MISSION CONCLUDING STATEMENT

The Kingdom of the Netherlands—Curaçao and Sint Maarten: Staff Concluding Statement of the 2018 Article IV Mission

November 9, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

An International Monetary Fund (IMF) team led by Ms. Lusine Lusinyan visited Curaçao and Sint Maarten from October 25 to November 9, 2018, to conduct discussions for the 2018 Article IV

Consultation.

Weak growth and underlying structural vulnerabilities persist in both Curaçao and Sint Maarten, magnified further by large negative external shocks, including spillovers from one of Curaçao's largest trading partners and the impact of Hurricanes Irma and Maria on Sint Maarten. The fiscal and external positions of both countries deteriorated, and significant uncertainty is impacting economic activity adversely. The challenging outlook makes the need for structural measures aimed at ensuring fiscal sustainability, enhancing competitiveness, strengthening investor confidence, and developing capacity more time-critical. The authorities recognize the need to act decisively to put both economies on the path of higher and sustainable growth.

Recent Economic Developments

In Curaçao, real GDP contracted by about 1¾ percent in 2017, marking five years of recession in the past seven years. Spillovers from Venezuela, through trade, the refinery, and tourism channels, have been the main drag on growth. Inflation was zero in 2016 but rose to 1.6 percent in 2017 driven by international prices. The unemployment rate increased to about 14 percent in 2017, among the highest in the region.

Curaçao's fiscal position worsened significantly. The current balance turned to a deficit of 0.6 percent of GDP in 2017 from previous surpluses, as nontax revenues declined and spending on goods and services increased. The overall balance also worsened due to a 1½ percent of GDP increase in construction spending on a new hospital. Gross public debt rose to 50 percent of GDP in 2017, as arrears to the public pension fund (APC) surged. Given the breach of the fiscal rule, which prohibits current budget deficits, Curaçao is required to compensate the deficit of NAf 117 million by achieving current budget surpluses starting in 2018.

In Sint Maarten, real GDP is estimated to have contracted by about 4¾ percent in 2017 following Hurricane Irma, which caused about US$2.7 billion in damages and losses. With major tourism infrastructure destroyed, cruise and stay-over tourist arrivals declined by about 25 percent (y/y) in 2017. Inflation increased in 2017 to 2.2 percent. With half of the labor force engaged in tourism, the labor market was affected although arrangements to keep employees via training and other programs helped.

The large drop in tourism-related revenues and increase in expenditure significantly worsened Sint Maarten's 2017 fiscal accounts. The 2017 overall deficit reached 3½ percent of GDP, partly financed by a loan from the Netherlands. Gross public debt stood at about 34 percent of GDP by end-2017. To support the recovery, the Netherlands set up a €550 million reconstruction fund (about 65 percent of GDP), committing up to €470 million to be disbursed through a World Bank-administered Trust Fund until 2025.

The external situation of the union has deteriorated since 2015 and remains weak. The current account deficit continued to widen to 15 percent of the union GDP in 2017, as tourism receipts declined in both countries while imports increased in Curaçao due to higher oil prices and construction activities. In Sint Maarten, lower imports and insurance payouts kept the current account positive. Official reserves declined to US$1.3 billion (about 4½ months of imports) as of September 2018.

Outlook and Risks

After further contraction in 2018, Curaçao's growth is expected to remain subdued over the medium term. Real GDP is projected to contract by 2 percent in 2018, as limited refinery operations more than offset the uptick in tourism. Given the refinery's uncertain future, the baseline assumes continued low-level operations. Growth would improve marginally over the medium term, remaining below ½ percent .

Sint Maarten's real GDP is projected to contract by 8½ percent in 2018. The recovery, particularly in stay-over tourism and airport reconstruction, remains slower than in other hurricane-affected regional peers. The tourism rebound and strong investment in reconstruction will lead to positive real GDP growth in 2019, converging to the historical trend of 1.9 percent by 2023, still implying a lower than pre-Irma level of real per capita GDP. The slow pace of recovery reflects in part a large gap between reconstruction needs (estimated at US$2.3 billion) and identified public and private financial resources (around US$1.2 billion). Limited information about the specific amounts, types, and timing of reconstruction activities creates significant uncertainty.

The union's current account deficit will gradually narrow over the medium term but remain higher than those of regional peers. Curaçao's current account deficit would improve slightly as tourism receipts increase and construction-related imports decline. In Sint Maarten, lower exports and higher construction imports will keep the current account deficit in double digits as a share of GDP in 2018–20. Official reserves will stabilize at about 4 months of imports, in line with regional peers.

Risks to the outlook are mainly on the downside. Weaker-than-expected global growth could curb tourism demand. A stronger U.S. dollar could negatively impact the islands' competitiveness vis-à-vis non-U.S. tourist markets. The high current account deficit, especially if it widens further, poses a risk to external stability. A slow progress in strengthening financial sector oversight, AML/CFT frameworks, and central bank governance could lead to further losses of correspondent banking relationships (CBRs). While a continuing crisis in Venezuela is the main risk for Curaçao, hurricanes remain a major risk for Sint Maarten. On the upside, quickly finding a strategic partner for the refinery could boost growth and investment in Curaçao, while availability of additional resources and faster implementation within well-defined priorities could speed up Sint Maarten's recovery and raise growth.

