



CENTRALE BANK VAN ARUBA

Economic vulnerability and resilience of Aruba: a central banker's perspective

University of Groningen

September 11, 2018

Speech by

Jeanette R. Semeleer

President

The Centrale Bank van Aruba

Ladies and gentlemen,

Good afternoon. It is nice to be in Groningen and certainly at the University of Groningen at the invitation of Professor Bert Steenge on the occasion of the Symposium on the Vulnerability and Resilience of Small States.

The topics at the symposium are close to my heart and work. I have learned a lot from this morning's presentations. I, therefore, deeply appreciate the opportunity to be part of the symposium and to share with you my thoughts on economic vulnerability and resilience of small island states focusing of course on Aruba, and what lies ahead for us from a central banker's perspective.

1. Introduction

Before continuing, please allow me to congratulate Edwina, with the achievement of her PhD degree. Yesterday was not only an exceptionally great day for Edwina in receiving her hard-earned PhD diploma, but also for the Aruban community and the Central Bank of Aruba, in particular.

Her dissertation "Small and smart? An exploratory analysis of economic choices of small countries and territories in the Caribbean is a jewel in a box that unfortunately is relatively empty. Her ample study provides us with many interesting data and analysis that could provide useful insights for leaders in the Caribbean on further strengthening institutional capability to achieve the hard- sought, and many times even fleeting, economic growth and well-being.

2. IMF Caribbean Forum 2017

As you are well aware, economic vulnerability and resilience are hot topics especially for many small island, particularly since the economic crisis of 2008 and recent concerns about climate change. In November of last year strengthening economic resilience was also the theme of a high- level Caribbean forum that was held in Jamaica.

Christine Lagarde, Managing Director of the International Monetary Fund (IMF), mentioned in her opening remarks that a strong economic growth is an essential foundation for a more resilient Caribbean. Growth that has been elusive for many countries in this region.

She identified three specific topics that are key to higher growth:

Firstly, crime and youth unemployment. On average, crime in the Caribbean costs nearly 4 percent of GDP per year. Strong efforts must be made to reduce the high youth unemployment rates. This will have an effective impact on the crime rates and, consequently, on economic growth.

Secondly, the Caribbean needs strong institutions and fiscal frameworks that will safeguard and sustain prudent fiscal policy over time, so that public debt in the region can be lowered towards sustainable levels.

Thirdly, a well-functioning and healthy financial sector that strikes a balance between risk-taking, growth, and stability is required in order to stimulate private investment and reduce nonperforming loan ratios.

3. Monetary policy and economic resilience

I fully agree with her and consider these three issues indeed essential for a healthy and robust Caribbean. But although it was not mentioned during the forum and neither in the proceedings, I would also like to stress the importance of an effective monetary policy for contributing towards reducing economic vulnerability and strengthening resilience.

Sound monetary policy is also a fundamental building block to achieve stable economic growth in the long run. I cannot imagine targeting higher economic resilience without the support of a stable internal and external value of money, a sound and incorruptible financial sector, and a trustworthy payments system. These are all tasks of the central bank.

As a matter of fact, many scholars, have recognized the role of monetary policy within the framework to obtain a resilient economy, especially within small island states. This notion was also apparent in the work done by Delisle Worrell for Barbados, a Caribbean island that is in many ways comparable to Aruba.

The excellent thesis "Small and smart?" defended yesterday by Edwina, provides additional ammunition in this respect. She not only analyses the effects of monetary policy decisions in small Caribbean islands, but she also attempts to answer questions as to why and how the relevant institutions in these countries have chosen certain policy options.

I am particularly pleased with the fact that Edwina has also included Aruba into her analysis. For you, this may seem only logical as she is a native from Aruba. However, most of the time, Aruba, as well as the other islands that were formerly colonies of the Kingdom of the Netherlands, are notoriously absent in many important studies.

4. The data issue

Even the flagship publications of IMF (World Economic Outlook), World Bank (Global Economic Prospects / World Development Report) and ECLAC (Economic Survey of Latin America and the Caribbean), do not include data on Aruba. Also, when these institutions publish data for the Caribbean as a whole, Aruba is always excluded.

