CENTRALE BANK VAN ARUBA

Economic outlook[1]

April 2016

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1. Introduction

1.1 Uneven global growth

The IMF estimates that in 2015, world output expanded by 3.1 percent (2016: 3.4 percent) in real terms. Growth estimates among the high income countries are spearheaded by the United States (2015: 2.5 percent) and the United Kingdom (2015: 2.2 percent); in developing countries, India and China are leading with growth estimates of 7.3 percent and 6.9 percent, respectively.

The pace of the global economic recovery is expected to maintain its uneven growth trend in high-income countries and in developing economies in 2016. Key elements that presently could impact global growth include volatility in the oil market, potential interest rate increases by the US Federal Reserve and the Bank of England, and slowdowns in China's economy.

For Latin America and the Caribbean as a whole, a decline in growth of 0.3 percent is estimated for 2015, with a similar contraction anticipated in 2016.[2] While this region expects an overall regional contraction, subregional differences exist. Brazil and Venezuela are projected to experience sharp contractions in economic activity. Given the size and interconnectedness of the Brazilian economy, significant negative spillovers onto growth in large parts of the region are likely. On the other hand, most Central American and Caribbean countries are projected to record positive growth in 2016.

1.2 A retrospective on 2015

The latest forecasting round (January 2016) for the Aruban economy is based on newly available information, statistical data, and policy changes by the government. Meetings with several key stakeholders indicate that several large projects have suffered delays, are on hold, or have been discontinued. For instance, the Bahia Principe Hotel project (total investment in the first phase of approximately Afl. 143 million), which was planned to begin in June 2015, is currently on hold. Similarly, the

[2] Source: IMF World Economic Outlook January 2016.

Windpark project (total investment of roughly Afl. 165 million) has been shelved until further notice, whereas the Hard Rock Hotel project (total investment of circa Afl. 190 million) has been cancelled.

These investment projects are substantial, and despite applying correction factors in the forecast exercise to account for possible delays in the realization of investments, the status change of these projects had important implications on the new estimations for 2015. In the case of nominal investments for 2015, the forecasted figure of January 2015 was adjusted downwards by 6.8 percentage points to a 1.5 percent decrease in the January 2016 estimate (Table 1a). Similarly, the forecasted real investments for 2015 were revised downwards by 6.6 percentage points to -2.1 percent (see Table 1b). Consequently, nominal 2015 GDP estimates were likewise revised downwards to 2.0 percent growth (see Table 1a).

New statistical releases provide revised data, which offer further insights into the state of the economy and its components. Balance of payments data for the first three quarters of 2015 indicated that tourism receipts grew by 3.8 percent, and that this growth was on a downward trend in 2015, indicating a lower than anticipated expansion for this period. Consequently, tourism exports have been revised downwards for 2015 (Tables 1a and 1b).

Table 1a: Revisions to the previous forecast (January 2015) (nominal figures)

	2013	2014	2015
Nominal GDP	Revised ▼by 0.3 percentage point to 1.8 percent growth.	Revised ▼by 0.4 percentage point to 2.6 percent growth.	Revised ▼by 3.1 percentage points to 2.0 percent growth.
Nominal consumption	Revised ▼by 0.7 percentage point to 1.2 percent growth.	Revised ▲ by 0.5 percentage point to 0.8 percent decrease.	Revised ▼by 3.8 percentage points to 1.6 percent decrease.
▪ Private	Unchanged at 1.5 percent growth.	Revised ▲ by 1.0 percentage point to 0.9 percent growth.	Revised ▼by 3.7 percentage points to 2.2 percent decrease.
▪ Public	Revised ▼by 2.3 percentage points to 0.5 percent growth.	Revised ▼by 0.5 percentage point to 4.5 percent decrease.	Revised ▼by 3.8 percentage points to 0.0 percent growth.
Nominal investments	Revised ▼by 0.2 percentage point to 8.3 percent decrease.	Revised ▲ by 2.3 percentage points to 2.0 percent decrease.	Revised ▼by 6.8 percentage points to 1.5 percent decrease.
▪ Private	Unchanged at 3.6 percent decrease.	Revised ▲ by 1.4 percentage points to 2.8 percent decrease.	Revised ▼by 5.6 percentage points to 1.1 percent decrease.
▪ Public	Revised ▼by 2.4 percentage points to 56.6 percent decrease.	Revised ▲ by 23.9 percentage points to 17.1 percent growth.	Revised ▼by 33.8 percentage points to 10.6 percent decrease.
Nominal imports	Revised ▼by 0.6 percentage point to 2.0 percent growth.	Revised ▲ by 0.9 percentage point to 0.8 percent decrease.	Revised ▼ by 2.6 percentage points to 2.1 percent decrease.
Nominal exports	Unchanged at 7.1 percent growth.	Revised ▼by 1.0 percentage point to 4.5 percent growth.	Revised ▼ by 0.6 percentage point to 2.9 percent growth.
▪ Tourism exports	Unchanged at 7.0 percent growth.	Revised ▼by 1.4 percentage points to 7.3 percent growth.	Revised ▼ by 1.1 percentage points to 2.8 percent growth.
▪ Non-tourism exports	Revised ▼by 0.1 percentage point to 7.2 percent growth.	Revised ▼ by 0.1 percentage point to 2.0 percent decrease.	Revised ▲ by 0.8 percentage point to 3.3 percent growth.

