to create destabilizing conditions which will impair the prospects for sustaining the prevailing economic expansion.

5. Macroeconomic policies

The above shows that concomitant with the economic expansion, the economy faces major internal and external imbalances that are reflected in high unemployment, persistent fiscal deficits and continued balance of payments deficits, which endanger the sustainability of that growth. Hence, there is an obvious need to eliminate macroeconomic distortions.

To achieve that, there are certain conditions that have to be met. This brings me now to the point of discussing the lines along which macro economic policy should be conducted to secure a sustained economic expansion of the Netherlands Antilles.

First, monetary policy should continue to play its part in preserving a climate of stability, conducive to a continued expansion of economic activities. To do that it is imperative that undue reliance on monetary policy be avoided. Namely, monetary policy should focus on containing domestically induced monetary expansion at a rate consistent with a sustainable level of economic growth. The Central Bank therefore tightened its monetary stance further in September of 1992 to include bank lending to the public sector in the monetary cash reserve arrangement.

The second principle is the very important objective of getting the public finances under control. Specifically, I believe that the current level of budget deficits are unsustainable¹⁾. In this context it is important to note that the prospects to resolve the budgetary problems are being threatened by recent developments in the wages of government personnel, as they make progress in the expenditure reduction field even more difficult to accomplish. A delicate balance therefore has to be struck between the control of public expenditure and the economic recovery.

The recently announced new plan for financial restructuring is considered a step in the right direction. The main objective of the financial restructuring is, to achieve balanced budgets for the respective governments by 1995. Important to the success of the financial restructuring of the Netherlands Antilles is the implementation of the proposed plan to establish a "Financial Restructuring Fund". The restructuring fund is intended to help finance the restructuring process and its means will be furnished through the restructuring of the Netherlands Antillean debt to the Netherlands.

1) That is given the specific characteristics of the Netherlands Antillean economy; particularly the openness, the level of foreign exchange reserves and the savings behaviour of domestic economic agents.

Recent developments, however, has made a revisiting of the financial restructuring plan necessary. The most significant change to the original plan is the scheduled introduction of a sales tax in 1993. An increase in the means for the restructuring fund will most likely be necessary.

Another condition that has to be met, is that of effective cooperation. To protect the recovery from the damaging trade-offs from wider policy-making, greater cooperation between the governments and the Central Bank in the context of the Tri-partite agreement and openness about each other policies is imperative. It ought to be pointed out that there has been a progressive strengthening of cooperation over a wide range of issues and policy since the signing of the first Tri-partite agreement in 1989. This enhanced cooperation should help to secure the prospects for sustained growth.

Finally, the pursuit of a sustainable economic expansion also raises the issue of competitiveness. As long as the inflation rate is in line and wage expectations are stabilized, this pursuit may be viewed as realistic. The degree of ambition currently feasible with respect to wage settlements is limited not only by prevailing productivity differences, but also by the uncertainties about ~~the long-term competitiveness implications.~~

6. Concluding remarks

The late 1980s and early 1990s experience of the Netherlands Antilles with an expansionary fiscal outcome and the consequences for the external accounts are broadly in accordance with the general assertions. Throughout the early 1990s the public sector deficits have been largely monetized, hence resulting in an increased adverse impact of the fiscal imbalances on the external accounts as suggested by the monetary approach to the balance of payments. Admittedly developments in the Netherlands Antilles has

been far more complex than presented here. Nevertheless, they illustrate the case where a significant rise in the public sector deficit in a small open economy with a fixed exchange rate regime can result in a deterioration of the external position.

It may therefore be concluded that to protect the balance of payments and hence the prospects for further growth the authorities must address the fiscal imbalances. It should be noted though, that other conditions, such as, international competitiveness and monetary conditions must also be kept in check.