The main reason for this omission is the fact that Aruba forms part of the Dutch Kingdom and is, therefore, not a separate member of the IMF (although we do have the regular Article 4 missions, just as every other member). However, I am pleased to announce here that after repeated request, this will change. The upcoming October edition of the IMF's World Economic Outlook will include Aruba into the analysis.

Presently, Aruba is already included in the databanks of international institutions such as the IMF and the World Bank. However, to be honest, the number of available data series and their timeliness could be better.

In order to fill these gaps, the relevant institutions in Aruba, especially the Central Bank of Aruba and the Central Bureau of Statistics, in close collaboration with the Government of Aruba to provide the latter with the necessary tools and financial means, should make a joint effort to make more data available and within a shorter amount of time.

First and foremost, it is imperative that the Central Bureau of Statistics updates its National Accounts which have not been published since 2011. Since that year, the Central Bank of Aruba fills this gap. It estimates and publishes national accounts data for Aruba, using indicator series such as imports, and keeps the public informed about the economic development of and prospects for our country. Of course, this is an enormous challenge as the latest realization year of the National Accounts lies 7 years back.

Secondly, we must make sure that our data is timely available and used by international institutions. Last year, through the hard work of the Central Bank's staff, Aruba has made an important step in this respect by becoming a member of the IMF's enhanced general data dissemination system (e-GDDS). Nevertheless, we must proactively further awareness that data is increasingly available.

We have come a long way. Although data availability and timeliness are far from being optimal, it is currently much better than 32 years ago, when Aruba became a separate entity, the so called "Status Aparte", within the Kingdom of the Netherlands. At the time that Aruba was still part of the Netherlands Antilles, very limited economic data for the island itself was available.

5. Aruba's vulnerability and resiliency

Now, turning back to Edwina's thesis. One of her conclusions is (and I quote): "The analysis in this chapter tends to indicate that Aruba is one of the most **vulnerable** and most **resilient** country among the selected Caribbean countries and it seems to be one of the most economically successful countries in the world." (End quote).

For me, as President of the Central Bank of Aruba, it was of course a pleasant surprise to read this, although it was not entirely unexpected. Edwina provides possible explanations, yet also makes some reservations on the comparability with other Caribbean countries as Aruba is the only one that is not fully independent.

6. Monetary policy framework

Before going further into detail on Aruba's vulnerability and resiliency, let me first describe the Aruban context with an emphasis on our monetary and macro prudential policy related to the macroeconomic events we have experienced in the past 30-plus years.

The monetary policy of the Central Bank of Aruba is aimed at maintaining the stability of the value of the Aruban florin. Our currency was introduced in 1986, at the time we obtained the Status Aparte within the Dutch Kingdom, with an exchange rate set at 1.79 florins per U.S. dollar, the currency of our main trading partner.

Since then, monetary policy has been successful in maintaining the peg with the U.S. dollar, and has served the Aruban economy very well. The operational target of our monetary policy is to have a sufficient level of foreign exchange reserves. In practice, sufficient means: a level that is able to absorb large external economic shocks. This makes Aruba's foreign exchange earnings capacity, and its accurate measurement and registration, extremely important.

Regrettably, we have experienced several crises since 1986, indicating that Aruba is indeed highly vulnerable. I will briefly mention the three most important ones since that period.

7. First crisis: tourism for oil

The roots of the first one was laid in the early 1980s. At that time, Aruba was basically a one-sector economy. The Lago oil refinery accounted for approximately 18 percent of total employment, direct as well as indirect, and 50 percent of government revenues. Changing oil market conditions lead to the closure of the refinery, which took place in March 1985. Aruba

lost its main source of foreign exchange earnings precisely at the time it became an autonomous entity with the Dutch Kingdom.

Aruba had to urgently find alternative sources of income. It had been a tourist destination since the late 1940s and at that time nearly 200,000 tourists visited the island annually. Other possibilities for domestic production were virtually non-viable, while the creation of other service-related sectors would have taken years before yielding results.

The choice to further develop tourism was an obvious one. Because of its pleasant climate, the Caribbean region was already a popular holiday destination, and Aruba had the additional advantages of being outside the hurricane belt and also having beautiful beaches.

