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**IMPACT OF THE INTERNATIONAL FINANCIAL SERVICES INDUSTRY
ON THE BALANCE OF PAYMENTS OF THE NETHERLANDS ANTILLES**

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**The impact
of the
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1. INTRODUCTION

The economies in the Caribbean have, although they are different from each other on several aspect, also a few similarities. For example, the net international reserves are of paramount importance in small open island economies, like the ones in the Caribbean. These reserves enable the economies to pay for their imports, which are necessary for consumption, investment and the production of exportable goods. The net international reserves are affected by transactions between residents and non-residents. These cross-border transactions are recorded on the balance of payments, which provides information on the magnitude and characteristics of mentioned transactions. Therefore, the balance of payments is an important concept, acting both as an indicator of economic developments and as an analytical tool for national and international policy makers.

A second feature which some Caribbean economies have in common, is the restricted supply of natural resources and the limited availability of land. These are perhaps two of the main reasons behind the development of tourism and international financial centers in the Caribbean. In the course of years, tourism and the international financial centers have developed to become significant contributors to total foreign exchange earnings of Caribbean island economies. In addition, the scope of the originally financial centers broadened to incorporate more aspects of the business services industry. Domestic companies developed intensive relationships with the international center and became more or less dependent on this international center for their existence. That is why we nowadays can speak of the international financial and business services industry. This industry comprises truly international oriented companies of the international services center and related domestic companies like law firms, notaries, real estate companies and others.

This paper discusses the impact of the international financial and business services industry on the balance of payments. For this goal, the second paragraph will be designated to the definition of

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this industry. When the industry is clearly defined, its impact on the economy in general is discussed in the third paragraph.

Paragraph four will give a description of the way cross-border transactions are registered in the Netherlands Antilles, after which six different types of cross-border transactions are identified. Each type of transaction will result in either an inflow or an outflow of funds. The impact these flows have in the case of the Netherlands Antilles will be dealt with in two separate ways in the fifth paragraph. The first part will take a transaction based approach, as the second part will take an activity based approach. The final paragraph will summarize the facts and present some concluding remarks.

2. THE INTERNATIONAL FINANCIAL AND BUSINESS SERVICES INDUSTRY

This paragraph presents a definition of the term 'international financial and business services industry'. In order to facilitate the description of mentioned term, the paragraph will start with a description of what is generally called an international financial center. This will serve as a starting point for the description of the broader term. Also the reasons underlying this extension will be mentioned. Furthermore, the international financial and business services industry will be defined by identifying several ISIC-codes (International Standardized Industry Classification codes) of industries/branches which are considered part of this industry. This will facilitate the comparability of the concept.

International financial centers are centers which have specialized in the provision of financial services in currencies other than the one used in the country in which they are located, often with the limitation only to conduct business with non-residents. As a result the financial transactions are not linked to the domestic financial sector. This separation has been created artificially in order to establish a different kind of jurisdiction for the financial institutions in the international financial center. This different jurisdiction enables the authorities to offer benefits the financial institutions can not get in the domestic sector. The main benefits offered by this split jurisdiction are less regulation and a more favorable tax regime. These benefits however, have proven to be insufficient to attract financial institutions to the center. Other preconditions which will have to be met are:

- Stable currency
- Political and social stability
- Governmental commitment to supporting the (international) financial sector
- Reliable telecommunication system
- Skilled labor

When a country offers all mentioned points, an international financial sector might evolve. The mere existence of such a center can (as will be discussed in the next paragraph) attract new business, either from within or outside the financial industry. The companies in the international sector will develop relationships with the domestic sector, which have to provide them with the necessary goods and services to conduct business. Certain domestic companies will adjust to this de-

mand and specialize themselves on specific areas like accounting, law firms, notaries, consultancy firms or telecommunication services. Gradually, a whole network of companies offering financial and other services, operating either local or international will be located in the economy. Such a network of interdependent companies and institutions can be called an international financial and business services industry. This industry is embedded in the domestic economy, so it is difficult to separate the international part from the domestic part for analytical purposes. This is even more so because measures affecting one part of the industry are likely to affect the other part as well, taking the magnitude and intensity of the intra-industry relationships into consideration.

