CENTRALE BANK VAN ARUBA

# PRESS RELEASE*

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Today the Centrale Bank van Aruba publishes its 2006 Annual Report. The statement by the President, which is also included in this report, is presented below.

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Preliminary estimations show that the Aruban economy grew in 2006 at virtually the same pace as in 2005. Fitch Ratings estimates an expansion in real GDP of 2.5 percent (2005: 2.4 percent). Economic expansion was spurred by increased construction and investment activities, mainly in the hotel and real estate sectors, as well as higher levels of domestic consumption. However, these effects were partially offset by a weak performance in the tourism sector.

Analysis of economic developments is seriously hampered by a lack of statistical information particularly on the labor market. Signs of labor shortages are becoming more apparent, triggered by the government's implementation of a more stringent immigration policy. This situation is further aggravated by the continued issuance of concessions for the construction of resorts and residential projects (i.e., condominiums), which will require even more labor in the near future.

The inflation rate accelerated further in 2006, fueled by a continued rise in the prices of water, electricity, and gasoline, a reflection of higher oil prices on the international markets. The 12-month average inflation rate rose to 3.6 percent in 2006, up from 3.4 percent in 2005. The inflation rate differential with the United States, Aruba's main trading partner, widened to 0.4 percentage point, slightly worsening Aruba's competitive position.

After a subdued performance in 2005, activities in the tourism sector turned negative in 2006, as both stay-over visitors and their nights spent on Aruba fell by 5 percent and 4 percent, respectively, compared to a slight 1 percent rise in 2005. The Aruba Tourism Authority attributes this contraction to increased hotel rates in combination with a decline in room availability during 2006, due to renovations and upgradings. Higher airfares caused by a rise in fuel costs also had a negative impact. The performance in the cruise tourism industry was more upbeat. Cruise passenger arrivals and port calls rose by 7 percent and 1 percent in 2006, respectively, following a decline of 4 percent and 2 percent in 2005. In total, almost 1.3 million stay-over and cruise tourists visited Aruba in

* The publications of the Centrale Bank van Aruba are also available on its website **www.cbaruba.org**.

2006. Fortunately, the period December 2006 through February 2007 showed a positive recovery in stay-over arrivals.

The sluggish performance in the tourism sector was also reflected in a 2 percent decline in registered gross tourism receipts, compared to 2005, when a 4 percent increase was registered. Consequently, the contribution of tourism receipts to the current account receipts of the balance of payments of the rest of the economy (excluding the oil and free-zone sectors) declined to 74 percent, 4 percentage points lower than in 2005. Therefore, the partial offsetting effect of the tourism sector income vis-à-vis the large other current account outflows of the rest of the economy became smaller and, thus, contributed to a further deterioration of the current account balance of the rest of the economy.

The current account deficit of the rest of the economy (excluding the oil and free-zone sectors) almost doubled -- from Afl. 309 million in 2005 to Afl. 587 million at the end of 2006. However, the capital and financial account of the rest of the economy recorded a notable Afl. 515 million surplus in 2006 (2005: Afl. 184 million), largely counterbalancing the earlier described current account deficit of the rest of the economy. The surplus on the capital and financial account was triggered predominantly by higher foreign direct investments, reflecting a prevailing foreign interest in investing in Aruba, particularly in the hotel and real estate sectors.

The main factors influencing the deterioration of the current account deficit of the rest of the economy were the aforementioned decline in tourism receipts and higher transfers to abroad related to dividend and interest payments as well as workers' remittances to families abroad. Also, the increased payments abroad for merchandise imports and services influenced this outcome. Moreover, the direct investment inflows related to investment and construction activities also led to current account outflows because of a rise in the import of construction-related materials and payments of fees related to construction and business services. In addition, a significant increase should be factored in on transfers to abroad related to dividends and loan repayments later on, thereby intensifying the drawdown on foreign exchange reserves in the future.

As a result of the current and capital and financial account transactions of the rest of the economy, the balance of payments of the rest of the economy recorded an Afl. 72 million net outflow of funds to abroad in 2006. In contrast, the external transactions of the oil and free-zone sectors led to a net inflow of foreign funds from abroad, amounting to Afl. 125 million. All in all, Aruba's overall balance of payments recorded an Afl. 53 million surplus, raising the level of international reserves to Afl. 651 million (2005: Afl. 598 million). Still, the 12-month average coverage of merchandise imports by international reserves declined further to 5.2 months (2005: 5.5 months), while the 12-month average coverage of all current account payments (i.e., payments for merchandise imports, services, income, and current transfers) shrank to 2.7 months in 2006 (2005: 3.0 months).

