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Kingdom of the Netherlands—Aruba: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of the Kingdom of the Netherlands—Aruba on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with the Kingdom of the Netherlands—Aruba, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of the Kingdom of the Netherlands—Aruba; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Press Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date.

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INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS—ARUBA

Staff Report for the 1999 Article IV Consultation Discussions

Prepared by the Staff Representatives for the 1999 Consultation Discussions
with the Kingdom of the Netherlands—Aruba

Approved by Alessandro Leipold and Jesús Seade

April 1, 1999

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I. INTRODUCTION

1. A mission visited Aruba in the period January 28–February 9, 1999 to hold the 1999 Article IV consultation discussions.[1] The mission met with members of the Council of Ministers (including the Prime Minister), the President of the Central Bank of Aruba, other officials of governmental departments and the central bank, and representatives of private business and labor unions. Aruba has an autonomous status within the Kingdom of the Netherlands since January 1986. Its government has jurisdiction over all domestic matters including monetary and fiscal policy, and issues the domestic currency, the Aruban florin (Af.), which has been pegged to the U.S. dollar at a rate of Af. 1.79 = US$1 since its introduction.[2] Aruba is not a member of the Fund, but the Aruban and Dutch authorities have requested separate Article IV consultation discussions. The acceptance of the obligations of Article VIII, Sections 2(a), 3, and 4, by the Kingdom of the Netherlands also applies to Aruba.

2. In concluding the last Article IV consultation on May 19, 1997, Executive Directors commended the authorities for Aruba's strong economic growth and moderate inflation of the previous decade, and the sound macroeconomic policy that had underpinned that performance. They observed that the continuation of stability-oriented fiscal and monetary policies would be essential in meeting the challenge of continued growth while avoiding overheating. In this connection, Directors encouraged the authorities to pursue the objective of near budgetary balance—a goal that would require further measures to restrain public expenditure and enhance tax administration over the medium term. Directors agreed that the peg of the florin to the U.S. dollar had served Aruba well, and commended the central bank for effective management of the monetary and banking system in a very open environment, including its cautious steps toward a more fully market-oriented system of monetary control and efforts to modernize the supervisory framework. Finally, Directors urged the authorities to pursue further improvements in Aruba's weak statistical base to strengthen the foundation for effective policymaking and surveillance.[3]

3. After early elections in December 1997, a coalition government of the two parties that had formed the previous administration took office in June 1998. The next elections are scheduled for 2002.

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[1] The mission comprised Messrs. Zanello (head), Bakker, and Ubide, with Miss Emerson as Administrative Assistant (all EU1). Mr. J. de Beaufort Wijnholds, Executive Director, participated in some of the meetings.

[2] Prior to gaining *status aparte*, Aruba was part of the Netherlands Antilles federation, whose currency, the Netherlands Antilles guilder, has been pegged to the dollar since 1971 at the same rate as the Aruban florin now.

[3] Appendix III describes the deficiencies of economic statistics in Aruba.

II. Recent Developments and Short-Term Prospects

4. **Aruba is a small island in the Southern Caribbean with a population of about 90,000 and a per capita income estimated at US$18,000 in 1998—one of the highest in the region.**[4] Its prosperity is founded almost entirely on tourism. Oil refining had historically been an additional economic pillar, but this sector's low ratio of domestic value added to gross output, its exclusive reliance on imported capital and technology, and its tax-exempt status limit its current significance for the Aruban economy.[5]

5. **In the decade following the 1985 closure of the Lago oil refinery, Aruba was transformed into a predominantly tourism-based economy.** Development of infrastructure and tourist facilities was actively promoted by fiscal incentives and official loan guarantees, setting the stage for real GDP growth at an average annual rate of 12 percent throughout the early 1990s.[6] By 1995 hotel capacity had tripled to about 6,500 rooms, and tourism accounted for more than half of total foreign exchange earnings. The boom led to a sharp decline in registered unemployment (from about 16 percent of the Aruban labor force in 1987 to about 1 percent eight years later) and to large-scale immigration, which helped meet the growing labor demand.[7] Initially, inflation remained subdued, although higher than in the United States—the exchange-rate anchor country and main export recipient.[8] It peaked in 1994 at an annual rate of about 6 percent, as expanding private demand (especially for housing), fueled by rapid credit growth, threatened to overheat the economy. In the event, price pressures unwound as fiscal restraint brought the public finance position to approximate balance in 1993 and 1994. Nonetheless, a 10 percent real appreciation (based on relative consumer prices) vis-à-vis the United States had emerged by that time (Figures 1–6).

6. **By the mid-1990s, the investment boom in the tourist sector had come to an end, and economic growth slowed down to a more sustainable pace.** With the imposition of a moratorium on the construction of new hotels and the completion of the investment program to upgrade the oil refinery, real GDP growth decelerated to about 4 percent on average in 1995–97. Preliminary data point to some weakening of growth in 1998 to about 3 percent.

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[4] Aruba is still establishing the statistical base to compile national accounts. The GDP figures cited in this report are model-based estimates by the staff and subject to a large margin of uncertainty. Official national income accounts are so far available only for a single year (1994).

[5] Other important industries are warehousing and transshipment, centered in a "Free Zone," and financial services.

[6] Furthermore, an ambitious investment program to reopen the island's oil refinery started in 1989, providing some additional stimulus to domestic activity.