The strict boundary between domestic and international *financial* sector however, stayed intact. Where domestic financial institutions have to comply with the monetary regulations of the authorities, international institutions do not: they usually get a limited license, which enables them only to provide international financial services. Therefore the two *financial* sectors can be separated and this makes it possible to keep the domestic financial institutions outside the definition of the international financial and business services industry.

In terms of ISIC-codes, the international financial and business services industry is defined as the collection of companies operating under the classification codes J and K, being 'Financial services' and 'Real estate and business services', respectively. In the old code² (the third revision) mentioned codes coincide with ISIC-class 8, being the 'financial and business services' industry. In both cases there has to be made an adjustment for the domestic financial institutions. The definition of the international financial and business services industry is presented in table 1.

Table 1: Definition of the international financial and business services industry

Standard	Classification	Description	Exceptions
New ISIC-code	J	Financial services	Domestic financial institutions
	K	Real estate and business services	
Old ISIC-code	8	Financial and business services	Domestic financial institutions

Note: Although not stated in the description, real estate was also incorporated in the old classification.

In the following paragraph, a general description of the impact of an international financial center on the economy will be presented.

² The old classification code is mentioned because the Bank van de Nederlandse Antillen presents a quarterly breakdown of the balance of payments based on this old code.

3. GENERAL DESCRIPTION OF THE IMPACT ON THE ECONOMY

This paragraph will give a qualitative insight in the impact of an international financial and business services industry on the economy. The international financial center will once again act as a starting point; additions with respect to the impact of an international financial and business services industry will be made. The overall impact can be divided in advantages and disadvantages which will be addressed in two separate subparagraphs.

3.1. Advantages

When an international financial center is located in an economy, this will lead to several benefits for the economy, which can be separated in direct and indirect ones. The direct benefits a country receives consists of two parts: direct benefits to the government and direct benefits to the economy. The direct benefits to the government may, among others, result from registration and license fees, work permits and profit taxes (if levied). In the case of the Netherlands Antilles, the direct advantage is mainly the result of a (albeit low) rate of profit tax.

The direct benefits to the economy consist of the operational expenditures of the international financial sector. Companies in such a center, whether physically present or not, need to purchase goods and services from the local markets. The most important of those local markets are the labor and real estate markets, especially when financial institutions are physically present. This will lead to growing employment and consequently a second round effect on government revenues.

Besides the impact of increased employment and overall demand, a second direct benefit exists. This benefit is related to the balance of payments. Since the internationally operating companies in the center by definition have no means to generate local currency, local expenses have to be met by an inflow of foreign currency. This inflow contributes to the net international reserves.

The indirect advantages of housing an international financial center include the creation of new jobs in fields demanded by the financial institutions. Examples are, as noticed before, jobs in accounting firms, law offices, notaries, trust offices, consultancy firms and telecommunication services. All this 'new' economic activity has a positive effect on government revenues; this can be called a third round benefit to the government.

Another indirect advantage is the constant transfer of knowledge from expatriates working in the international financial center to local employees in this center. This will ensure that the local workforce is continuously updated with the latest global information and knowledge. As a result, efficiency may rise and average costs may come down. This in turn will attract other business to the existing center, creating economies of scale and resulting in spill-overs with respect to technology and leading to a learning curve effect in financial and other business services. All in all, the international financial center will become an attractive place for the settlement of new companies and will cause demand for domestic goods and services to rise, especially in the fields mentioned. Somewhere along the line, there is a point in time where it is no longer possible to separate the domestic part of the industry from the international part. That is the point where the international financial and business services industry enters the economic panorama.

The main benefit of an international financial and business services industry above the benefits of an international financial sector is the diversification of economic activities and the increasing importance of domestic companies. These two elements might even act as a trigger to further development of the international financial and business services industry by attracting business in related fields like logistics or information technology.