Key Policy Messages

Strengthening Fiscal Frameworks, Ensuring Fiscal Sustainability, and Building Resilience

Both countries need to urgently adopt a medium-term fiscal framework with a long-run debt anchor. Fiscal challenges and mixed compliance have exposed the shortcomings of the current rules-based framework. This includes the lack of a fiscal anchor, drawbacks of the balanced current budget rule, rigidities in capital spending, the lack of a well-defined 'escape clause', which allows for deviations from the rules in the face of major shocks, and of stipulations to build fiscal buffers. The authorities are considering some elements (like a fiscal reserve fund in Sint Maarten, and an implicit debt target in Curaçao) but a more systematic approach is needed, including through strengthening the legislation.

In both countries, fiscal risks should be addressed through structural measures and greater fiscal transparency.

- Budgetary arrears vis-à-vis the social security and pension funds have become endemic. In Cura ç ao, the authorities are planning to reduce the large stock of arrears to APC; in Sint Maarten, the authorities' plan envisages the repayment of most arrears from 2021. While greater fiscal discipline and tight spending controls would prevent future arrears, further reforms to ensure financial viability of the social security funds and the healthcare systems are needed. The envisaged introduction of a general health insurance in Sint Maarten, which needs to be budget neutral, would increase coverage and transparency.
- Fiscal transparency, reporting and coverage would need to improve significantly, to facilitate policy analyses and assess financing and liquidity needs. Use of extra-budgetary funds, including for investment, should be avoided; at a minimum, their data should be consolidated with the budget, and a coherent public investment management framework developed. Budgetary decisions should be aligned with the governments' policy priorities.

Curaçao: Significant Fiscal Deterioration and Risks Call for a Strong Structural Response

Curaçao's fiscal position is expected to improve from 2018, but additional structural measures are needed to put the public debt on a sustainable downward path. Under current policies including cost-cutting measures, gross government debt is projected to decline slowly. Stronger measures are required to underpin the medium-term plan bringing debt down to 40 percent of GDP. The ongoing multi-year cuts in some personnel expenditure and across-the-board reductions in spending on goods and services are steps in the right direction, but to be sustainable and effective, they need to be accompanied by adjustments in public services provision, organization of public administration, and stronger public financial management.

In the mission's view, creating space for fiscal buffers and public investment would require further structural reductions in current spending and greater revenue mobilization.

- The public-sector wage bill at over 12¼ percent of GDP is among the highest in the region, especially relative to the quality of public services. Reducing it closer to the regional average by 2023 would generate about 1½ percent of GDP in savings. Such reduction could be achieved through attrition, a hiring freeze, review of non-wage benefits, preferably within a broader civil service reform to modernize service delivery and make it more efficient and performance-oriented .
- The persistent deficits of the largest health and social insurance schemes call for further measures. Despite past reforms, the general old-age pension fund (AOV) remains underfunded, and the APC struggles to meet its target coverage ratio. While the authorities are looking into reducing some non-contributory pension programs, consideration should be given to further

increasing the retirement age. Despite expected savings on medical services, further cost-cutting measures should be identified to offset the higher operating costs of the new hospital (especially if contributions do not rise). The design of some social welfare schemes (like sickness insurance and unemployment benefits) appears to create serious disincentives to work and would need to be reformed.

- Revenue administration reforms could help mobilize additional revenue of 0.2 percent of GDP annually, and the authorities have embarked on technical assistance (TA) from CARTAC in this area.
- The created fiscal space would allow a gradual increase in public investment over the medium term. It would also be important to build fiscal buffers, including from saving additional revenue from better tax administration.

Sint Maarten: Post-Hurricane Response Requires Clear Prioritization and Strengthening Fiscal Resilience, with Critical Donor Support

After a significant deterioration in 2018, Sint Maarten's fiscal position should improve from 2019, as the economy recovers and the envisaged measures are enacted. The authorities have taken initial steps to strengthen tax administration with TA from the regional Dutch counterparts. The 2018 budget amendment and the 2019 draft budget include some measures to contain spending such as enacting a civil service pension reform and lower personnel costs. In the mission's view, there is some scope for higher tax revenue and lower current spending in 2019. The overall fiscal deficit would reach 7¼ percent of GDP in 2018, and nearly halve in 2019. Partial liquidity support has been provided by the Netherlands for 2018, but further modalities for deficit financing remain under discussion. Assuming that budget shortfalls are financed by loans, government debt is projected to peak at close to 47 percent of GDP in 2020 before declining toward 40 percent in the medium term, but remain sensitive to adverse shocks, such as from natural disasters and contingent liabilities from state-owned enterprises. Different loan-grant mixes would result in a wide range of potential outcomes for the debt ratio.

