



CENTRALE BANK VAN ARUBA

June 17, 2011

Today the Centrale Bank van Aruba published its 'Report 2010: Economic and Financial Developments'. The statement of the President, which is also included in this report, is presented below.

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In 2010 much of the Aruban economy continued to encounter challenges and uncertainties. Relying largely on external sources of income, Aruba's economy historically has been vulnerable to changes in world economic conditions. Consequently, the global economic and financial crisis of 2008-2010, combined with the temporary shutdown of the refinery, the slowdown in the tourism sector and a significant drop in foreign direct investment had a severe impact on the Aruban economy, as nominal gross domestic product (GDP) fell by 3.8 percent to Afl. 4,306.1 million in 2010.

On the other hand, the world economy appears on the mend following the global crisis and the further bouts of financial turbulence and contagion risks associated with the Greece and Ireland sovereign debt crises. While the return to broad price stability remains an important policy achievement, macroeconomic instability has persisted in much of the world economy, continuing to pose challenges for and in many ways make new demands on economic policies. In this context, the world economy stays a complex mosaic of contrasting developments in countries and regions where trends in aggregate output do not converge.

During 2010, the island's economy was characterized by a decline in business activities in many sectors, a situation reminiscent of but less grave than the period 1985-1986. Almost 25 years ago the culprit was the sudden closure of the Lago refinery. This time that same refinery, now operated by the Valero Energy Corporation (VEC), was the main reason for the contraction of Aruba's economy. Coinciding with the most severe economic and financial crisis since the Great Depression, the VEC announced its intention in June 2009 to temporarily shut down the Valero refinery as the narrow heavy sour crude oil margins did not make it economically feasible to operate the refinery. Moreover, the enacted 1 percent turnover tax on export sales on January 1, 2007 was a significant source of dispute because

it negatively impacted the refinery's operations and threatened continuity over time. In the words of the VEC, "various tax disputes with the Government of Aruba (GOA) created uncertainties with respect to the future economics of the refinery."<sup>1</sup>

The operational shutdown of the refinery, which took place in July 2009, was more detrimental to the Aruban economy than the then on-going global crisis itself. It caused a decline in the number of contracted personnel at the refinery (estimated at about 1,200), a loss of foreign exchange income, and substantial uncertainty within other sectors of the economy. Moreover, the ensuing economic recession led to a decline in government revenue.

In late February 2010, the GOA and the VEC reached a settlement agreement, which ended the tax dispute between the two parties. The settlement stated that the Valero refinery would enter into a new tax covenant, thereby relinquishing its tax holiday status, and be subject to a flat profit tax rate of 7 percent and a dividend withholding tax rate of zero percent. Moreover, all imports and exports would be exempt from the turnover tax and throughput fees of any kind of any kind. After two years, more specifically on June 1, 2012, the refinery would start to make a minimum annual tax payment of US\$ 10 million, in equal quarterly installments. It also has been granted the entitlement to carry forward, as a tax credit, any excess of its tax prepayments versus its future tax liabilities. At the end of May 2010, the Aruban Parliament adopted a number of laws that permitted the implementation of the provisions of the tax settlement.

Shortly after the Parliamentary approval of the settlement, the VEC paid US\$ 118 million to the GOA as part of the deal. In the third quarter of 2010, the refinery initiated a company-wide maintenance program, announcing an investment of about Afl. 161 million. Due to the improved sour crude oil price differentials and refining margins in the first six months of 2010, the VEC's investment program was designed to prepare its production units for a possible restart by the end of September 2010. Aside from being an impetus to economic activity, the investment program was only partial good news because of uncertainty as to whether the refinery was going to fully restart its operations. It was not until the beginning of 2011 that almost all of the associated uncertainty was eliminated and the start of production became a reality. The importance of the restart of the refining activities are highlighted by estimations by the Centrale Bank van Aruba (CBA) that indicate that the inactivity of the refinery during 2010 had a negative direct impact (not accounting for the

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<sup>1</sup> Valero Energy Corporation, *10-Q Quarterly report pursuant to sections 13 or 15(d)*, Second Quarter 2010, p. 12.

indirect effects of the shutdown of the refinery) of about 3.4 percentage points on the estimated decrease of 2.8 percent in the real GDP.

