

**KINGDOM OF THE NETHERLANDS—ARUBA: 2007 ARTICLE IV CONSULTATION
CONCLUDING STATEMENT OF THE MISSION**

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1. **Aruba has made great strides since 1986, when it gained autonomy from the Kingdom of the Netherlands.** Per capita income (in U.S. dollar terms) has more than tripled over the past 20 years making Aruba one of the most developed islands in the Caribbean. This impressive result has been achieved with the help of market-friendly policies that have fostered a stable macroeconomic environment and a rapid expansion of the tourism sector, now accounting for more than 50 percent of GDP. Equally important has been the openness of the economy as foreign investment and migrant workers have been key contributors to economic growth.

2. **However, the heavy dependence on tourism has rendered the economy vulnerable to external shocks.** The tourist sector accounts for 80 percent of Aruba's non-oil export revenues and is heavily geared toward visitors from a single market: the United States. The exposure to shocks in the tourist industry was apparent in 2006 when GDP growth virtually stalled and the deficit in the non-oil current account sharply widened following a pronounced drop in tourist arrivals. The vulnerability of the economy has been aggravated by a steady increase in public debt from 39 percent of GDP in 2000 to 45 percent of GDP in 2006 as the result of an unfavorable fiscal trend during 2000-04.

3. **The tightening of macroeconomic policies since 2005 has been helpful in this regard.** After a jump to an unusually large fiscal deficit of 9.3 percent of GDP in 2004—owing to financial problems at the general medical insurance fund (AZV) and financial obligations resulting from government guarantees related to the construction of hotels—the deficit narrowed to 2.6 percent of GDP in 2006. Monetary policy has been geared toward containing domestic credit growth, which has in particular curtailed the rapid expansion of consumer loans. These policies have helped to stem the rise in public debt and maintain a sufficient level of foreign exchange reserves.

4. **The task is now to implement policies that will support further fiscal consolidation and boost Aruba's growth potential.** The room for maneuver in the event of unexpected external shocks remains limited. Without further fiscal consolidation, a negative shock to the economy would almost certainly require a pro-cyclical tightening to avoid a marked loss of international reserves and an unsustainable rise in the level of public debt. It is important, therefore, to adopt a strategy for keeping Aruba's public finances on a sustainable path and bolstering its growth potential. Key in this regard are maintaining macroeconomic stability, reducing public debt, strengthening public institutions and policy frameworks, and creating an economic environment that is conducive to investment and diversification.

5. **The near-term outlook is mostly favorable.** Real GDP is projected to expand by about 2 percent in 2007 and 2008. The tourism sector is making a strong comeback and will, together with continued robust investment, be a key engine of growth in the near term. The main risk to this outlook are a more pronounced and protracted slowdown in the U.S. economy and a further increase in oil prices and attendant deterioration in the terms of trade. Inflation is projected to ease from slightly over 6 percent in 2007 to just under 4 percent in 2008 as the impact of one-off supply shocks, including the introduction of the turnover tax (BBO) and the increase in utility tariffs, gradually dissipates. However, there are notable risks to this projection. In particular, it is possible that the full impact on inflation of the BBO will take longer to materialize. This, together with further increases in the oil price and signs of tightness in the labor market, could provide additional impetus to inflation.

THE NEAR TERM: MAINTAINING MACROECONOMIC STABILITY

6. **Consolidation of the fiscal accounts is continuing.** The mission projects the 2007 fiscal deficit to be 2 percent of GDP, a welcome decline of 0.6 percentage points, while the 2008 budget submitted to parliament entails a further reduction to 1 percent of GDP. Contrary to previous years, the adjustment in 2008 is to be achieved mainly by containing growth in current expenditures. However, renewed financial problems at the AZV are casting a cloud over the 2008 budget and will increase the deficit by about ½ percent of GDP in the absence of corrective measures (discussed below). To the extent that these problems cannot be resolved in the short run, the government should identify offsetting savings in current expenditure. Cuts in public investment, which is already at a low level, would best be avoided. Any larger-than-budgeted revenues should be saved.