The factors inducing the large current account deficit of the rest of the economy in 2006 -- higher imports of goods, increased outflow of funds to abroad related to dividend and interest payments and workers' remittances -- are related mainly to the economic structure and development of Aruba. The outward bound payments related to these factors are the result of high economic growth based mainly on foreign capital and foreign human resources, and are generally irreversible in the short or medium term. However, the Bank is mainly concerned about the persistent high current account deficits of the rest of the economy resulting from excessive consumptive spending, as this causes undue pressure on the foreign exchange reserves. This pressure becomes much more evident when the export sector, particularly tourism, is performing below par.

The Bank's monetary policy is aimed on countering excessive credit creation by the financial system, induced partly by excessive liquidity creation by government due to ongoing high expenditure levels that lead to heightened domestic consumption. Such policy would partly reduce the pressure on the foreign exchange reserves. Through a quantitative credit restriction on the banking sector, the Bank subdues excessive domestic consumption and its direct negative effects on the foreign exchange reserves caused by increased imports of goods and services. The more common and market-oriented interest rate mechanism is not operative in our economy, given the small size of the money and capital markets.

In 2006, the Bank further tightened its monetary policy by lowering overall credit growth limit by one percentage point to 5 percent, introducing at the same time a separate growth limit of 5 percent on consumer credit and raising the penalty fee for excess lending by 2 percentage points to 8 percent. The Bank also raised the monetary cash reserve requirement from 8 percent to 9.5 percent in October 2006 to neutralize part of the excess liquidity within the banking system. In addition, the Bank took measures to restrict credit allocation by the banklike financial institutions to maintain a level playing field within the financial sector. As a result of these measures, overall banking sector credit grew by 4 percent in 2006, thus remaining within the Bank's credit growth guideline.

For 2007, the Bank's preliminary estimates show a slowdown in economic growth in real terms to about 1 percent, while inflation is expected to accelerate to about 7.5 percent. On the one hand, investments in the hotel and real estate sectors will remain buoyant, and tourist arrivals are expected to recover and reach the 2005 levels. On the other hand, inflationary pressures are rising, spurred by, among other things, the introduction of a turnover tax ("Belasting op Bedrijfsomzetten" or BBO) by the government in January 2007, high wage costs resulting from increasing labor shortages induced partially by the government's more restrictive immigration policy, and additional construction projects currently in the pipeline. A further rise in the price of oil on the international market and other commodity prices will also push up domestic prices.

Given these conditions, the Bank decided to maintain the credit growth limitation for 2007 at 5 percent. Additionally, the credit development of the banklike financial institutions is monitored closely. Moreover, the Bank will evaluate a further rise in the monetary cash reserve requirement if required by macroeconomic conditions, such as the level of foreign exchange reserves, the balance of payments' current account of the rest of the economy, the inflation rate, and/or the excess liquidity within the banking system.

Curtailing the excessive liquidity creation by the government requires a radical change in fiscal management and discipline. The vicious circle of structurally spending more than the government receives from taxes and other income, and financing the resulting deficit by contracting new loans should be broken. The government should diligently and in a transparent manner strive for financial surpluses to be able to repay its maturing debt and increase its investments. Given its acute liquidity constraints, the government's attention is focused largely on dealing with its cash problems at hand. Moreover, its goal to reach a balanced budget has been predominantly geared towards revenue-generating measures without sufficiently lowering its expenditures.

Fiscal policy is still unstable, which makes conducting business and planning investments quite a challenge. This notion is enforced by a delayed presentation of the budget to Parliament. The 2006 budget was presented to Parliament in May of that year, while the 2007 budget was presented to Parliament in March 2007, but was still not approved by the end of May 2007. Accountability also is deficient. The governments in the past and present have not included the presentation of annual financial statements as an instrument to improve accountability.