3.2. Disadvantage: misuse

Besides the advantages associated with the establishment of an international financial center, there is also an important disadvantage. The availability of numerous banks and other financial institutions attracts people who want to misuse the financial system for money laundering purposes. To combat this threat, the government will have to allocate resources to a regulatory and supervisory body. As a result the net benefits to the government will be lower. However, it must be kept in mind that increasing expenditures on programs to detect and deter money laundering may in itself attract new business. So although there is a cost-disadvantage, it is possible that the economy will profit from it in future.

Other costs that are mentioned by several authors to represent disadvantages to the economy are the costs associated with the setup of the necessary conditions for a international financial center, like the ones mentioned in the second paragraph. This entails making provisions for a stable currency, which for a small open economy means that the monetary authority will have to give up some of its independence in the formulation of monetary policy. Political and social stability, the second condition mentioned, can not be bought although providing social security and social services will increase the possibility. Furthermore, considerable investments are needed to establish reliable telecommunication services and a good education system. If an international financial center already does exist, mentioned costs have been made in the past, so the current costs are lower. Besides that, these costs can be seen as an investment for the future, since they will provide favorable macro-economic conditions to support sustainable growth of both the domestic economy and the international financial and business services industry. So although mentioned by several authors, the 'disadvantages' presented here might even turn into advantages, as an economy will take a lead over other economies which do not make this investments.

4. REGISTRATION OF TRANSACTIONS

This paragraph first describes to way transaction are registered in the Netherlands Antilles, and afterwards will discuss the different type of transactions that exist.

4.1 Registration

The impact of the international financial and business services industry on the balance of payments of the Netherlands Antilles is ideally measured by summing up the cross-border transactions conducted by all the companies and institutions in this industry. Information on these transactions is gathered through cross-border transaction reporting forms, which commercial banks are obliged to fill in for the Bank van de Nederlandse Antillen. Cross-border transactions arise when a resi-

dent and a non-resident enter in an agreement to transfer funds from one to the other. Transactions between two residents or two non-residents are not recorded on the balance of payments.

To provide insight in the impact on the balance of payments, the following discussion will separate between transactions causing an inflow of foreign exchange and those causing an outflow. The distinction between an inflow and an outflows depends on the residency of both the recipient and the sender. A transaction is an inflow when a resident receives foreign exchange from a non-resident; for an outflow the argument goes the other way around.

Residency is the most important factor in cross-border transactions. In the Netherlands Antilles residency for balance of payments purposes is determined by looking at the kind of bank account used in the transaction. If the bank account is a resident-account, the holder of the account is considered a resident. Of course all commercial banks have to have proper procedures in place to determine the residency of an applicant. This may entail requests for copies of the statutes of enactment, registrationnumbers with the chambers of commerce or taxnumbers.

4.2 Types of transactions

Companies in the international financial and business services industry enter in transactions in a few simplified ways. A company can either receive money from a client for services provided, pay a supplier for the goods or services delivered or transfer money to and from its parent. Table 2 shows that there are 12 possible transactions a company can get itself into, but only six of them are cross-border transactions. If you try to measure the impact of the international financial and business services industry on the balance of payments, you would like to sum all six possibilities. However, since the cross border transactions are recorded from the resident's point of view, only the first line of table 2 will be available for analysis.

Table 2: Possible transactions (X means no cross-border transaction)

Company	Client		Supplier		Parent	
	Resident	Non-resident	Resident	Non-resident	Resident	Non-resident
Resident	X	Inflow	X	Outflow	X	In/outflow
Non-resident	Outflow	X	Inflow	X	In/outflow	X

In other words, the transactions of non-resident companies, which form part of the international financial and business services industry are not recorded on the balance of payments as such. These transactions also are recorded from the resident's point of view, which means that the cross border transactions in the second row of table 2 will be allocated to whatever industry or branch the resident counterpart is active in. So the flow of funds is recorded, but it is not possible to trace this flow back to the non-resident company from the international financial and business services industry. Whenever you use the balance of payments to measure the impact of the international financial and business services industry on that balance of payments, it will only be half the story.