7. **Monetary policy should not be relaxed until there are clear signs that inflationary pressures are abating.** The planned fiscal consolidation will reduce the burden on monetary policy to contain domestic demand growth, but the uncertain inflation outlook and the still considerable current account deficit suggest that monetary policy should remain on hold for now.

8. **The peg of the florin to the U.S. dollar has served Aruba well.** Although this exchange rate policy has limited the flexibility of policymakers to respond to external shocks, it has provided an effective nominal anchor that has been instrumental in achieving generally low inflation. The exchange rate is at a competitive level as reflected by the rapid recovery in tourism in 2007. To underpin the credibility of the exchange rate peg, the CBA has successfully achieved a reserve level of about six months of imports of goods. Maintaining an adequate level over the medium term will require additional fiscal consolidation and structural reforms.

THE MEDIUM TERM: ENSURING FISCAL SUSTAINABILITY

9. **The government's plan to balance the budget by 2009 and reduce public debt to less than 40 percent of GDP needs to be supported by concrete measures.** Under unchanged policies the fiscal deficit is projected to be 1½ percent of GDP in 2009. This

includes the loss of the AZV, which in the absence of corrective measures is projected to amount to $\frac{3}{4}$ percent of GDP in 2009. Although the ratio of public debt to GDP will continue to decline under this scenario, it will not fall below 40 percent until 2012. This not only leaves very little room for maneuver in the case of a negative shock to the economy, but also limits the scope for increasing public investment and education as interest payments will continue to absorb a large share of the government's financial resources. The goal is therefore to identify additional measures. In this context, the government should:

- Take immediate action to stem the losses of the AZV. This can be done by introducing co-payments, increasing premiums, and reducing health care costs, including by engaging in cooperation with other islands in the region to exploit economies of scale. It is key that the solution to the AZV's financial problems takes into account the effects of the rapidly ageing population in Aruba. It will also be important to strengthen monitoring of the AZV to identify emerging problems at an earlier stage.
- Rationalize the civil service. The share of personnel costs in total government expenditure is high compared to other islands in the region. Limiting growth in personnel costs to 3 percent per year over the medium term, as recommended by the National Committee on Public Finance (NCPF), does not appear to be feasible without a reduction in the size of the civil service as wages are likely to grow faster than average inflation over the medium term.
- Make a greater effort to limit growth of spending on goods and services to 2 percent per year as recommended by the NCPF.

10. **The reform of the civil service pension fund (APFA) needs to be completed soon.** Although the coverage ratio of APFA has improved significantly since the partial reforms in 2005, it remains insufficient. It is important, therefore, that agreement be reached with the labor unions about the terms for transferring the civil servants still in the old scheme to the new scheme. This would help to raise the fund's coverage ratio to 100 percent and bring APFA under the supervision of the central bank. It is also important that the government settles its remaining payment arrears with APFA.

11. **Reform of the universal pay-as-you-go pension system (AOV) should no longer be delayed in the face of rapid population ageing.** In light of increased life expectancy and a structural shortage in the domestic supply of labor, consideration should be given to a gradual increase in the effective retirement age. Other options are raising the income ceiling, increasing premiums, or lowering the replacement ratio, but key is to take action now while the AOV is still in a financially sound position.

STRENGTHENING POLICY FRAMEWORKS AND PUBLIC INSTITUTIONS

12. **Good progress is being made in improving the budget process and work is underway to strengthen fiscal responsibility.** The timely submission of the 2008 budget to

parliament and the inclusion of a medium-term fiscal framework in the budget documents are useful steps toward a more transparent budget process. The planned changes to the budget law, to be implemented in 2008, will provide important institutional support for fiscal consolidation by imposing greater fiscal discipline, improving fiscal management, and strengthening the fiscal framework.

13. **Further strengthening the CBA's independence is also important in this context.** Although in practice the CBA enjoys a high degree of operational independence, experience in other countries suggests that the control of the supervisory board over the management and the budget of the CBA, as stipulated in Aruba's central bank law, is excessive and should therefore be curtailed. In addition, the central bank law should stipulate the term in office of the CBA president as well as the modalities for dismissal. The law should not allow for direct financing of the budget, even though this has not been an issue for a long time.