The negative performance in Aruba's aggregate output in 2010 coincided with the moderate growth of tourist arrivals, particularly in the second half of the year, and the distressed construction activities. Overall, the economic performance of Aruba's other industries was not enough to prevent the negative outcome in the real GDP during 2010.

Growth in tourist arrivals reached 2.5 percent in the first half of the year, but weakened to 0.6 percent in the second half, as the U.S. market showed debilitated progress in the latter part of the year. For the year as a whole, tourist arrivals grew by 1.6 percent of which 0.9 percentage point was related to the U.S. market. The performance of tourist arrivals from the United States was associated with growing concern about the sustainability of the U.S. economic recovery. Nominal tourism receipts increased by 2.2 percent or Afl. 47.7 million in 2010. In the first eight months of 2010, the hotel occupancy rate grew by 1.9 percentage points to 78.1 percent, in contrast to average daily rates which fell by 0.8 percent to Afl. 321. Meanwhile, revenue per available room (RevPar) went up by 4.5 percent to Afl. 147 in the first eight months of 2010. At the same time, in line with expectations, cruise tourism did not perform well. This result is in part related to volatile oil prices and a decline in advanced bookings, many of which originated up to six months earlier when the global economic and financial crisis was still on-going. A positive development was the resumption of the flights of the KLM and the calls of Carnival Cruise Lines to Aruba. Both are strategic partners for Aruba's tourism industry.

The retail sector recorded a modestly improved performance in 2010 compared to 2009. Nonetheless, the level of activities in this sector remained subdued when compared to 2008 and prior years. Apart from the difficult economic situation in 2010 and the reluctance of consumers to spend, the retail sector faced a problem of over-capacity, built-up in the years leading up to the recession.

The construction sector also had been severely affected by the recession and remained depressed in 2010. This result is evidenced by information obtained by the CBA through both quantitative indicators (number of construction permits granted, imported cement and electrical installations approved), and qualitative indicators (business perception surveys and regular business visits). Besides the negative impact of the temporary shutdown of the Valero refinery during 2010, this fallout had its roots along with lower overall investment activities on the island, estimated at -9.9 percent in real terms. This situation was, among others, brought about by the delay in the implementation of announced public-private

partnership projects and the delay of some large investment projects (e.g. Ritz Carlton Hotel).

Workers suffer with the decline in wages and employment that tends to occur during a recession. In this context, the distress in the construction sector had its repercussions on the labor market, as it caused a surge in the unemployment rate. Coupled with meager performances in other sectors such as wholesale and retail trade, hotels and restaurants, real estate, renting and business activities, the number of persons without a job appears to have remained on a relatively high level in 2010. Preliminary estimates by the CBA indicate an unemployment rate of 9.0 percent at the end of 2010, equivalent to around 4,800 persons.

Fewer individuals with a job mean less income available for private consumption, one of the backbones of Aruba's economy. In real terms, private consumption is estimated to have declined by 0.3 percent in 2010. Lagging consumptive spending also was reflected in the performance of selected economic indicators: a 2.7 percent reduction in turnover tax receipts (BBO) in real terms<sup>2</sup>, a 3.8 percent decline in container transport, and a 2.9 percent decrease in consumer credit extended by the banking sector.

The banking sector in Aruba was also affected by weaker business activities in 2010. The weak outcome in consumer credit occurred in an environment where the commercial banks, within the boundaries of prudential parameters and requirements, are no longer restricted in the amount of credit they are allowed to grant. The CBA did away with the credit-ceiling instrument as of January 1, 2010, and introduced a new monetary policy framework. The very modest developments in credit should be attributed essentially to both restrained demand for consumer credit and loans to businesses. Moreover, the tightening of lending conditions may have contributed to the depressed outcome in both categories of credit. On the other hand, housing mortgages increased by 5.8 percent. The refinancing of existing debt may have played a major role in this increase, considering the meager performance in housing construction.