Source: CBA.

Government policy-related actions also impacted CBA forecasts. On July 8, 2015, the government increased the rate of the general health care insurance levy (BAZV) by 1 percentage point to 2 percent. At the same time, the employee premium for the general health insurance (AZV) was reduced by 1 percentage point. The hike in the BAZV, which is estimated to generate about Afl. 33 million in additional revenue, not only induced inflationary pressures, but also impacted consumptive spending through a reduction in disposable income. The latter impact was somewhat mitigated by the 1 percentage point reduction in the AZV employee premium, which is estimated to have returned Afl. 15 million to households. The previous measures are reflected in the decline in both nominal and real private consumption in 2015 (Tables 1a and 1b). Compared to 2014, real consumption contracted by 2.4 percent in 2015.

Table 1b: Revisions to the previous forecast (real figures) (January 2015)

	2013	2014	2015
Real GDP	Revised ▼by 0.5 percentage point to 4.2 percent growth.	Revised ▼by 0.3 percentage point to 0.8 percent growth.	Revised ▼by 2.3 percentage points to 0.1 percent growth.
Real consumption	Revised ▼by 0.7 percentage point to 3.4 percent growth.	Revised ▲ by 0.4 percentage point to -2.1 percent decrease.	Revised ▼by 3.9 percentage points to 2.4 percent decrease.
▪ Private	Unchanged.	Revised ▲ by 1.0 percentage point to 0.5 percent growth.	Revised ▼by 3.9 percentage points to 3.1 percent decrease.
▪ Public	Revised ▼by 2.4 percentage points to 1.9 percent growth.	Revised ▼by 0.8 percentage point to 8.1 percent decrease.	Revised ▼by 4.0 percentage points to 0.6 percent decrease.
Real investments	Revised ▼by 0.3 percentage point to -8.2 percent decrease.	Revised ▲ by 2.3 percentage points to -2.9 percent decrease.	Revised ▼by 6.6 percentage points to -2.1 percent decrease.
▪ Private	Unchanged.	Revised ▲ by 1.4 percentage points to -3.7 percent decrease.	Revised ▼by 5.4 percentage points to -1.7 percent decrease.
▪ Public	Revised ▼by 2.5 percentage points to 56.6 percent decrease.	Revised ▲ by 23.7 percentage points to 16.0 percent growth.	Revised ▼by 33.3 percentage points to 11.1 percent decrease.
Real imports	Revised ▼by 0.6 percentage point to 0.4 percent growth.	Revised ▲ by 0.9 percentage point to 1.5 percent decrease.	Revised ▼ by 3.9 percentage points to 1.8 percent decrease.
Real exports	Revised ▼by 0.4 percentage point to 6.0 percent growth.	Revised ▼by 0.7 percentage point to 3.1 percent growth.	Revised ▼ by 0.6 percentage point to 1.7 percent growth.
▪ Tourism exports	Revised ▼by 0.7 percentage point to 5.4 percent growth.	Revised ▼by 1.1 percentage points to 5.5percent growth.	Revised ▼ by 1.0 percentage point to 1.5 percent growth.
▪ Non-tourism exports	Unchanged.	Unchanged.	Revised ▲ by 0.1 percentage point to 2.0 percent growth.

Source: CBA.

2. Economic forecasts

2.1 Gross domestic product and its components

In 2016, the Aruban economy is expected to grow by 1.8 percent in nominal terms to Afl. 4.9 billion, and by 1.1 percent real terms (Tables 2 and 3). The overall growth performances were mixed in the years following the closure of the oil refinery, and the estimated growth for 2016 remains near the average long term growth pace of 0.9 percent per year in real terms. Consumption in real terms is projected to decrease marginally, i.e., by 0.3 percent to Afl. 2.4 billion. Total investments are forecasted to grow by 2.5 percent in 2016. Real exports are projected to increase by 1.8 percent, while real imports are likely to increase by a mere 0.7 percent in 2015.

Tourism: the driver of economic growth

Tourism is projected to remain the main driver for economic growth, contributing significantly to exports. For 2016, tourism receipts per night are expected to remain at the same level as in 2015. Based on this assumption and information on room capacity and airlift, the number of stay-over visitors and tourism receipts is projected to grow by 5.3 percent and 3.7 percent, respectively. For 2015, both U.S. and Venezuelan markets (+7.7 percent and +40.6 percent, respectively) remained important sources of growth and contribution, which is likely to be the case also for 2016.