The problem is that the companies in the international financial and business services industry can be either resident or non-resident, so not all companies will be covered by the registration of cross-border transactions. The IMF fifth manual on the balance of payments states on this point that every offshore company has to be considered a resident of the economy in which it is located, but it does not state how this can be established. The registration method used by the majority of countries for the compilation of the balance of payments is not capable of monitoring non-resident transactions as well.

As noted above, the Bank van de Nederlandse Antillen considers all offshore companies which use a resident account as a resident, but not all companies do so. Since the use of non-resident accounts was one of the very reasons to start an international financial sector in the first place, it will not be easy to alter the residency of all non-resident companies in the international financial and business services industry. This difficulty with the residency still is a pending point for which no sufficient international solution has been found yet.

Back to the different types of transactions and the way to measure the impact on the balance of payments. When trying to measure the balance of payments benefit as a result of the local operational expenses of the international financial and business services industry, a problem arises because the payment of the local supplier might not be a cross-border transaction (see the supplier column in table 2). So how do you measure the beneficial inflow of money involved in this type of transaction? An approximation has to be made, which can be done by using the following explanation. Resident companies in the international financial and business services industry pay their bills to resident suppliers, but are prohibited to enter in business with a resident client. What will happen is that the bills get paid, but there is no flow of funds to support the company's resident account. So from time to time, the parent will find it necessary to transfer money to mentioned account. This flow of funds (intra-company, cross-border) can be seen as an inflow for the payment of resident suppliers. It will normally not take place at the same time and the nature of the transaction cannot be traced by this approximation method. The level of accuracy on the *magnitude* of the transactions depends on the strength of the prohibition of entering in transactions with resident clients. The more resident clients a company has, the less replenishment will seem to be necessary to pay the resident suppliers, and an understatement of total purchases from the supplier will result.

Now let's turn to the outflow of funds. Whenever a company pays her foreign bills using the resident account, an outflow will be recorded on the balance of payments, since a resident transfers funds to a non-resident. There is another possibility for an outflow to occur, namely when a company transfers its profits to her foreign parent. This is only possible when clients use the resident account to pay for the services they received from the company, because only in that case will a company build up profits on the resident account. So the outflow to the foreign parent will have to be met by inflows from clients. A third possibility of an outflow enters the balance of payments from the side of the resident client. When this resident pays a non-resident company which is part of the international financial and business services industry, this will become visible on the balance of payments as an outflow from the client. This flow is recorded, but it is not possible to follow the flow of funds to the international financial and business services industry.

The next paragraph will present the impact of the international financial and business services industry on the balance of payments. However, do not forget the remarks made in this paragraph.

5. IMPACT ON THE BALANCE OF PAYMENTS

To measure the impact of the international financial and business services industry on the balance of payments of the Netherlands Antilles, data based on the residency of the companies for both the inflows and the outflows from 1991 - 1995 were used. In the following a two step approach is used.

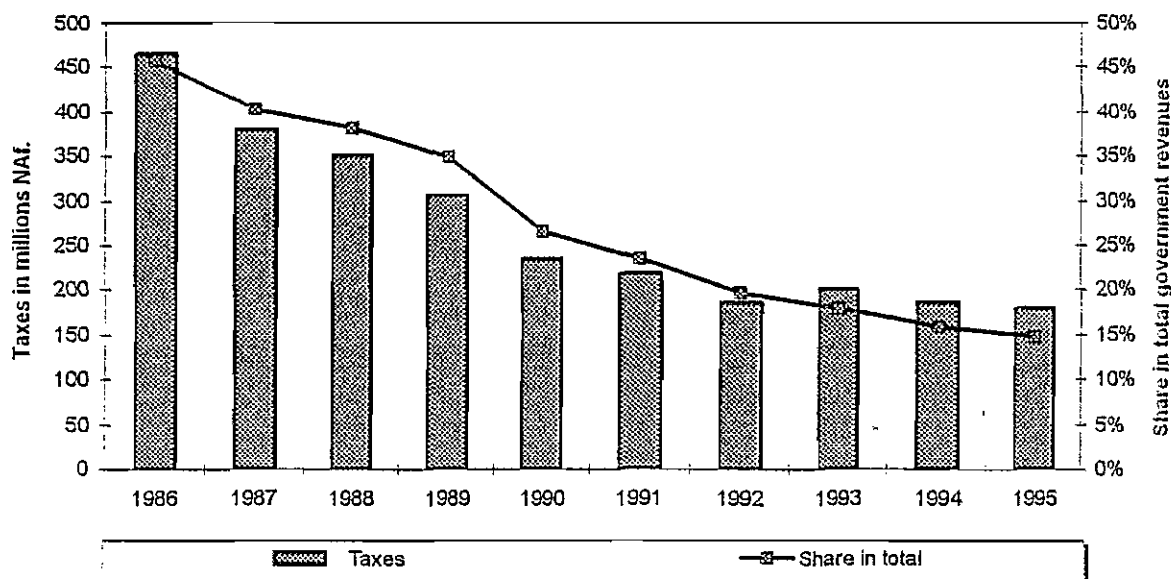
First of all, the transaction based presentation of the balance of payments is used. In this presentation, the international financial sector enters in only two different types of transactions, namely the 'profit taxes' and 'Operational expenditures'. The second approach uses the breakdown of the balance of payments by kind of economic activity to measure the impact of the international financial and business services industry on the balance of payments.