The removal of the limitation in credit growth by the CBA marked the end of the direct system of monetary policy, and the introduction of an indirect arrangement mainly comprising the Reserve Requirement (RR). This instrument, through which commercial banks are obligated to hold 11 percent of their short-term liabilities (less than 2 years and excluding domestic interbank deposits) as unremunerated deposits at the CBA, is currently used by the CBA to mop up part of the excess liquidity within the banking system, and

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<sup>2</sup> Corrected for the tariff reduction of the BBO as of January 1, 2010 and the incidental receipt of Afl. 211.6 million related to the Settlement Agreement with the VEC.

signals the CBA's monetary intentions.<sup>3</sup> Under the CBA's new monetary policy framework, the main monetary policy objective remains the same, i.e., the preservation of the stability of the value of the Aruban florin, as mandated by the Central Bank Ordinance. Within this context, the operationalization of the monetary policy of the CBA became more flexible, meaning that it is subject to periodic revision, depending on the expected developments in, among others, the net foreign assets.

In light of the new, more flexible, monetary policy framework the CBA established the so-called Monetary Policy Committee (MPC) in May 2010. The committee consists of the President and both Executive Directors of the CBA, with the main responsibility of periodically reviewing CBA's monetary policy stance, based on a selected number of economic indicators, among others, gross domestic product, net foreign assets, inflation, credit, and liquidity. In 2010, the MPC held seven meetings. The MPC concluded in its meetings that the rate of the main instrument of monetary policy, the RR, could remain unchanged based on the economic and financial situation. Because the decision-making process within the monetary policy framework is dynamic, the CBA has flexibility to add other instruments as needed to its arsenal of monetary policy instruments.

Lower demand for credit and the removal of credit restrictions, however, were not enough to influence the relatively high spreads in interest rates (8.2 percent in 2010) adopted by the commercial banks. The spread between the weighted average interest rates on new loans and new deposits widened further in 2010, as the average rates on new deposits showed a steeper decrease than the average rates on new loans, a disquieting pattern that has been going on for some time. This phenomenon, and particularly the level of the interest rates on loans and deposits has been a topic of debate for years, not only in Aruba, but in many of the neighboring Caribbean islands as well.

The challenge of relatively high interest rate margins is endemic to small island economies, such as Aruba, where diseconomies of scale are more the rule than the exception. The introduction of interest rate ceilings (for loans) or floors (for deposits) does not seem to be the solution, and many countries tend to move away from these instruments. It would be more fruitful to take measures that promote competition between the commercial banks, thereby mitigating the negative effects of the existing oligopolistic market structure on pricing. Already at the beginning of 2010, the CBA moved toward more market-oriented monetary policy instruments in an effort to stimulate competition.

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<sup>3</sup> For more information, please refer to Box 2.2, p. 21 of the *CBA Report 2009: Economic and Financial Developments*, published in July, 2010.

However, unlike other sectors of the economy, the push for more competition in the banking sector also bares risks for maintaining financial stability. The costs and benefits of increased competition must be well-balanced in the pursuit of lower interest rates on loans, without further depressing the interest rates on savings and deposits, while a sound and safe financial system for a stable socio-economic development remains a top priority. The recent global financial and economic turmoil is a case in point.

Besides low demand for credit, the economic contraction during 2010 led to a substantial increase in loan defaults, as measured by past-due loan status of more than 90 days on the payment of interest or principal by businesses and individuals. Nonperforming loans recorded a steep increase in the second half of 2010, particularly with respect to commercial mortgages. Although the commercial banks have adequate capital buffers in place to cover possible loan losses, this trend requires careful monitoring.

Fortunately, price stability was not a cause for concern during 2010, as the 12-month average inflationary pressures remained restrained with a 2.1 percent increase in prices. This outcome had to do essentially with the development in energy prices. If the food and energy components are eliminated, however, the so-called core inflation stood at -0.3 percent, indicating a light decrease in prices of the remaining components of the consumer price index. The latter prices have been showing a steady decreasing trend over the last year and conveyed a stable development in the inflation differential of 0.4 percentage point with the United States, Aruba's main commercial and tourism partner.