Investments turning around

In 2016, investment activities are expected to increase for the first time since 2012, driven by a number of large investment projects. The most significant projects are the continuation of the Dr. H. Oduber Hospital expansion and the Green corridor. Apart from these two, significant renovation and expansions are planned in the hotel sector and by the Aruba Airport Authority (AAA). If these projects are implemented as planned, they will likely boost employment and subsequently consumption. Public investments are budgeted at a lower level for 2016 (-0.7 percent) than in 2015, partially offsetting the buoyed private investment performance.

Consumption subdued

Despite the projected growth in investment and tourism in 2016, private consumption is likely to continue to show weakness. Private consumption is forecasted to remain weak and contract by 0.2 percent as consumer sentiments remain largely pessimistic. Public sector consumption expectations are in line with the government’s sustained efforts to reduce the fiscal deficit in accordance with the legal target set in the State Ordinance on Aruban Financial Supervision. Therefore, public sector consumption is expected to contract by 0.4 percent.

Imports grow due to investments and tourism

The previously mentioned increases in investments and tourism are reflected in imports. The investment projects that are on schedule for execution in 2016 will require significant imports of materials. Likewise, the expected increase in stay-over visitors should lead to an increase in the imports of goods needed to cater to these visitors. The projected growth in imports is still relatively subdued at 0.7 percent because of the anticipated weakness in consumption.

Table 2: Main forecasts (in nominal terms)

	2013	2014	2015	2016
Nominal GDP	4,620.5	4,742.5	4,835.5	4,922.3
Percentage change	*1.8*	*2.6*	*2.0*	*1.8*
Nominal consumption	4,157.0	4,124.8	4,059.8	4,084.7
Percentage change	*1.2*	*-0.8*	*-1.6*	*0.6*
Nominal investment	1,109.0	1,087.1	1,070.4	1,113.7
Percentage change	*-8.3*	*-2.0*	*-1.5*	*4.1*
Nominal exports	3,169.9	3,313.1	3,410.2	3,520.0
Percentage change	*7.1*	*4.5*	*2.9*	*3.2*
Nominal imports	3,814.5	3,782.5	3,704.9	3,796.0
Percentage change	*2.0*	*-0.8*	*-2.1*	*2.5*

Source: CBA.

Table 3: Main forecasts (GDP percentage growth in real terms)

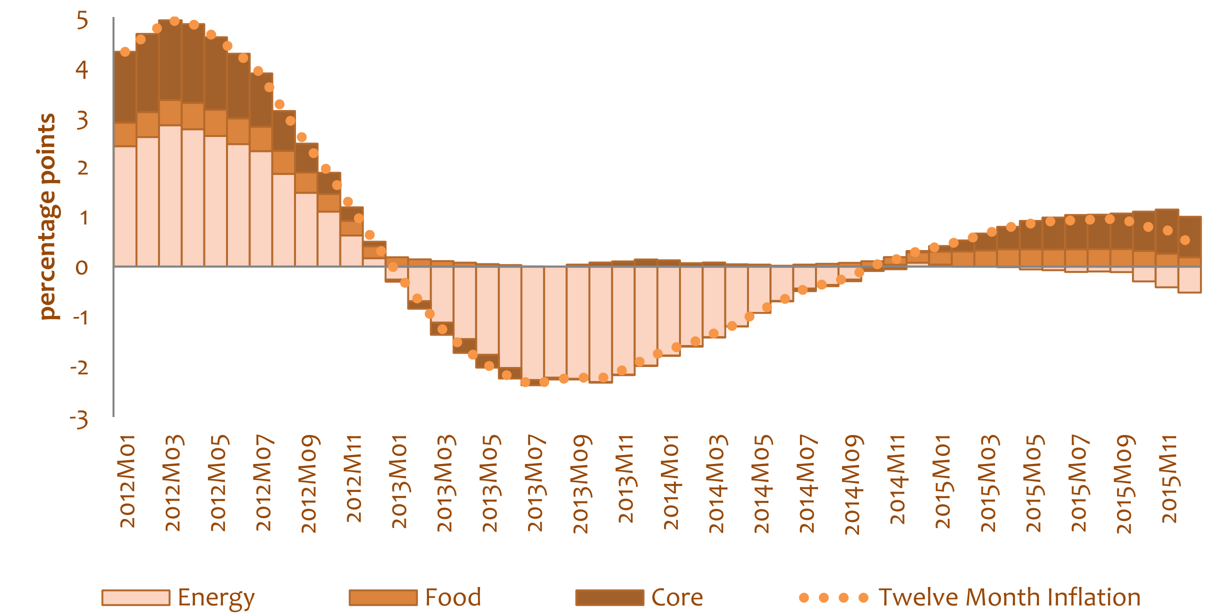
	2013	2014	2015	2016
Real GDP	*4.2*	*0.8*	*0.1*	*1.1*
Real consumption	*3.4*	*-2.1*	*-2.4*	*-0.3*
Real investment	*-8.2*	*-2.9*	*-2.1*	*2.5*
Real exports	*6.0*	*3.1*	*1.7*	*1.8*
Real imports	*0.4*	*-1.5*	*-1.8*	*0.7*

Source: CBA. Base year: 1995 = 100.