5.1. Transaction based approach

For the international financial sector the impact on the balance of payments consists of the inflow of profit taxes and both the inflow and outflow of operational expenditures. The definition of profit tax is straight forward since it comprises the taxes paid by the international financial and business services industry to the Island Government of Curaçao. This is the only transaction which enters as an inflow stemming from the non-resident company in the international financial and business services industry because this type of transaction actually can be traced back to its source. The government namely only receives tax payments from non-residents who are in some way related to the international financial and business services industry.

The profit tax revenues have been a major source of foreign exchange income, but this has been declining as can be seen in graph 1. Recently, total taxes received from the international financial and business services industry have stabilized at a level between NAF. 180 million and NAF. 200 million and they still form a significant part of total government revenues.

Graph 1: Level and significance of taxes from the international financial and business services industry



Source: Bank van de Nederlandse Antillen

The second transaction type used in this approach is called “Operational expenditures” and consists of payments and receipts in relation with normal operating procedures of the companies involved. The operational expenditures inflows have shown a strong increase over the last five years, as can be revealed from table 3. This table also gives insight in the composition of total inflows to the resident companies in the international financial and business services industry and the government. The overall impact of the international financial and business services industry on the inflow side of the balance of payments has remained fairly stable at around 20%. The impact on the outflow side shows to be much less significant, with an impact of around 8%

Table 3: Composition and impact of in- and outflow from the international financial and business services industry (in millions Naf.)

Transaction	1991	1992	1993	1994	1995
Taxes	217.0	186.5	200.0	184.9	180.0
Operational Expenditures (in)	409.4	504.5	519.3	503.3	688.0
Total in	626.4	691.0	719.3	688.2	868.0
Operational Expenditures (out)	226.3	229.5	302.0	297.9	307.5
% of total inflows	20%	20%	21%	19%	22%
% of total outflows	7%	7%	9%	8%	8%