The fixed exchange rate between the Aruban florin and the U.S. dollar is sustained in the long term by maintaining a comfortable level of foreign exchange reserves. In contrast to the last three years, the international reserves dropped 11.3 percent or Afl. 167.0 million to Afl. 1,308.1 million in 2010. This result was attributed mainly to incidental transactions related to, among other things, the oil sector in the last month of 2010. The level of international reserves remained adequate despite the mentioned decline, as the average import coverage ratio in months of current account payments actually increased from 5.9 months in 2009 to 6.3 months.

After four consecutive years of surplus, the balance of payments recorded a deficit of Afl. 167.0 million in 2010. Transactions of the oil sector and to a lesser extent the non-oil sector contributed to this outcome. The current account deficit of the oil sector was Afl. 825.4 million, as imports of crude oil and other goods were higher than exports of refined oil. The financing of this deficit was done mostly from trade credits received and withdrawals from the oil sector's foreign bank accounts for the total amount of Afl. 698.6 million, and the purchase of Afl. 127.7 million in foreign exchange from the commercial

banks. The non-oil sector bought, on balance, Afl. 39.3 million in foreign exchange from the commercial banks. This amount was used together with its current account surplus, to cover the deficit on the capital and financial accounts related essentially to advances on imports of goods and services and increased balances on foreign bank accounts.

Public finances entered another stage of adversity in 2010, when the financial deficit (including the change in payment arrears) reached a new level of Afl. 190.4 million, equivalent to 4.4 percent of the GDP. This outcome is still below what it would have been, were it not for the incidental government revenue of Afl. 211.6 million stemming from the Valero tax settlement agreement. As the public sector revenue picture changed during the period 2008-2010, the outlook of the government finances for the coming three years is challenging, given the government's substantial financing needs to cover both the deficit and the repayment of several large loans.

With the aim to structurally reform some costly programs such as the health care and the pension system, the government introduced a series of so-called Social Dialogues, based on the "Dutch Polder Model" of consensus in economic policy. The CBA contributed to the Social Dialogues by presenting medium and long-term projections of government finances under different scenarios.

The results of the first round of this Social Dialogue are encouraging. The involved parties reached an agreement in June 2010 on three main fiscal challenges: the civil servants pension fund (APFA), the old age pension insurance (AOV), and the general health insurance (AZV). Measures to address the significant weaknesses in all three schemes were implemented in January 2011. The agreement reached within the first round of the Social Dialogue is commendable and has been welcomed by international institutions, such as the International Monetary Fund (IMF) and Standard & Poor's. However, the IMF also expressed the view that these measures will yield limited fiscal savings in the short-term, more specifically a reduction in the underlying fiscal deficit by 2 to 2.5 percent of GDP. The latter estimation excludes some expansionary reforms resulting from the Social Dialogue Agreement.

Along this line of fiscal policy, the IMF concluded that to reach a balanced budget, more adjustments are needed on both the expenditure side and the revenue side of the budget. Its calculations show that expenditure corrections would fall short about 2.5 percentage points of the estimated required adjustment, necessitating additional revenue-generating measures that should promote economic growth, be fair and transparent, and prompt high taxpayer compliance with low administrative costs. More specifically, the IMF recommended

investigating the possibilities of introducing a value-added tax (VAT) to replace the current turnover tax (BBO).

The GOA reduced the BBO tariff by half at the beginning of 2010, using the rationale of improving the purchasing power of consumers. The argument was that this reduction would not only benefit consumers but also would have extended positive effects for businesses, tourists, and even the informal sector. Aside from the anticipated positive effect on purchasing power, the tariff reduction of the BBO also has a downside, i.e., a loss in government revenue. Since the BBO applies to tourists as well as domestic consumers, the tariff reduction led to a loss in government revenue (excluding the government revenue received from the settlement agreement with the VEC) from tourists as is illustrated by the estimation by the CBA that tourists contributed by about 42 percent to the BBO revenues of the government in the period 2007-2009.