Inflation predicted to remain subdued

Inflationary pressures are expected to remain at a low level. Following a period of deflation in 2013 and 2014 caused primarily by a reduction in energy tariffs (Chart 1), and a 12-month average inflation of only 0.5 percent in 2015, this inflation rate is anticipated to accelerate to 1.0 percent in 2016. Historically, movements in the energy prices have been the main source of price volatility, thereby affecting the inflation rates. However, the recent decline in oil prices did not fully impact the general price level, in light of the partial coverage in hedging contracts in place for 2015 and 2016. Nonetheless, the Water and Energy Company (WEB) did reduce the tariffs for household electricity consumption as of January 1, 2016. This reduction will likely have a downward impact on inflation in 2016. On the other hand, domestic nonenergy prices are expected to edge up as the increase of indirect taxation (BAZV) in July 2015 will still have an effect on the 12-month average inflation rate in the first half of 2016.

Chart 1: Contribution to inflation (12-month average)

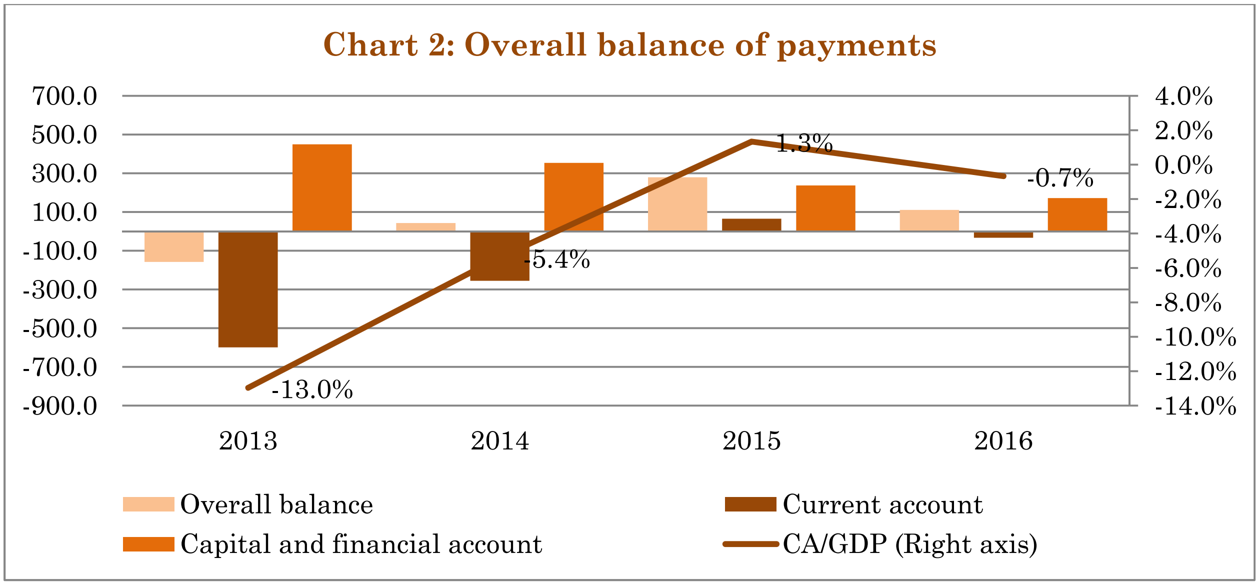


Source: CBS.