With the financial support from the Netherlands, the government of Aruba embarked on this mission. Its target was to double the available hotel room capacity in the next five years. From 1986 to 1992, the number of tourists increased by an average annual rate of growth of more than 18 percent. Hotel capacity increased at a higher level than originally planned. In the first few years of the 'Status Aparte', in particular, economic growth reached double-digit figures.

This economic expansion, however, came with its side-effects. The rapid expansion led to an overheating of the economy leading to high labor demand and rising inflation. The expansion of the economy also impacted the level of credit. Its growth rate peaked at nearly 20 percent on an annual basis, largely induced by consumer credit. The CBA concluded that a shift in monetary policy to a more moderate stance was needed and restricted credit growth to 15 percent. In subsequent years, the CBA tightened its monetary policy even further. The year 1993 marked the end of the booming period, and economic growth returned to more manageable levels. At that time, Aruba had also found a new operator for the oil refinery.

8. Second crisis: the millennium years

Aruba prospered in the remaining years of the 20th century, but its small and undiversified economy remained vulnerable to external shocks. Its tourism sector depends largely on economic performance of the international economy and visitors' perception, preferences, and patterns. The economic slowdown in the United States at the beginning of the new millennium, further intensified by the 9/11 events, was the prime source of a new crisis for Aruba.

As a reaction, the government instituted a crisis intervention task force and allocated more funds for tourism marketing and promotion, thereby making our economy even more dependent on this source of income.

In the meantime, the CBA suspended the credit ceiling in early 2002 as credit demand fell and reserves were at an adequate level. After the global economic recovery in 2003, Aruba's economy started to recover from the recession and expanded again in the following six years.

9. Third crisis: the global financial crisis

The global financial crisis, initiated by the collapse of the U.S. subprime housing market in 2007, initially had a modest impact on Aruba's economy as the financial sector had limited foreign exposure, partly as a result of the strict capital control enforced by the CBA. Furthermore, as a consequence of the macro-prudential requirements, the banking system already maintained high capital and liquidity cushions.

Nevertheless, the CBA increased the macro-prudential indicators for commercial banks to increase their resistance towards external shocks. Furthermore, the commercial banks were required to deposit a larger amount of liquidity at the CBA. This tightening meant less room for credit to be granted and, therefore, less outflow of foreign exchange reserves.

The effects of the international financial turmoil were sensed from 2009 on and primarily in the real sector of the domestic economy, affecting, in first instance, tourism development. Foreign direct investment dropped markedly, particularly in tourism and real estate sectors.

The already weak economic conditions were destabilized further by the temporary closure of the oil refinery in July 2009. In that year, the economy contracted by more than 11 percent. The government of Aruba tried to stimulate the economy by, amongst others, identifying projects financed jointly by the private and public sector (the so-called PPP-projects), mainly geared towards improvement of the road infrastructure of Aruba.

Despite the government's expansionary economic policy, Aruba's economic performance remained subdued in this period, and the financial situation of the government worsened. For example: Aruba's debt-to-GDP ratio rose to 86 percent, whereas 40 percent is the internally recommended maximum ratio.

10. Aruba's resiliency

In terms of Aruba's resilience, looking back over the past 32 years of 'Status Aparte', Aruba weathered several crises, partly by acting decisively and resolutely when such events occurred.

I am of the opinion, just as Edwina has indicated in her dissertation, that the fact that we are part of the Dutch Kingdom has been very helpful in enduring these crises. This means, we have better conditions for obtaining political, economic and financial stability compared to other Caribbean countries.

Besides effective monetary policy, our resiliency has also benefitted from a prudent supervision regime. A solid financial sector is an essential precondition for economic growth. In addition to high solvency and liquidity buffers, the critical success factors here include adequate governance, risk management, and compliance culture among the supervised institutions, as well as a strict supervisory regime in which enforcement takes place and where the root causes, and not the symptoms, are tellingly dealt with.

Additionally, Aruba has an adequate justice system and an effective institutional approach to battle financial crime and corruption, an important condition to keep and attract foreign investors.

11. Lessons learned

Now, what have we learn from this?

