**Financial Supervision in Curacao and the Euro Area: What can we Learn from Each Other?**

*Lecture by Prof Age Bakker at the University of the Netherlands Antilles, January 28, 2013*

It is a great pleasure to speak at UNA. This is not the first time for me to speak in the region. Twenty years ago I held a guest lecture in the then Netherlands Antilles on Integration in Europe: a Model for Regional Cooperation? At the time Europe was preparing for one of its greatest projects, the establishment of a monetary union. In my lecture I tried to draw some lessons from that experience for economic cooperation in Latin America and the Caribbean.

Now, twenty years later, economic cooperation in Europe is under pressure. The introduction of the euro has brought many advantages, but these are now called into question as the crisis in Europe has exposed significant flaws in the design of the monetary union. We are now so much sadder and hopefully, a little bit wiser.

The crisis has shown in particular the importance of fiscal discipline and the need to have independent financial supervision. Europe has taken wide-ranging measures to strengthen financial supervision.

In this respect the CFT is a far less special or unique body now than at first it seemed to be when it was established five years ago.

These have been five eventful years for Curacao, just as they have been eventful for the rest of the world, as the financial crisis hit and later the sovereign debt crisis in Europe.

Therefore, it seems the right moment to see what we can learn from the experience with financial supervision in Curacao and in the euro area. What can we learn from each other?

First, I will take a general look at the fiscal challenges and then zoom in on the Curacao and European experience. I will then make a comparison of financial supervision in Curacao and the euro area and see what lessons we can draw.

**Budgetary challenges**

Curacao faces huge budgetary challenges. This has become very clear in the course of last year, although the underlying deterioration of public finances dates back much longer.

Curacao is not alone in facing fiscal challenges. Fiscal problems are a general issue in the Western world. The US government stands at a fiscal cliff and faces serious challenges to curb its ever rising debt. This has resulted in a downgrading by the credit rating agencies, a quite humiliating experience for the world power.

Even more serious are the issues in Europe where the crisis negatively impacts growth. Countries like Greece and Spain are in serious trouble and have been downgraded below investment grade. In many countries governments fell, including in the Netherlands, where the first Rutte cabinet fell over its failure to comply with European requirements.

If one can believe the credit rating agencies Curacao is nicely positioned in the middle of this turmoil. For now, it is just at the right side of the ratings, but a great effort is needed not to slide lower. I believe this can be avoided by decisive action in Curacao.

The reasons for the fiscal problems are rather similar worldwide. There are three main reasons.

First, the financial crisis has had a serious downward impact on economic growth and employment, which has put downward pressure on public finance. Second, all countries face a greying population as life expectancy has increased everywhere. Third, public health costs have increased because of new techniques and the need for more care as we live longer.

To be sure, of course it is a good thing that life expectancy is increasing, but when we built our pension and health systems we did not make sufficient provision for this.

In an ever more closely interlinked world, where financial flows cross borders at a mouse click, investors demand predictable and stable government finances.

In 2011 the fiscal deficit was 5% of GDP and if nothing is done it would increase to 9% in 2015, a clearly unsustainable level. Reserves are depleted and there are serious liquidity constraints, again if nothing is done.

The reasons why Curacao faces similar challenges as elsewhere is that Curacao is on the same trend as regards economic growth, a greying population and soaring health costs.

First, Curacao is lagging substantially behind on economic growth, also compared to the Latin American region. GDP per capita in 2013 will be still below the level of 2007, just before the financial crisis started. It is clear that this forms a huge challenge for fiscal policy. Therefore, there is an urgent need to strengthen the economic growth potential of Curacao.

Second, the population of Curacao is getting older and this hits Curacao relatively hard. In 1960 everyone above 65 years had 6 working people supporting him, now this is only 3 and on present trends in 2030 there will be only 2 workers for each retired person. This puts a huge burden on the working population and negatively impacts the competitive position of Curacao. Raising the age of retirement is, therefore, inescapable.

Third, national health costs have soared in Curacao and now stand at a level which also in international compassion is extremely high. Recent calculations show that Curacao health costs are double the Latin American level.

So, measures are a must, there is no choice. The negative balance-of-payments is another warning signal. This signal must be taken seriously because the link which Curacao maintains vis-à-vis the US dollar is an important asset for maintaining  the confidence investors.

Now, let´s compare the situation in Europe.

When the single currency was established an important requirement was that there would be comparable economic fundamentals in EU-countries. Therefore, in the Treaty of Maastricht criteria were set for countries who wanted to join the Euro. These criteria related to the size of government debt, deficits and inflation. It was important because once the exchange rate is gone, there would is no other mechanism to correct for external shocks. Devaluation of the currency no longer is an option, just as it is not an option for Curacao.

The problems in the euro area are no so much a consequence that the monetary arrangements in the euro area would not work. Actually, the euro as a common currency is doing just fine. Inflation since the establishment of the euro has been low and the euro is a strong currency.