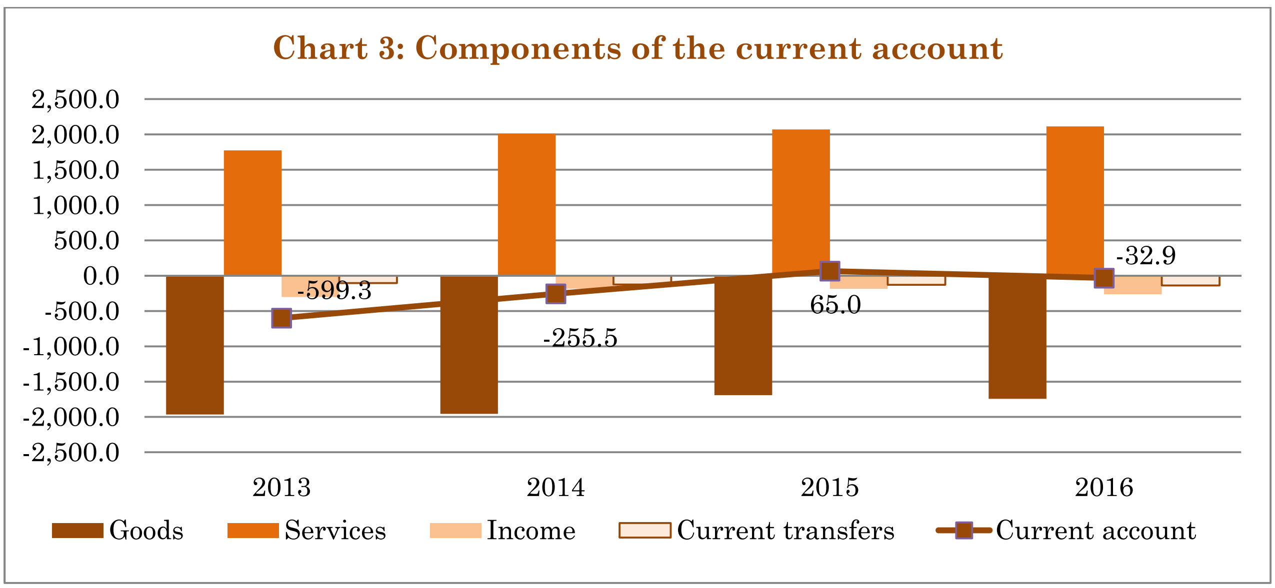
2.2 Balance of payments

The balance of payments for 2016 is forecasted to record an overall surplus of Afl. 111.1 million (Chart 2). This surplus is the result of an expected positive capital and financial account balance mitigated by an anticipated current account deficit balance equivalent to 0.7 percent of GDP.

Tourism receipts are likely to contribute again positively to the services account of the current account balance for 2016 (Chart 3). The goods account deficit is forecasted to increase by 3.2 percent in 2016. Imports of goods will grow moderately in 2016 as investment projects are assumed to commence and/or continue, while certain new tourism-related projects are in the pipeline for execution during 2016. More important, a smaller payment outflow related to the imports of oil-related products is expected due to the fall in oil prices.

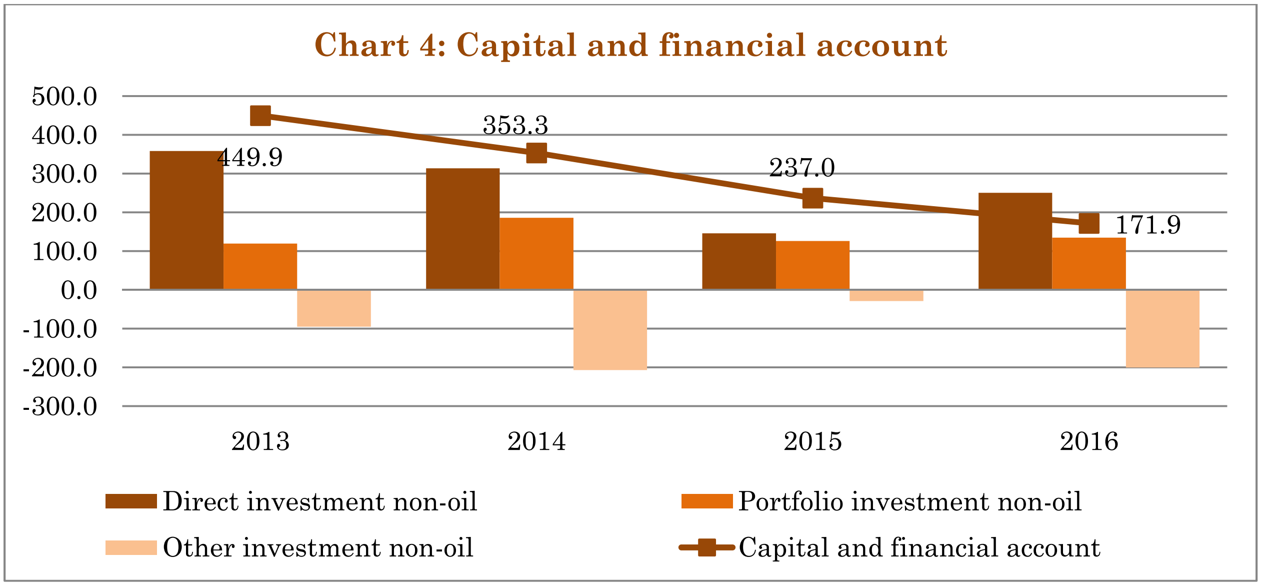


Source: CBA.
Please note that figures for 2015 are estimates, while figures for 2016 are forecasts.