Source: Bank van de Nederlandse Antillen

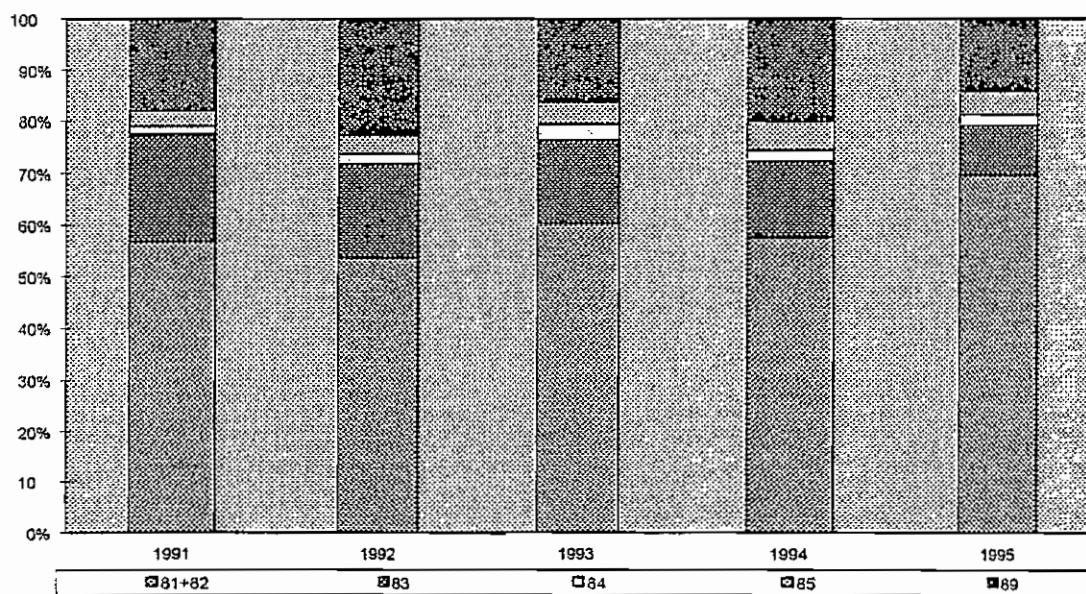
5.2. Activity based approach

The second approach used, divides the balance of payments in several parts, with the kind of economic activity of the resident as a criterion. Since this paper deals with the international financial and business services industry, or class 8 of the old ISIC classification scheme, this paragraph will present the shares of the branches identified within this industry. These branches are the following classes (with the new ISIC code in parentheses):

- 81 + 82 (J-65/66) :Financial services
- 83 (K-70) :Real Estate
- 84 (K-74) :Business services
- 85 (K-71) :Rental services
- 89 (J-67, K-73) :Other financial or business services

As can be revealed from graph 2, the 'Other financial and business services' form the largest inflow for the international financial and business services industry after the financial institutions themselves. Mentioned branch contains the related services like accounting, law firms, notaries, consultancy firms and trust offices. The importance of these flows shows the growing intensity of the relationship between the internationally orientated companies and the originally domestic companies. The outflows, which are not shown in the graph, show a similar pattern.

Graph 2: Relative importance of the branches in the international financial and business services industry



Source: Bank van de Nederlandse Antillen

6. SUMMARY AND CONCLUDING REMARKS

The net international reserves are very important to small open island economies like the ones in the Caribbean, since they enable them to pay for their imports. Furthermore the international financial and business services industry has become an important pillar of several economies in this area. This paper discussed the impact of the international financial and business services industry on the balance of payments in general and in the case of the Netherlands Antilles in particular.

The overall impact of the international financial and business services industry on the balance of payments is however, not completely covered by the registration. Currently, only the cross border transactions of resident companies in the international financial and business services industry can be ascribed to this sector. Cross-border transactions of the non-resident companies are registered, but cannot be traced back to the international financial and business services industry, since they are recorded from the resident counterpart's point of view. So considering the method of registration, the balance of payments reflects the correct values, but there are some transactions (in which a non-resident company is one party) where more information would be advantageous. To gather this type of information, the currently employed registration method will have to incorporate transactions of non-residents as well, or all companies in the international financial and business services industry will have to be considered residents, that is, they have to use resident accounts for their financial transactions.

At this moment, both options seem to be unrealistic; the first one because it would require a huge effort to monitor all non-resident companies, while there will just be some additional information, no new in- or outflows. The second option is not practically feasible because the use of non-resident accounts by the companies was inspired by the special treatment which was connected to it. The companies are likely to lose these benefits when using resident accounts. An international solution to counter this problem still has to be found.

Using only the resident companies to measure the impact of the international financial and business services industry on the balance of payments, it turns out that this sector accounts for about one fifth of total foreign exchange inflows of the Netherlands Antilles. Detailed information shows that the related domestic part of the international financial and business services sector is responsible for the second largest part of this inflow, after the financial institutions themselves. Figures for the outflow show considerably less involvement from this industry. As a result, this industry can be said to support the net international reserves of the Netherlands Antilles.