So what went wrong? With the benefit of hindsight one can say that the major flaw of the Treaty of Maastricht by which the euro was established was that the arrangements for fiscal discipline were insufficient and lacked teeth.

With the establishment of the Economic and Monetary Union the M of Monetary was well arranged as sovereignty for monetary policy was surrendered to the European Central Bank. But the E of Economic was completely based on voluntary arrangements. There was no good financial supervision.

It was hoped that financial markets would exert discipline as investors would distinguish between the different countries of the euro area. But in practice this did not happen. The spreads, that is the interest rate margins, between Germany and for instance Greece were very low. Apparently, investors thought that sovereign risk was negligible.

This all turned around when in the wake of the financial crisis investors started to worry about the ability of governments to pay back their debt. This became even more urgent when it transpired that the Greek government had misinformed the markets about its problems. Markets do not like surprises, and certainly not nasty surprises based on misinformation.

The major flaws of the EMU were that there were no binding obligations for economic policy coordination, no supranational fiscal authority and only limited power for the Commission and the European Parliament.

These weaknesses became very visible when in 2005 large countries as Germany and France could not comply with the Maastricht norms, but nevertheless did not accept that their policies would be constrained by European rules, let alone that sanctions would be applied to them. Therefore, they forced through a relaxation of the rules. This of course completely undermined fiscal discipline as other countries felt free to also not obey the rules.

The euro crisis has led to a host of reforms in the euro area in order to strengthen financial supervision. One of the most important changes is that the position of the Commission has been strengthened. The Commission can give binding instructions to countries to adjust their budget, impose sanctions if countries do not comply with them and impose fines if national authorities provide wrong information. The Council of Ministers can no longer by an easy combination of votes overrule this.

In other words, there is a quasi-automatic imposition of sanctions and an automatic follow-up in the European Court of Justice if countries challenge this.

The reforms mean that the Commission can act as a truly independent financial supervisor. The powers of the Commission go quite far and it can give binding instructions, not only on fiscal policy, but also on strengthening the economic growth potential of member countries, if their competitive position is endangered.

The cost of not addressing increasing imbalances and allowing sovereign debt to run up over time has been very high and it has been a painful process. Countries were forced to take painful measures to stabilize government finances and strengthen their competitive position. In a number of countries the government fell, including in the Netherlands.

**Financial supervision compared**

Now, that financial supervision has been strengthened it may be useful to compare the situation in Curacao and the euro area.

For Curacao financial supervision has been in place since 2008, first on a provisional basis and later, from the moment Curacao became a country on 10-10-10, on a formal basis as part of the Kingdom Law. Supervision has been delegated to the Cft, which therefore now celebrates its first lustrum.

First, as regards the legal framework for financial supervision, there seems to be a rather comparable situation. In both cases financial supervision is written in higher legislation, in Europe in The treaty and in the case of Curacao in the Kingdom Law.

What is interesting is that Curacao has written down the requirement of a balanced budget is in the Staatsregeling as well and in doing so, Curacao is a little bit ahead as compared to other countries. Members of the euro area have agreed to write this in their own national legislation, buy many still have to do so. Germany was the first one to move here.

But we all know, as we say in Dutch: papier is geduldig. What matters is how supervision is organized and what procedures are foreseen if the law is not abided by.

Here, a distinction is that the Commission has the power to sanction which is not on a comparable scale foreseen in the Kingdom law. If the Cft feels that its negative advice does not lead to corrective action and the budgetary situation threatens to run out of hand, the Cft can only advise the Rijksministerraad to give an instruction to the country concerned. As we know, this was the situation last year in Curacao, when the Cft felt that the budgetary situation required immediate attention.

Another distinction is that supervision in Curacao applies to a balanced budget for current goods and services, the so-called Golden Rule, whereas Europe sets a limit for the total deficit for current and capital expenditures. When the Euro area was established the Golden Rule was considered, but it was felt that the definition of capital expenditures was too soft and that countries could escape the rules too easily.

Nevertheless, there is logic to the Golden Rule which Curacao applies, because it allows, when the norm is fulfilled, to borrow through the Netherlands and thus profit from a very low interest rate because of the triple A status of its partner in the Kingdom.

Of course, a supervisor is only as good as the information he receives. There will always be a tendency for governments to bend the rules as much as possible and to look for escape routes. In the case of Europe the European Statistical Office acts as the independent arbiter of the data provided by the countries. This helps keep supervision at a level playing field. This is lacking in Curacao and it has been difficult at times to get the right information.

Lastly, supervision as such can be distinguished between the preventive arm, which sees to it that draft budgets are drawn up in accordance with the norms, and the corrective arm, which sees to it that budgetary positions are restored to balance if deficits do occur when executing the budget.

When comparing Curacao with the euro area it appears that the preventive arm does not operate very differently. In both cases advice is given as budget proposals are presented to parliament.