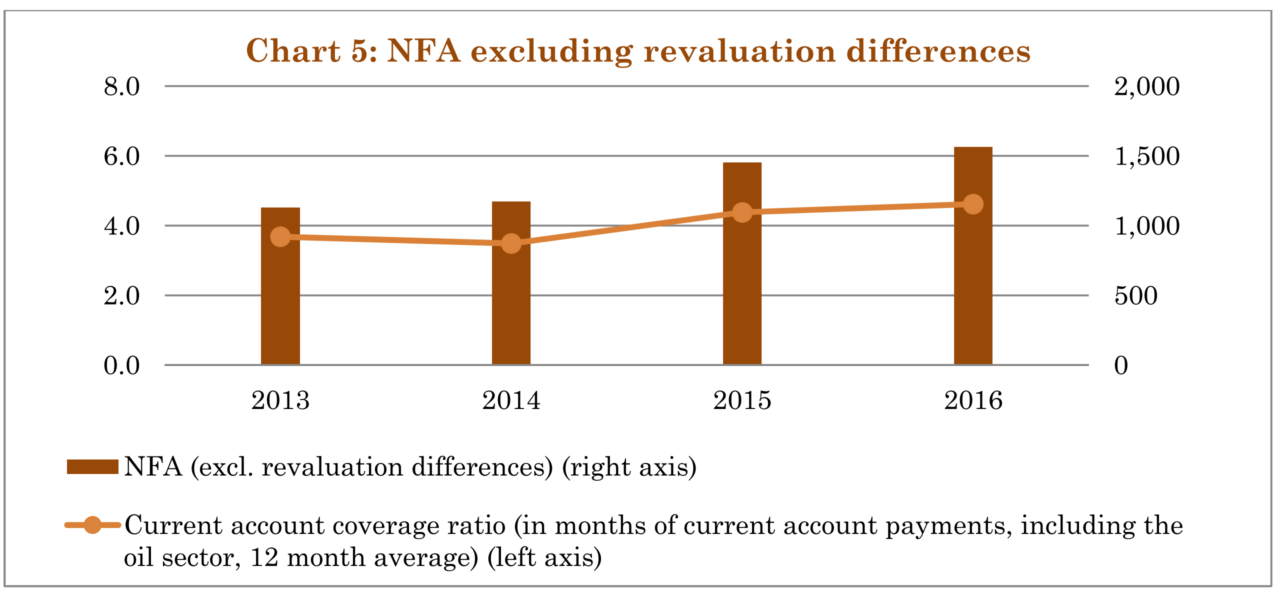
Source: CBA.
Please note that figures for 2015 are estimates, while figures for 2016 are forecasts.

The capital and financial account is projected to record a surplus of Afl. 171.9 million in 2016 (Chart 4). Foreign Direct Investments (FDI) are anticipated to contribute positively to the financial account in 2016 as the steady overall foreign currency inflow from real estate and timeshare sales, and from other tourism-related investment projects, is expected to continue. For example, the renovation of the Hilton Hotel, planned for 2016, will induce international capital investments. Furthermore, for the purposes of the CBA's forecast, the government is assumed to cover a large part of its financing needs in 2016 with funds borrowed on the international capital market.



Source: CBA.
Please note that figures for 2015 are estimates, while figures for 2016 are forecasts.

The net foreign assets (NFA, excluding revaluation differences) are forecasted to increase by Afl. 111.1 million in 2016 (Chart 5). Hence the NFA is projected to reach Afl.1,564.6 million in 2016. To assess reserve adequacy, the CBA monitors several benchmarks. One of these benchmarks is that reserves should cover current account payments at a rate of at least 3 months. The 2016 current account coverage ratio is forecasted to reach 4.6 months, given the projected increase in the NFA relative to current account payments. This is 1.6 months higher than the 3-month international benchmark.



Source: CBA.

Please note that the current account coverage ratio for 2015 is an estimate, while the current account coverage ratio and NFA for 2016 are forecasts.

2.3 Outlook risks

Notwithstanding the potential restart of the refinery (see Chapter 3), outlook scenarios as well as the GDP forecast for 2016 are subject to a number of upward and downward risks.

- Relatively large projects weigh significantly on the growth of the investment component as well as on projections for gains in consumption and employment. Therefore, any potential delay in the execution of large investment projects could dampen both the growth in investments as well as consumption.
- Oil prices have proven quite volatile in the past, leading to significant movement in the domestic inflation rate. Despite mitigating measures by the utility company to partially hedge the price of its fuel oil consumption, significant movement in oil prices could potentially influence local gasoline prices as well as import prices for goods.
- Future measures to align the government deficits to specific targets could result in a further contraction of government consumption.
- Private sector confidence remains a crucial condition for the private investment climate and could act as both an upside and a downward risk.
- The positive tourism performance in the last five years has been driven in large part by a growing Venezuelan market. Given the unpredictability of this particular source market, and considering the geopolitical uncertainties in the region as well as the anemic international economic environment, export receipts are vulnerable to demand shocks.
- Potential downside risks to the 2016 balance of payments forecast include the volatility of tourism, which affects tourism receipts, and potential setbacks in investment projects.
- The upward risks to the forecast include an exceptional growth in tourism receipts and a further decline in oil prices.

3. Medium-term scenarios

With or without a refinery?