One of the lessons learned is that the Aruban authorities should closely monitor and evaluate domestic, as well as international economic and financial developments, to be able to respond swiftly to economic shocks. To this end, timely and accurate statistics as well as improvements in several areas, including the national accounts and labor market statistics, are needed to support effective economic analysis and evidence-based policymaking.

The government could consider drafting an economic crisis management plan with the aim to prevent or lessen the damage that a crisis could have on the real sector of the economy. One important prerequisite for such a plan is sound fiscal policy that allows the government to use funds to stimulate the economy when needed. The government could contemplate creating a contingency fund to be used in times of financial and economic crisis.

Another lesson learned is that the economy of Aruba should diversify, in order to be less vulnerable to negative shocks in a particular market. Further diversification efforts should be undertaken within the tourism and/or other (service-oriented) sectors.

Additionally, the balance of payments should be further strengthened through trade-related innovation policies. For instance, the development of sustainable energy, produce within Aruba, and the revamping of the investment climate that could boost foreign direct investment.

Also, we should cultivate the systemic ability to anticipate the effects of economic disruptions and develop the innovation capability to pro-act and adapt.

Rather than focus solely on the absorption capacity to withstand and recover from shocks and disruptions, economic resilience in current environments demands foresight and the adaptive capacity to innovate, learn, and transform. Developing dynamic economic resilience, therefore, also depends on the stock and flow of digital capabilities.

So, what does the CBA currently do for resilience? We are further developing our macro-prudential policy which strengthens the financial system's resilience to economic shocks, and limits the build-up of risk during the economic cycle. Macro-prudential policy thereby complements micro-prudential policy, which focuses on the risk position of individual institutions.

12. Banking on the Future: Bela Yen and Beyond

As I mentioned before, monetary and macro-prudential policies have traditionally been the main occupancy of central banks and financial regulators. With the recent surge in financial technologies and digital transformation, new strategic thinking and tinkering of regulatory innovation are forthcoming.

While regulatory reactions have been ambivalent, ambiguous and oftentimes antagonistic, it would be challenging to think of 21st century regulation without innovation¹.

Associated with the rise in digital transformation is not only a set of new (distributed) technologies and institutional mechanisms, but more importantly, the transformation and evolution of certain values, norms, and beliefs about the nature of money and trust.

Beyond money and markets, the social reconstruction and codification of trust is a fundamental inflection point in the evolution of financial services, and consequently the future of central banking, which to a significant extent is based on (monetary institutional) trust.

What may seem revolutionary, if not paradoxical at first hand, increasingly regulators are becoming innovators as they entertain, explore and experiment with the adoption of distributed ledger technologies, digital currencies, artificial intelligence, augmented reality, and host of other digital technologies.

¹ Peterson, R. R. (2017). How regulators become blockchain innovators. Access: <https://www.coindesk.com/regulators-become-blockchain-innovators/>

The need for (re-)framing and fostering the resilience of Caribbean islands from an innovation perspective is thus imperative in an inclusive digital economy².

Despite the stylized divergence and diversity in terms of population and production, the Caribbean shares several (geo-) economic invariants, including economic space, openness, concentration, and exposure to economic disruptions, ecological risks, social inequity, and environmental destruction.

Strapped for financial and human capital, these states are notorious for being tough on business. With the majority of local businesses being (relatively) small and (predominantly) focused on domestic markets, the lack of access to financial and available human capital remains a severe constraint to development³.

On average, more than one-third of businesses across the Caribbean report that they experience significant challenges with access to finance and credit, with the small(er) tourism-based economies facing even more severe constraints. Likewise, the availability of human capital and a skilled workforce seems to be one of the major barriers to business in the Caribbean.

Moreover, (financial) capital constraints reach beyond markets with repercussions for society. Globally, available data suggests that the Caribbean lags in terms of financial inclusion, and trails behind other regions. In general, the unbundling of financial services and the specialization of financial instruments are comparatively limited.

On average, less than 50 percent of households have a bank account at a financial institution, and more than 40 percent of the general population remains un(der)-banked with a significant lack of financial literacy and education.

These vulnerabilities are well recognized and have been discussed for over half a century, often inducing a 'small island' stigma developmental paradigm.