During the execution of the budget the Commission can give early warnings if the budget gets off track, to which the authorities need to formally react. In Curacao quarterly reports on the execution of the budget are presented (uitvoerinsgrapportages), which likewise then give the Cft the possibility to ask for corrective action if the budget execution is not on track.

As far as the corrective arm is concerned, that is if deficits nevertheless occur, in the case of Curacao no sanctions can be applied, albeit that the country cannot borrow for capital expenditures as long as the budget is not balanced. This is different from the euro area where fines and sanctions can be applied. Up till now, though, this has never taken place.

What is unique about the regulations for Curacao is that deficits have to be compensated for over the next three years. The thought behind this is that reserves need to be rebuilt to their original level. This is in principle a powerful arrangement for maintaining a healthy reserve position. However, it is clear that compensation of the deficits which Curacao up till now has encountered will be a burden for the coming years.

So, what lessons can we draw? I see five major lessons.

First, experience shows that for supervision to be effective, the supervisor must be able to operate in an independent manner. Supervision only works with a mandate outside of politics. Writing things in law does not have sufficient power if there are no sanctions or if decisions by the supervisor can be overturned by governments.

This has led to major changes in Europe, where the relevant Commissioner is now seen as a super minister of finance who can overrule national legislation.

I believe that the independence of the Cft is crucial and has to be beyond doubt. We try to achieve this by being transparent in our analysis and clarifying the reasoning behind our advice. The website of the Cft is widely consulted and provides a major source of information on relevant developments. Each working day we have 50 hits. In whatever form the Cft continues after 2015 this independence will need to be secured.

Second, experience both in Curacao and Europe has shown that quality and completeness of information is a key requirement for the supervisor to do its work properly. This deserves constant efforts and the Cft has been in touch with the government to be as transparent as possible about future scenarios and the underlying assumptions. This is also a requirement for parliament to do its work responsibly.

Third, supervision has to be on a broad basis, including the social funds. Curacao has a tendency to focus on the Landsbegroting, but therefore the problems in the social funds have escaped attention. In Europe the criteria apply to the collective sector, including the social funds, and I feel such approach would help Curacao, which is confronted with major deficits at the funds.

Fourth, the government should us independent forecast for its growth projections in order to avoid that the government uses overoptimistic assumptions. Curacao uses the independent forecast of the central bank and this is a good thing. Some European countries are clearly lagging behind in this respect.

Lastly, there must be a credible threat of sanctions if advice is not heeded, otherwise the supervisor will become a paper tiger.

All in all, we can learn from each other. The Kingdom Law stipulates that financial supervision and the role of the Cft will be reviewed in 2015. Whatever conclusion will be drawn by then, it will be important to take some of these lessons on board.

**Conclusion**

Let me conclude. Fiscal stability is a necessary condition for economic growth. It is not sufficient and more needs to be done. But I believe that Curacao is well placed to resume growth once it has put its house in order. I feel that there is a window of opportunity to address now the long-standing issues which have brought Curacao at its own fiscal cliff.

The transition cabinet is taking important measures which I believe will help restore fiscal stability. I realize these measures are difficult as they impact the whole population. However, postponement is no longer an option. In order to maintain the support for the measures the government should ensure that the strong shoulders carry the heavy burden.

In the end fiscal discipline is about mentality. This means that I would hope that parliament develops a best practice where new policy demands from parliamentarians always need to accompanied by proposals how to cover for them and how to compensate for this in the budget. Amendments to existing legislation should be done in a budget neutral fashion.

Curacao stands out in a positive way in two respects. Curacao did not face a huge bill for problems in the banking sector. Actually the financial sector fared relatively well during the crisis, which is a reflection of the fact that Curacao banks did not embark on the sort of risky adventures as the US and European banks.

Secondly, Curacao has a much more healthy debt situation than other countries, which is a reflection of the debt resolution in 2010, when the Netherlands took over part of the Curacao government debt. At 35 per cent of GDP Curacao compares well, but it is clear that if nothing would be done debt levels would increase very quickly.

Restoring fiscal order would imply also that there is light at the end of the tunnel. In particular, once the budget is balanced, government can borrow for capital expenditures for infrastructure at low interest rates due to triple A status of its Kingdom partner. This would give a much needed boost to the economy.

I have said that Curacao and Europe can learn from each other for strengthening financial supervision. But for its growth strategy I would advise Curacao to look elsewhere and not compare itself with Europe.

For its future economic strategy I believe Curacao should rather look for other peers, in the Caribbean of in Latin America. Countries like Barbados, the Bahamas or Panama and similar small countries can provide useful benchmarks for a new and much needed growth strategy. I feel that the advice of the Platform of Dutch Caribbean Economists also can be very useful.

Finally, trust in government is key and independent financial supervision is a key factor in ensuring this trust. The transition cabinet is taking courageous measures to restore fiscal order and in doing this restore trust in government. We at the Cft believe we can be a partner in this process and thus help give Curacao a new start.