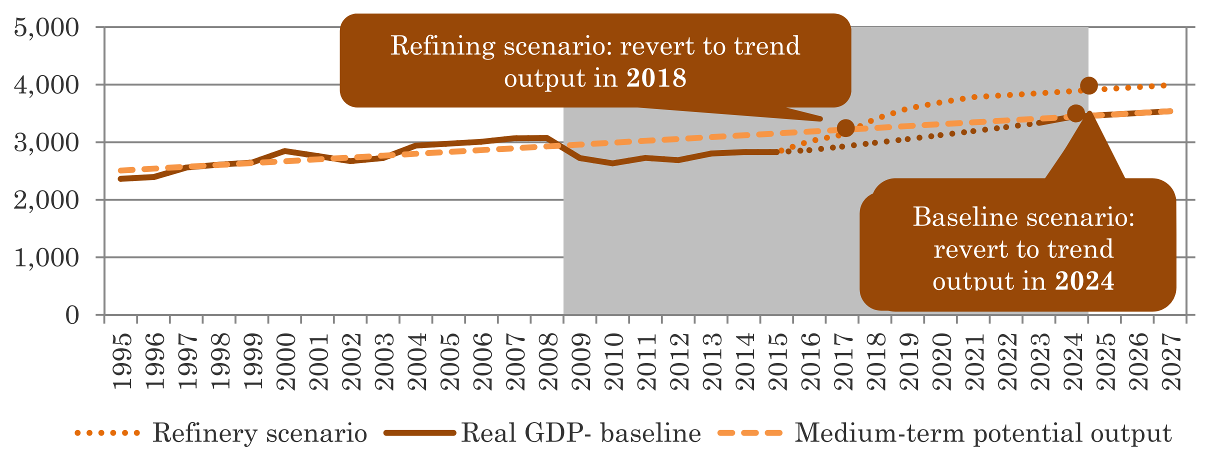
Based on government-released information regarding ongoing negotiations with Citgo, a scenario that includes the re-opening of the oil refinery is considered in forecasting medium-term GDP growth for Aruba. To offer a preliminary output estimate, the CBA has calculated two stylized scenarios for medium-term GDP growth (Chart 6):

1. A *baseline setting without refinery*, in which it is assumed that potential GDP will revert to its trend output (+0.9 percent in real terms) by the year 2024 by closing the output gap experienced since 2009.

2. An *alternative scenario where a restart of the refinery is assumed in 2018* at full capacity, while all other major economic activities are presumed to remain equal to the baseline.

To achieve a full capacity restart by 2018, the alternative scenario considers that the refinery will carry out substantial investments and contribute to employment from 2016 onwards. Additional investments are assumed for the period of 2018 onwards, during which the refinery is expected to become operational. Given these assumptions, the contribution to real GDP in the refinery reopening scenario leads to shortening of the time frame for GDP to revert to its medium term potential, closing the gap 6 years earlier, namely, in 2018.

Chart 6: Real GDP medium term forecast and refinery reopening scenario*



Source: CBA.

* Base year 1995.

Net foreign assets 2016-2018: four scenarios

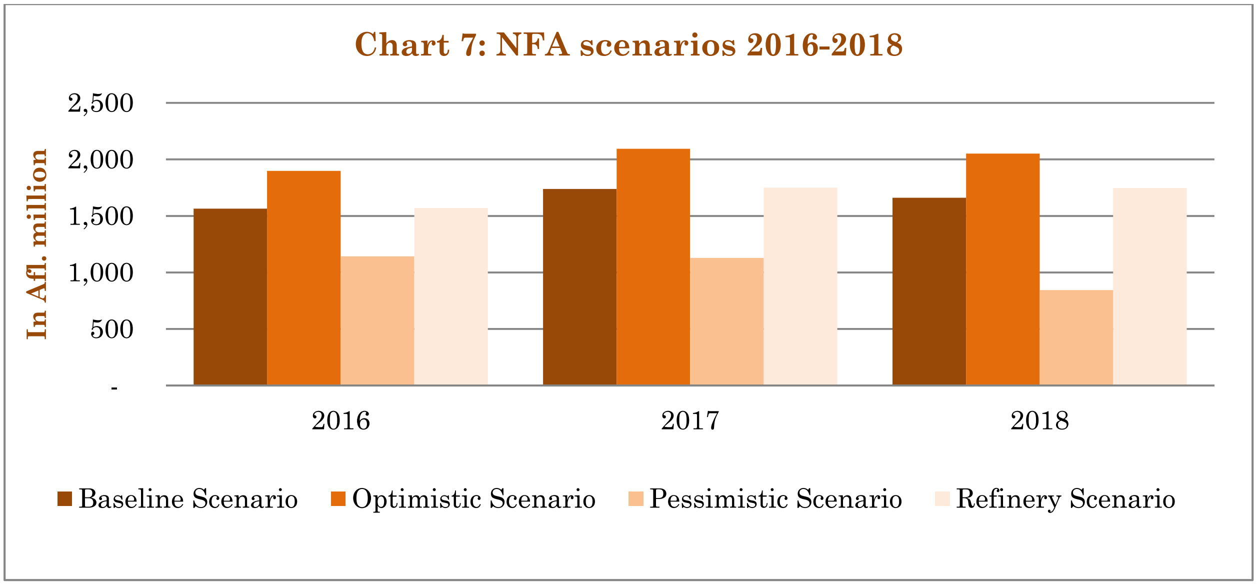
For the period 2016-2018, at least four scenarios could occur and impact the net foreign assets significantly. These scenarios are a baseline scenario (scenario 1), an optimistic scenario (scenario 2), a pessimistic scenario (scenario 3), and a scenario that includes a restart of the refinery (scenario 4). These scenarios will be discussed in detail below.