The loss in revenue further increased the pressure on the GOA's already weak financial position. As part of its advisory role, the CBA cautioned the GOA of the potential ensuing fiscal risks. While it agreed with the government on the objective of improving the purchasing power of consumers, the CBA expressed concern about the impact a reduction in the BBO rate would have on the financial position of the government.

Besides economic monitoring, CBA's supervisory activities were enhanced in 2010, particularly in the area of anti-money laundering and the combating of terrorism financing (AML/CFT). The deficient Aruban AML/CFT framework required swift actions, after the unfavorable outcome of the October 2009 Mutual Evaluation Report of the Financial Action Task Force (FATF). The report cited an incomplete and incoherent AML/CFT framework. To improve this situation, the GOA installed an AML/CFT strategy group, presided over by Aruba's Prime Minister. With the assistance of an external consultant, a plan of action to remedy the identified deficiencies in the AML/CFT framework was drafted.

The FATF placed Aruba under the enhanced follow-up procedure, which implies that Aruba has to report back to the FATF during each of the three FATF Plenary Meetings held each year. After the second Plenary Meeting of 2010 the FATF was of the opinion that Aruba still had to demonstrate substantial progress in the implementation of its action plan. However, at the third Plenary Meeting the FATF decided that Aruba had made significant advances and should report back to the Plenary Meeting of June 2011 instead of February 2011. Still, the FATF decided to leave Aruba in the *enhanced follow-up procedures*, and to review in June 2011 whether Aruba could be moved to the *regular follow-up procedures*.

Aside from the FATF issue, the CBA continued to monitor the effects of the aftermath of the global economic and financial crisis on the supervised financial institutions in Aruba. All

supervised financial institutions were able to continue to operate within the prudential parameters set by the CBA in the area of solvency and liquidity. The three company pension funds, whose coverage ratio had declined below the minimum requirement of 100 percent since 2008, succeeded in bringing their coverage ratio above the required minimum by the end of December 2010.

The incorporation of the civil servants pension fund (APFA) under the supervision of the CBA as of January 1, 2011, forms a new challenge to the CBA supervisory activities. Previously, the APFA was under the oversight of the Minister of Finance. In connection with its underfunded position, the APFA has to submit, in the short term, a recovery plan to the CBA for its approval. The GOA has committed itself to offer ample financial support to the APFA if and when needed, thereby providing a basis for the APFA's supervision by the CBA. However, the underfunding of the APFA remains substantial and may require additional corrective measures.

The Aruban economy is anticipated to grow by 8.9 percent in real terms in 2011, derived mostly from a further pick-up in the tourism sector and the restart of the Valero refinery activities. Overall consumption is expected to strengthen by nearly 0.9 percent, with the private sector as the main catalyst, given that government consumption is predicted to decline in real terms. Investments are forecast to show a strong rebound in both the public and private sectors, while the CBA foresees a net growth in the external sector as tourism is expected to continue to increase, although still below the average rates of growth recorded in the previous decade.

The assumptions underlying the CBA's projections for the short to medium term take into account future policy measures likely to be implemented. Both projections and policy assumptions are generally based on information available to the CBA at the time of analysis. One of the main downside risks to the baseline scenario is that the world economy will not meet the expected real GDP growth of nearly 4.2 percent for 2011. The current turmoil in the Middle East and Northern Africa, which has significantly driven up oil prices on the international market, increases this risk. An additional risk is significantly weaker than expected economic growth in the United States. Because of these possible risks, there is reason for concern about the depth of the tourism recovery underway in Aruba since its economy would be vulnerable under these scenarios. On the other hand, an upside risk is the realization of the investment plans of the GOA and the VEC regarding a liquefied gas project to replace oil as the main energy source on the island.

The year 2010 was difficult and challenging for Aruba. Some significant obstacles were dealt with, while others still await suitable solutions in 2011 and beyond. Effective results,

which are not always based on win-win situations, require determination and willingness of all involved parties to bring outcomes that in the end will benefit the people of Aruba.