More importantly and relevant to present times, the Caribbean is concurrently being disrupted by a host of new digital and financial technologies (FinTech), in addition to societal and other market trends that challenge the status quo.

The rise in FinTech is largely explained – not so much by technology – but by its social prowess and pull from underserved and next-generation markets. FinTech holds the potential

² Peterson, R. R. (2018). The Future of Fintech in the Caribbean. Access: <http://ifcreview.com/restricted.aspx?articleId=12818>

³ Peterson, R. R. (2016). 'Building Resilience and Innovation: Towards a more prosperous Caribbean', in *Achieving a Resilient Future for Small States: Caribbean 2050*, Commonwealth Secretariat, London

to enable financial inclusion and stability, and it is pivotal to realizing the Sustainable Development Goals (SDGs).

With less than 50 per cent of the Caribbean being served by financial institutions, and more than 50 per cent being digitally connected, the prospects for (digital) financial technologies and (specialized) intermediaries are a clear and present indication that the Caribbean is nearing a transformational tipping point.

While the Caribbean continues to recover from concomitant disruptions, and is 'bouncing back', it is dubious whether it is 'bouncing forward'. In fostering resilience in an increasingly digital economy, the question is not merely about absorbing shocks and maintaining a steady state, but more importantly, transitioning and transforming towards steady change.

The resilience of Small Island Caribbean Economies is, however, not dictated by inherent endowments or contextual impulses, but more importantly, should also be fostered by cultivating the systemic ability to anticipate (the effects of) economic disruptions and develop the innovation capability to pro-act and adapt.

The latter dynamic reframing of economic resiliency is oftentimes overlooked in traditional discussions and developments on economic resilience, yet quintessential in resolving the so-called paradox of (innovation in) small island states³.

The future of Caribbean economic resiliency and growth will thus require the integrated improvement and innovation of processes, skills, and technologies.

More importantly, leading the future begets an eco-systemic approach towards developing (national and regional) digital capabilities across public sector institutions and private sector enterprises.⁴

Improving the quality, efficiency and agility of government and governance is sine qua none for fostering resilience in an inclusive digital economy.

As architects of the future, nimble regulators are likely to take the lead, as witnessed by numerous recent accounts of monetary innovation and experimentation by central banks.

Yet, rather than maintain stability and a steady state, digitization will demand resiliency and steady change on the part of regulators. Moreover, trust rather than technology will be essential in this transformation.

⁴ Peterson, R. R. (2016). 'Building Resilience and Innovation: Towards a more prosperous Caribbean', in *Achieving a Resilient Future for Small States: Caribbean 2050*. Commonwealth Secretariat, London.

The strategic plan of the Central Bank of Aruba – Bela Yen – is our blue print for this transformation. Bela Yen is a saying in Papiamentu, meaning full steam ahead. In this plan, we chart our course towards the future, with our mission to contribute to the financial stability and economic well-being of the Aruban community. Hereto, the CBA is focused on three main ambitions:

- Maintaining the stability of the value of the florin vis à vis the U.S. dollar.
- Promoting financial soundness and integrity of the financial system.
- The CBA is an attractive organization for top talents.

The vision is to be a prominent central bank in the region, driven by a culture of integrity, excellence, and innovation. Over the past two years, the CBA has made significant strides towards realizing its vision by, for instance, strengthening its regulatory frameworks, advancing (big) data analytics, and developing a new instant payments system.

Leaning into the future and leading with foresight will require nimbleness and agility. While some speculate on the demise of regulators, the art and science of governance, however, is knowing when and how to effectively adjust your sails in the midst of unexpected changing circumstances.

In more evolutionary terms, it is not the strongest of species, but the most agile that thrive on transformation. Bela Yen!

In conclusion, from a central banker's perspective, managing the nexus of monetary, fiscal and (macro-) prudential policies is essential for strengthening the economic resilience of small island economies. Thereto, we must build the requisite institutional capabilities. The fact is that we are small but we can become even smarter!

With this, I am convinced that Edwina's thesis will play an important role in the coming policy discussions of Aruba.

Thank you very much for your attention.