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Fabian Briegel

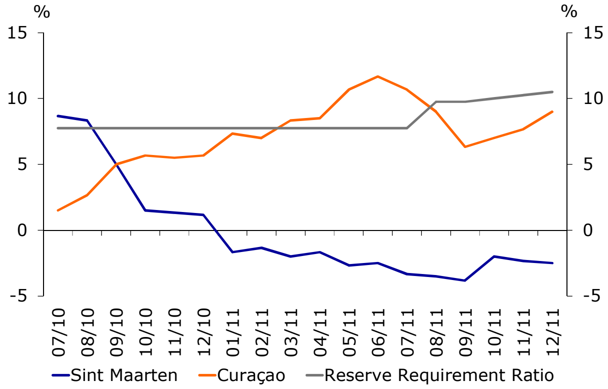
# Curaçao and Sint Maarten: Frozen credit

Rabobank

*As Curaçao's current account deficit had reached unsustainable levels and international reserves had come under downward pressure, the Central Bank of Curaçao and Sint Maarten introduced a six month freeze on private credit extension. This measure will temporarily tackle consumption loan growth that drove the current account deficit, but more needs to be done.*

**Untamable private loan growth?**

*Annual growth rates and reserve requirement ratio*




Source: Central Bank of Curaçao and Sint Maarten

Last week, the Central Bank of Curaçao and Sint Maarten (CBCS) announced a temporary six-month freeze on private loan growth. The decision reflects the CBCS's concern that the recent decline in its international reserves on the back of a very large combined current account deficit of both islands, which the CBCS expects to have reached a level of 25.2% of the monetary union's GDP last year, predominantly driven by Curacao, could continue. As double-digit annual growth rates of private credit on Curaçao have been a major driver of the island's current account deficit (29.2% of GDP), as well as that of the monetary union, the CBCS had initially tried to cool down private credit provision by means of successive hikes of the reserve requirement ratio from 7.75% in mid-September 2011 to 10.75% on January 18th, 2012. The increases of the reserve requirement ratio were intended to mop up ample excess liquidity at local banks that had been largely channeled into private loans amid restrictions on foreign lending. Since most capital and consumption goods have to be imported into Curaçao's island economy, these loans eventually contributed to the large current account deficit. The CBCS's efforts were unsuccessful and private loan growth continued to accelerate, however. Consequently, the CBCS eventually resorted to a complete freeze on the provision of private credit, as it considers raising the reserve requirement to 'unprecedented' levels undesirable, citing its impact on the income-generating capacity of local banks.

The credit freeze will limit the size of banks' loan portfolios to the amounts outstanding on February 29, 2012, while already concluded loan commitments for the financing of projects that strengthen the islands' economic base will be excluded. However, questions about the measure's effectiveness and its impact on the overall economy remain. Given these uncertainties, CBCS's gains in terms of a more sustainable current account deficit in the short-term could come at a high price, as the complete credit freeze could seriously harm Curacao's and St. Maarten's feeble economic recovery. Since no distinction is made between loans for consumption and investment purposes, private investment growth will likely suffer, while it remains to be seen whether the improvement in net exports on the back of declining imports will completely compensate for this lost growth. The credit freeze's non-discriminatory nature could therefore push the islands' economies back into recession. Notwithstanding the eventual balance between the possible increase in net exports and the likely decline in domestic consumption and investment, lower economic growth would reduce the current account deficit, but one may wonder whether this is a price worth paying.

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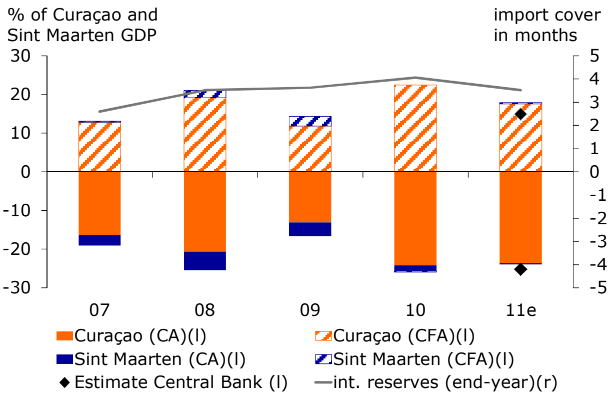
**Balance of Payments under pressure**
*Current Account (CA) and Capital and Financial Account (CFA)*




Source: Central Bank of Curaçao and Sint Maarten, IMF, Rabobank

Even though the unsustainable size of the current account deficit and the declining level of international reserves are certainly worrisome, the CBCS's foreign exchange reserves position still covers slightly more than 3 months of imports, which is an acceptable level of import cover for countries with a pegged exchange rate. In the recent past, the international reserves of the former Netherlands Antilles have oftentimes fluctuated around this level. Consequently, the CBCS argues that its step is precautionary, as it rightfully notes that rising food and oil prices could lead to further upward pressure on the current account deficit and bring about a quick drop of the foreign exchange reserves below this threshold.

Amid a challenging external environment, that is not only characterized by volatile commodities prices but also considerable risk aversion among investors, a swift start to reduce the monetary union's external financing needs, the equivalent of its current account deficit, is certainly laudable. As external financial inflows proved insufficient to completely finance the very large current account deficits in recent years and foreign exchange reserves cannot permanently plug this gap, increased attention for this issue is warranted. Otherwise, the stability of the peg of the Antillean guilder to the USD and the stability of the monetary union's economy as a whole could come under pressure. However, it remains to be seen whether the chosen credit freeze, and particularly its non-discriminatory nature, is not too blunt and whether it brings about a long-term solution.

Instead of imposing a general freeze of private credit growth, the CBCS could have opted for a policy mix implemented by its predecessor in 1997 and 1998, when the former Netherlands Antilles' foreign exchange reserves merely covered 1.2 and 1.5 months of imports, respectively. The then Central Bank of the Netherlands Antilles also tried to tame loan growth, but it explicitly targeted consumer loans by means of imposing credit ceilings on this type of credit, while leaving business loans unaffected. Additionally, it also increased the mandatory cash reserves to mop up excess liquidity.

Irrespective of whether business loans are spared or not, these measures will only provide a short-term solution to the islands' considerable current account deficits. In the medium-term, a structural solution has to be found to reduce these deficits to more sustainable levels. With considerable trade deficits being the driving force behind the current account deficits, Curaçao and St. Maarten will have to embark on structural reforms to bring exports and imports into a healthier balance. While limiting credit growth below nominal economic growth, as suggested by the IMF, is a laudable first step to rein in imports, the islands' export performance has to improve over the medium-term as well. In order to achieve this goal, Curaçao and St. Maarten will have to embark on a structural reform agenda that not only aims at productivity enhancements and the expansion of already existing industries, but also cuts back on red tape and improves the islands' investment climate. Even though these reforms will be challenging, the alternative of running the risk of balance-of-payments difficulties and a painful revaluation of the Antillean guilder should make these steps worth taking.

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