The baseline scenario (scenario 1) takes into account that tourism receipts would grow at 3.7 percent 2016-2018. Additionally, FDI is forecasted to contribute to the NFA with Afl. 230 million yearly. Imports are projected to pick up in 2016-2018, as investment projects are assumed to commence and/or continue, while new projects are in the pipeline. Moreover, oil prices are forecasted to increase slightly and reach $53 per barrel of crude oil in 2018. Consequently, about Afl. 230 million would flow out annually because of imports of oil products. Finally, the government is assumed to borrow Afl. 55 million on the domestic market in 2016-2018.

These assumptions underlying the baseline scenario would result in balance of payments surpluses in 2016 and 2017, and a deficit in 2018. The NFA consequently would expand by Afl. 111.1 million in 2016 and by Afl. 173.5 million in 2017, then contract to Afl. 1,660.8 million in 2018 (Chart 7). The current account coverage ratio would then reach 4.9 months in 2018.

A second scenario (scenario 2), an optimistic one, assumes that several positive shocks would occur in 2016. These shocks include a tourism receipts growth of 5.9 percent in 2016, a drop in average annual oil prices to $35 per barrel, and the government borrowing entirely from abroad to cover its financing needs. These shocks would contribute positively to the balance of payments in 2016, compared to the baseline. Furthermore, in this scenario, FDI would be larger than in the baseline and contribute Afl. 335 million to the NFA in 2016. The NFA would therefore reach Afl. 2,051.6 million in 2018, equal to 5.4 months of current account coverage (Chart 7).

A third scenario (scenario 3), a pessimistic one, assumes a decrease in tourism receipts by 3.4 percent in 2016. Additionally, in this scenario the government borrows Afl. 150 million domestically, while the remainder of its total financing needs would be covered with funds borrowed from abroad. Oil prices would reach $65 per barrel in 2016, and the FDI will be smaller than in the baseline due to project delays. These shocks would result in a negative balance of payments in 2016. The NFA would then reach Afl. 844.1 million in 2018, which would lead to a current account coverage ratio of 2.8 months. An NFA below 3.0 months of coverage is considered inadequate.



Source: CBA.
Please note that figures for 2016-2018 are forecasts.

Finally, **there is also a scenario (scenario 4)** where the refinery re-opens and starts processing oil in 2018. The restart would not make a large contribution to NFA during the period 2016-2017 as no processing would be going on, and only funds to pay wages will flow in (assumed around Afl. 6 million per year). Using an average of the overall balance of the oil sector for the period 2000-2008, it is estimated that the refinery could contribute with a yearly net inflow of foreign funds of about Afl. 74 million. This is a preliminary estimate since it does not account for the size of the operation during this period or, among other things, the future oil prices. If this additional net inflow of NFA is added to the baseline scenario, NFA would total Afl. 1,746.8 million in 2018. In addition, the current account coverage ratio would stand at 5.1 months in 2018 (Chart 7).

4. Concluding remarks

The Aruban economy is projected to grow in 2016 owing to the increase in investments and further expansion in the tourism sector. Investment is likely to pick up in 2016, as some large projects that got underway in 2015 gain momentum in 2016. Consumption is not anticipated to have a positive contribution to economic growth. In real terms, it actually is forecast to register a small contraction. The weakness in consumption is reflected in a relatively modest expansion in imports, only to be pushed up by the anticipated growth in the tourism sector and investment activities.

While higher than in 2015, inflation will likely remain relatively subdued in 2016, as lower gasoline prices partially mitigate the impact of the increase in indirect taxation (BAZV) on domestic prices.

The balance of payments is forecasted to record an overall surplus in 2016, resulting from a positive balance on the capital and financial account, partially mitigated by a small deficit on the current account. The main contribution to this surplus comes from increased tourism receipts, and a net inflow from foreign direct investment and foreign government borrowings. Consequently, the level of NFA is set to increase and, therefore, remain at an adequate level, when compared to the benchmarks monitored by the CBA.

The main risks to this outlook are potential delays to investment projects, which have often occurred in previous years. Also, considering the geopolitical uncertainties in the region as well as the weak international economic environment, the tourism sector is likely to be vulnerable to demand shocks.

Moreover, depending on the type of measures to align government deficits to specified targets, government consumption could be negatively impacted, while private sector investment projects could be further hampered. In the medium term, the outcomes for GDP, the balance of payments, and government finances are heavily influenced by whether or not the refinery resumes its operations. Yet, even in a scenario with a restart of the refinery, further fiscal consolidation would be needed to reach the targeted government deficits.