In addition, the government raised import duty tariffs in June 2006 to generate additional revenues to finance government operations. These tariffs were partly scaled down again as of January 1, 2007, to compensate for the introduction of the BBO. The latter was introduced as of January 1, 2007, after an intense but short information campaign by the Tax Department. Consequently, there was limited time for stakeholders and the general public to reflect and give their feedback on the proposed changes in tax structure, as well as to adequately prepare for its introduction. With this tax the government intends to bring about a shift in the tax structure from direct to indirect taxes. In normal circumstances, the BBO will have a neutral effect on the profit and loss account of companies. Its cascading feature, however, will generate inflationary repercussions. To compensate for consumers' ensuing loss of purchasing power, the government adjusted the wage and income taxes downward, and raised the minimum wage level.

In 2006, the financial operations of the government resulted in an Afl. 62 million deficit (including the change in unmet financing requirements), lower than the Afl. 152 million deficit registered in 2005. This decline was largely the result of a decline in payment arrears and a rise in tax revenues. Noticeably, government expenditures rose at almost the same pace as its revenues attributable largely to a surge in payments for goods and services, higher wage-related outlays, and increased interest expenses. Again, the government had to resort to local financiers and the international capital market to cover part of its financial needs and to repay maturing debt. This borrowing raised its total outstanding debt by Afl. 124 million to Afl. 1,996 million and the debt-to-GDP ratio by 0.2 percentage point to 47 percent at end 2006.

Throughout 2005 and 2006, the Bank emphasized the importance of introducing adequate legislation with regard to government fiscal policy, the so-called Fiscal Responsibility Law (FRL). This legislation will strengthen fiscal discipline and promote transparency and accountability by improving the current budgetary procedures, including public finance management within a multi-year budgeting framework. Such legislation will also stipulate a maximum on government expenditures and debt, including mandatory balanced budgets. The Bank recommends that amendments to such legislation require a two-third majority vote in Parliament to ensure a sound and stable budgetary process.

The Bank fully supported the initiative of the Minister of Finance and Economic Affairs to institute a National Commission on Public Finance (the Commission) to evaluate, among other things, the development of a set of fiscal responsibility rules to ensure accountability, transparency, and public availability of information within a multi-year budgeting framework. The result would be a set of criteria to regularly monitor the development of the financial position of the government and to enable the achievement of a balanced budget and a debt-to-GDP ratio of 40 percent on the short term. In its report "Sound Public Finance and Public Accountability in Aruba" of February 2007, the Commission presented several recommendations that, if fully implemented, will enable government to reach and maintain a sound financial position in the future.

Over the years, the Bank has considerably expanded and strengthened the supervisory framework regarding the financial sector. Also in view of the international standards for financial sector regulation and supervision and the combating of money laundering and terrorist financing, it is important to broaden in the short term its supervisory scope to company service providers and stock exchanges. However, the legislative processes take time. The draft State Ordinance on the Supervision of Trust Companies is still in the legislative process stage, while a proposal is currently being drafted to bring stock exchanges under the Bank's supervision. With the technical assistance of De Nederlandsche Bank N.V., the Bank is currently working on proposals to strengthen the supervisory ordinances for the banking and insurance industry. These proposals will mainly address the legislative shortcomings identified by the International Monetary Fund and provide the Bank with a more solid legal basis to enforce compliance through supervisory laws and regulations governing this banking and insurance industry.

In August 2006, the Bank issued a revised policy rule for the admission and licensing of banks and insurance companies, to be able to better protect the interests of Aruban depositors and policyholders. Under the revised policy rule, a foreign bank or insurer is only allowed to operate via a branch office (or an agency in the case of an insurer) if it is an international bank or insurer with a balance sheet total of at least US$ 10 billion and an "A" rating issued by Standard & Poor or a comparable rating agency. Foreign banks or insurers that already operate in the Aruban market via a branch office or agency and do not meet the aforementioned conditions are required to establish a separate legal entity in Aruba before July 1, 2007, through which they can continue their banking or insurance activities on this market.

In 2006, the operations of the Bank again produced favorable results. The Bank's profits rose by Afl. 7 million to Afl. 11 million, largely induced by increased net interest revenues following higher yields on the Bank's foreign investments and its efforts in cost control. The Bank continuously strives to strengthen its operations. In 2006, the Bank focused on further improving IT security and data integrity, given the technology-based environment of the Bank and its associated risks. Several assessments were conducted by third parties on the Bank's network architecture and applications.