While donor budget support is critical in 2018–20, significant fiscal effort will be needed over the medium term to ensure debt sustainability and build fiscal resilience. Fiscal measures leading to an improvement of about 1 percent of GDP in the overall fiscal balance by 2023 relative to pre-hurricane levels, would ensure a firm decline of the debt-to-GDP ratio. To rein in current spending, the authorities could further rationalize spending on goods and services and reduce the wage bill. Continuing to strengthen tax administration, modernizing the IT systems, and expanding the taxpayer base could boost revenue. Sint Maarten's recent membership of the Caribbean Catastrophe Risk Insurance Facility and the authorities' plans to set up a fiscal buffer after 2020, in line with past IMF recommendations, are welcome steps towards implementing a disaster risk financing strategy. These priorities are broadly in line with the authorities' Governing Program 2018–22, which emphasizes the need to prioritize and cut costs, along with seeking additional funding to meet the reconstruction needs, and the Financial Recovery Plan which envisages achieving budget surpluses after 2020.

Removing Impediments to Investment and Growth

Important structural impediments continue to stifle growth in both countries. Red tape and weak governance remain a key bottleneck. In Curaçao, where the Establishment Law dates back to 1946, the authorities' plans to simplify administrative procedures for business and work permits, including launching an automated application system should be implemented without delay, supported by all involved ministries and agencies. In Sint Maarten, the government should streamline administrative requirements and regulations for businesses. Persisting labor market mismatches need to be addressed through retraining, improvements in educational and vocational training programs, and more flexible labor market regulations.

Improving the business environment is essential to promote diversification in tourism and other sectors and strengthen economic resilience. A strong tourism sector, with a modern and efficient infrastructure, high-quality accommodation, and a clean environment, could create further opportunities for other business, educational, and medical service sectors to develop around it. In Sint Maarten, improving resilience against natural disasters through enforcing hurricane-resistance building standards, regularly maintaining key infrastructure, and developing a crisis recovery framework could minimize hurricane damage as well as enhance long-term growth via stronger investor confidence. Ensuring policy continuity and political stability are critical factors for supporting business investment decisions.

Policies to Safeguard External Stability

Policies in both countries and at the union level should contribute to strengthening external stability. Measures aimed at a faster and sustainable improvement in the budgetary positions and structural reforms to boost competitiveness, would contribute to safeguard external stability. Monetary policy effectiveness is hampered by high excess liquidity in the banking system. While the Centrale Bank van Curaçao en Sint Maarten (CBCS) has been increasing its policy rate in line with the U.S. Federal Reserve (given the exchange rate peg to the U.S. dollar), competition among highly liquid banks and institutional investors keeps downward pressure on the interest rates domestically, creating incentives to search for higher returns abroad. The CBCS should continue to closely monitor developments in official reserves and remain ready to act if pressures emerge.

Strengthening Financial Sector Oversight

There is an urgent need to strengthen financial sector oversight. Past weaknesses in oversight have become evident recently, requiring central bank intervention through emergency administration of three financial institutions. The risks from withdrawal of CBRs persist. The authorities plan to intensify financial sector supervision and strengthen enforcement, recognizing weaknesses and resource constraints and are encouraged to seek TA. The process of updating macroprudential databases should conclude as quickly as possible to contribute to effective financial sector surveillance. While financial innovations are gaining traction in the union, the authorities should proceed cautiously and are advised to balance the tradeoffs between potential efficiency gains and risks to stability and integrity.

Strengthening Governance

Governance concerns remain at the forefront in both countries. Weak revenue and spending outcomes, limited transparency, inefficient public administration, a long-lasting absence of the central bank president, weaknesses in financial supervision, and cases of corruption, tax fraud, and money laundering point to important challenges in the areas of governance and integrity. Both countries have taken first steps towards establishing an Integrity Chamber to combat corruption and promote integrity within the public sector. In Curaçao, the discussions on the draft law on integrity chamber should accelerate, and in Sint Maarten, the authorities should operationalize the recently established chamber.

The mission is encouraged by recent changes in the CBCS governance. The CBCS has adopted a new Strategic Plan emphasizing transparency, among other key objectives, and has taken actions to address major financial stability risks. Completing the Executive Board as quickly as possible is key to further strengthening the central bank governance. Progress is also being made on strengthening the AML/CFT framework, especially on the regulatory front, but implementation needs to be accelerated.

Building Capacity and Addressing Important Data Gaps

Current policy challenges have intensified the critical capacity- and institution-building needs that Curaçao and Sint Maarten have been facing. Strengthening institutions with a medium-term and macro-fiscal focus, addressing weaknesses in tax administration, public financial management, and IT systems, would help improve policy implementation and contribute to stronger growth. The authorities are encouraged to seek TA in these areas, including by accelerating Sint Maarten's membership of CARTAC. Efforts to strengthen statistics and address critical data gaps should continue, and adequate resources would need to be allocated to this end.

***

The IMF team would like to thank the authorities in Curaçao and Sint Maarten and other interlocutors for their gracious hospitality, excellent cooperation, and frank and open discussions.

IMF Communications Department

MEDIA RELATIONS

PRESS OFFICER: RAPHAEL ANSPACH

PHONE: +1 202 623-7100 | **EMAIL:** MEDIA@IMF.ORG