BOLSTERING LONG-RUN GDP GROWTH

14. **Conditions need to be created for growth in services with high value added.** Aruba's potential GDP growth has been predominantly driven by increases in the labor force. This is a reflection of the large inflow of foreign workers who are attracted by the expanding tourist sector and construction activities. However, with a population density that is already more than 500 inhabitants per square kilometer, Aruba's current growth model is bound to come under pressure at some point in the future. It is important therefore to develop a sustainable growth strategy and create an environment that is conducive to investment and diversification. Key in this regard are further tax reform and more efficient financial intermediation, but consideration should also be given to introducing land auctions, so that land prices will reflect the increasing scarcity of this resource in Aruba.

Reforming the tax system

15. **Recent tax reforms were an important step toward a more investment friendly environment, but more can be done.** As a small open economy, Aruba should avoid levying high taxes on capital and skilled labor, which are mobile and tend to gravitate toward countries with favorable tax regimes. Instead, it should consider relying more heavily on indirect consumption-based taxes. The introduction of the turnover tax is therefore an important achievement. The reduction in the corporate income tax rate from 35 percent to 28 percent together with the rationalization of various exemptions and incentives is also welcome. Additional tax reforms include:

- Further rationalization of import duties. The recent reduction to four schedules was a step in the right direction, but a number of goods continue to be subject to special duty rates.
- Reduction of the high marginal income tax rate. The highest marginal rate is currently 58 percent, compared to an average of 34 percent in the Caribbean region. The high marginal tax is a disincentive for high-skilled workers seeking employment in Aruba.

The revenue loss that this reform will entail could be offset by an expansion of indirect tax revenues.

- Elimination of the tax on foreign exchange transactions. This tax is a nuisance to foreign investors and constitutes an exchange restriction under Article VIII of the International Monetary Fund's Articles of Agreement.

Strengthening financial intermediation

16. **Aruba's banking sector is characterized by a limited degree of financial intermediation and a low level of competition.** Although Aruba's banking sector is large relative to the size of its economy, with banking sector assets close to 100 percent of GDP, domestic financial intermediation is limited, with private sector credit amounting to only 59 percent of GDP. The low level of competition among banks is reflected in very high profitability arising mainly from a wide margin between lending and deposit rates of about 7 percentage points.

17. **The characteristics of the banking system reflect in part the CBA's reliance on credit ceilings and capital controls.** Although these quantitative measures have been effective in containing domestic credit growth, they have also hindered greater competition between commercial banks and contributed to excess liquidity in the banking system.

18. **A key step toward the creation of a more competitive and efficient banking sector would be for the CBA to make greater use of indirect monetary instruments.** The mission therefore welcomes the CBA's plan to abolish the credit ceilings by the end of 2008 and to begin issuing a sufficient amount of central bank certificates at commercially attractive interest rates to mop up excess liquidity. The CBA's financial position is sufficiently sound to carry out this operation. In the course of 2008, the CBA will increasingly engage in open-market operations to manage liquidity in the banking system. This will make the yield on central bank certificates the key reference rate that banks will use in setting their deposit and lending rates.

19. **The financial system is generally sound, but the large exposure of commercial banks to the tourist sector warrants continued supervisory vigilance.** In this regard, the CBA raised the minimum risk-weighted capital adequacy ratio from 10 to 12 percent in 2007. Banks and the CBA should consider employing stress tests to gain additional insight in the banking sector's capacity to withstand large shocks.

20. **The authorities have made substantial improvements in Aruba's statistical base, but further progress is needed in several areas.** Great effort has been made to update national account and labor market statistics. Preliminary national accounts in current prices for 2002-06 will soon be published. Next, attention should be given to national accounts in constant prices and new weights for the consumer price index as the current weights are outdated. The CBS is developing plans to address these issues.

We thank the authorities for their open and constructive engagement and for their warm hospitality.