IMF CONCLUDES 2002 ARTICLE IV CONSULTATION WITH THE KINGDOM OF THE NETHERLANDS—ARUBA

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On February 24, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Kingdom of the Netherlands—Aruba.[1]

Background

After growing at over 4 percent per year in 1996-2000, the Aruban economy experienced two years of retrenchment, with GDP falling an estimated 1.2 percent in 2001 and 3.8 percent in 2002. This downturn reflected a lull in investment activity, but especially weak tourism following the U.S. recession and the terrorist attacks of September 11, 2001. In 2003, sharply higher private and public investment and a modest revival in tourism should boost economic growth to over 4 percent. With higher tourism capacity and continued sustained investment, economic growth should remain around 3 percent in the medium-term.

With the exchange rate pegged to the U.S. dollar, inflation has been low, averaging 2.7 percent in the 1990s. Higher energy prices, indirect taxes, and faster credit growth as a result of controls being suspended, caused inflation to accelerate in the second half of 2002, reaching 4.5 percent in November. The external accounts remain in a comfortable position, and net foreign assets are above the central bank target of 5-6 months of imports. The banking sector is highly liquid and well capitalized despite the downturn, but interest rates remain high because of a lack of competition.

Weak growth and the introduction of universal health care exacerbated existing fiscal imbalances in 2001-02, resulting in a marked worsening of the government deficit, from 0.2 percent of GDP in 2000 to an estimated 4.9 percent in 2002 (including health care). Off-budgetary outlays of almost 6 percent of GDP related to past guarantees to foreign investors were also realized in 2002. To stem this deterioration, the government froze public sector wage indexation for three years and raised excise rates in the second half of 2002. A new indirect tax on imports and services is planned for 2003. A New Fiscal Regime for corporate income was also introduced, which will result in more uniform taxation of corporate profits and dividends. Although the previous offshore and tax holiday regime will be phased out, incentives for export-oriented activities will remain through an imputation system.

Executive Board Assessment

Directors commended the authorities for their record of sustained economic growth and low inflation, which has enabled Aruba to achieve one of the highest per capita incomes in the region. While unfavorable external shocks to the tourism sector and a pause in investment had caused a decline in economic activity, Directors expected that, barring

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

new adverse shocks, growth would resume this year, spurred by sharply higher private and public investment and a modest recovery in tourism. Looking ahead, Directors emphasized the importance of improving public finances and strengthening the economy's resilience as a basis for sustained macroeconomic stability and future growth.

While considering the current exchange rate regime appropriate, Directors noted that the high inflation differential with the United States could threaten competitiveness, and welcomed the authorities' decision to tighten monetary policy by reemploying credit controls. Directors also encouraged the authorities to move forward with plans to switch from direct to indirect instruments of monetary policy, so as to ensure a better allocation of credit and more effective competition in the banking sector. Directors cautioned, however, that the transition to indirect instruments should be gradual in order to avoid losing monetary control, and encouraged the authorities to avail themselves of technical assistance to support these efforts.

Directors agreed that the main policy challenge was to strengthen public finances. They viewed the authorities' objective of a balanced budget by 2007 as appropriate in the medium term, although more adjustment would be required in the long run to address population ageing. Directors also saw the need to make greater progress towards balance in the 2003 budget, including through measures to durably restrain growth in current spending. Specifically, they encouraged the authorities to implement as soon as possible reforms of the public employee pension system and the civil service, and actions to curb the growth of health care spending. Directors also noted that fiscal consolidation would be facilitated by improving the transparency of the fiscal accounts, particularly through the regular provision of government financial statistics. In this connection, they also underscored that the authorities should abandon the practice of financing the deficit through the accumulation of arrears.

Noting that Aruba's revenue-to-GDP ratio was low, especially relative to the region, Directors encouraged the authorities to address weaknesses in tax administration, an important prerequisite for introducing a broad-based indirect tax, and also to simplify the income tax. They noted the recent decision to delay the introduction of the new tax on imports and services, and most Directors encouraged its implementation as soon as possible. Directors welcomed the New Fiscal Regime for corporations, as it would lead to more uniform taxation of corporate income, including through the phasing out of the offshore and tax holiday regime. Directors also noted that overall, simplicity, equity, and transparency in the tax system should be priority objectives.

Directors commended progress in strengthening financial sector supervision and regulation, in line with the recommendations of the recent Offshore Financial Sector assessment. To strengthen anti-money laundering regulation, Directors encouraged the authorities to quickly pass legislation to bring money transfer companies and company service providers in the offshore sector under the supervision of the central bank.

Directors agreed that the decision to turn the telecommunications company into a private law company and introduce competition in the mobile phone market would increase economic efficiency. They underscored the need to continue along this path, by increasing the operational autonomy of other public sector activities and, at a later stage, by selling shares to private investors.

Directors commended the authorities for the publication of national accounts in current prices, which greatly improves available information on the Aruban economy. They urged the authorities to intensify efforts to fill statistical gaps in the areas of labor markets and government finances, as well as to further develop national accounts data.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Kingdom of the Netherlands—Aruba: Selected Economic Indicators

	1998	1999	2000	2001	2002
	(Percent change)				
Real economy					
Real GDP	6.7	1.3	3.6	-1.2	-3.8
Nominal GDP	8.7	3.6	7.8	1.7	-0.7
Real final consumption	5.0	4.7	-3.3	6.8	3.6
Real investment	11.8	-8.0	-9.3	-17.4	3.0
Real exports	3.0	2.8	-4.2	-4.7	-11.4
Real imports	3.5	2.2	-14.3	-2.9	-1.6
Inflation (period average)					
CPI (Aruba)	1.9	2.3	4.0	2.9	3.2
Real exchange rate index (1995=100)[1]	101.2	101.3	102.0	102.0	103.7
	(In millions of U.S. dollars)				
Balance of payments					
Current account	-14.3	-347.9	294.9	410.2	-75.5
(In percent of GDP)	-0.9	-20.2	15.9	21.7	-4.0
Non-oil current account	-129.4	-249.1	-211.1	-168.8	-224.7
(In percent of GDP)	-7.8	-14.4	-11.4	-8.9	-12.0
Financial and capital account	102.8	368.1	-313.5	-324.1	147.9
Errors and omissions	1.2	-9.4	-7.5	-10.6	5.6
Change in reserves (- = increase)[2]	-51.9	-2.9	15.0	-82.8	-78.0
	(Percent change)				
Monetary aggregates					
Net foreign assets	40.4	3.4	-8.1	25.4	25.8
Net domestic assets	1.8	14.4	7.7	-2.7	5.1
Quasi-money	11.7	11.8	3.0	-0.2	5.0
	(In percent of GDP)				
Public finances central government					
Balance	1.9	1.4	-0.2	-2.6	-3.6
External debt	13.1	11.9	11.3	11.6	15.2
Domestic debt	17.5	18.2	19.0	22.4	22.8
U.S. dollar	The Aruban florin is pegged to the U.S. at AFL 1.79=US$ 1				
SDR (end of period)	2.52	2.46	2.33	2.25	2.37

Sources: Data provided by the Aruban authorities; and IMF staff estimates.

[1]Relative to the U.S. dollar. CPI based. Period average.
[2]Including gold, excluding revaluation differences.