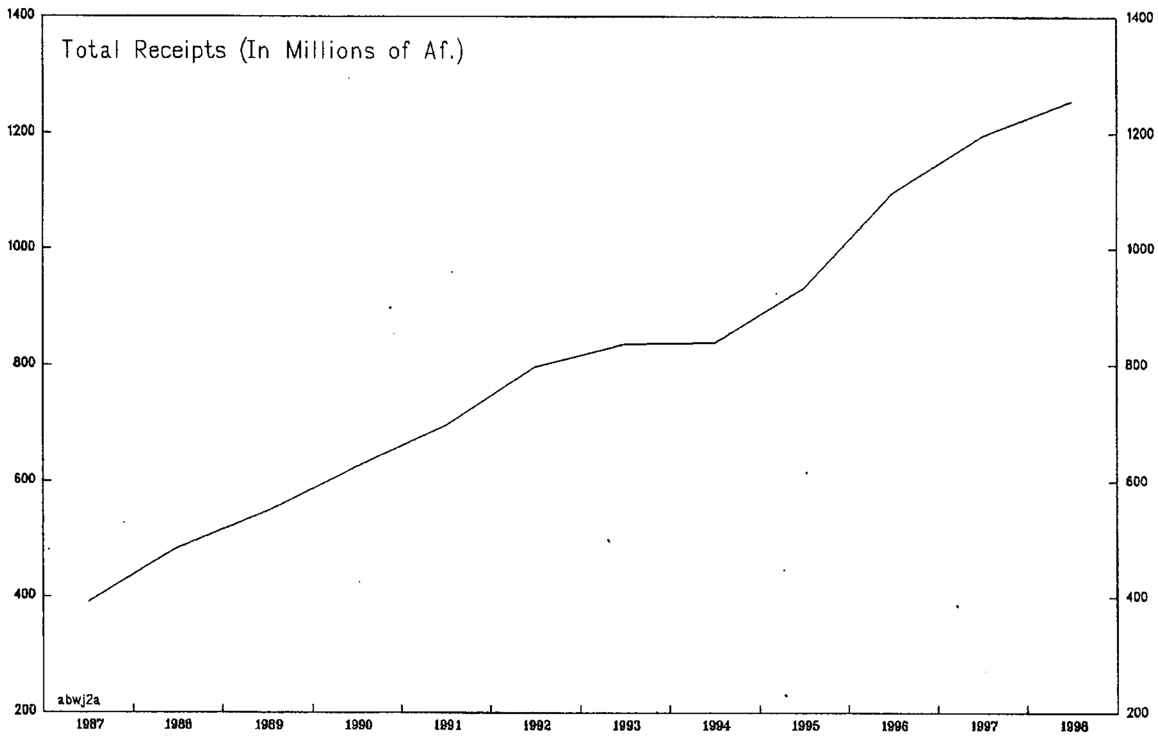
[7] The liberal immigration policy increased Aruba's population by about one-fifth from 1986 to 1993.

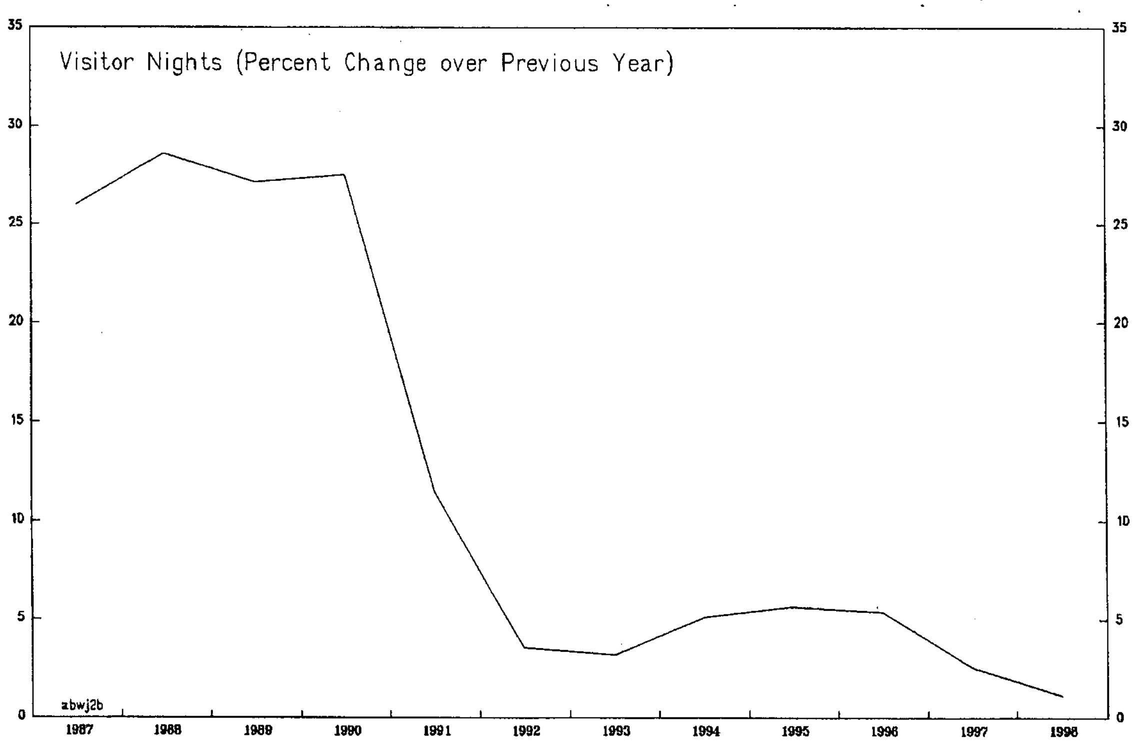
[8] Persistent inflation differentials vis-à-vis the United States can be explained by the fact that about 50 percent of the consumption basket used in the computation of the CPI refers to nontradables.

FIGURE 1
ARUBA
Real GDP Growth
(In Percent)

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

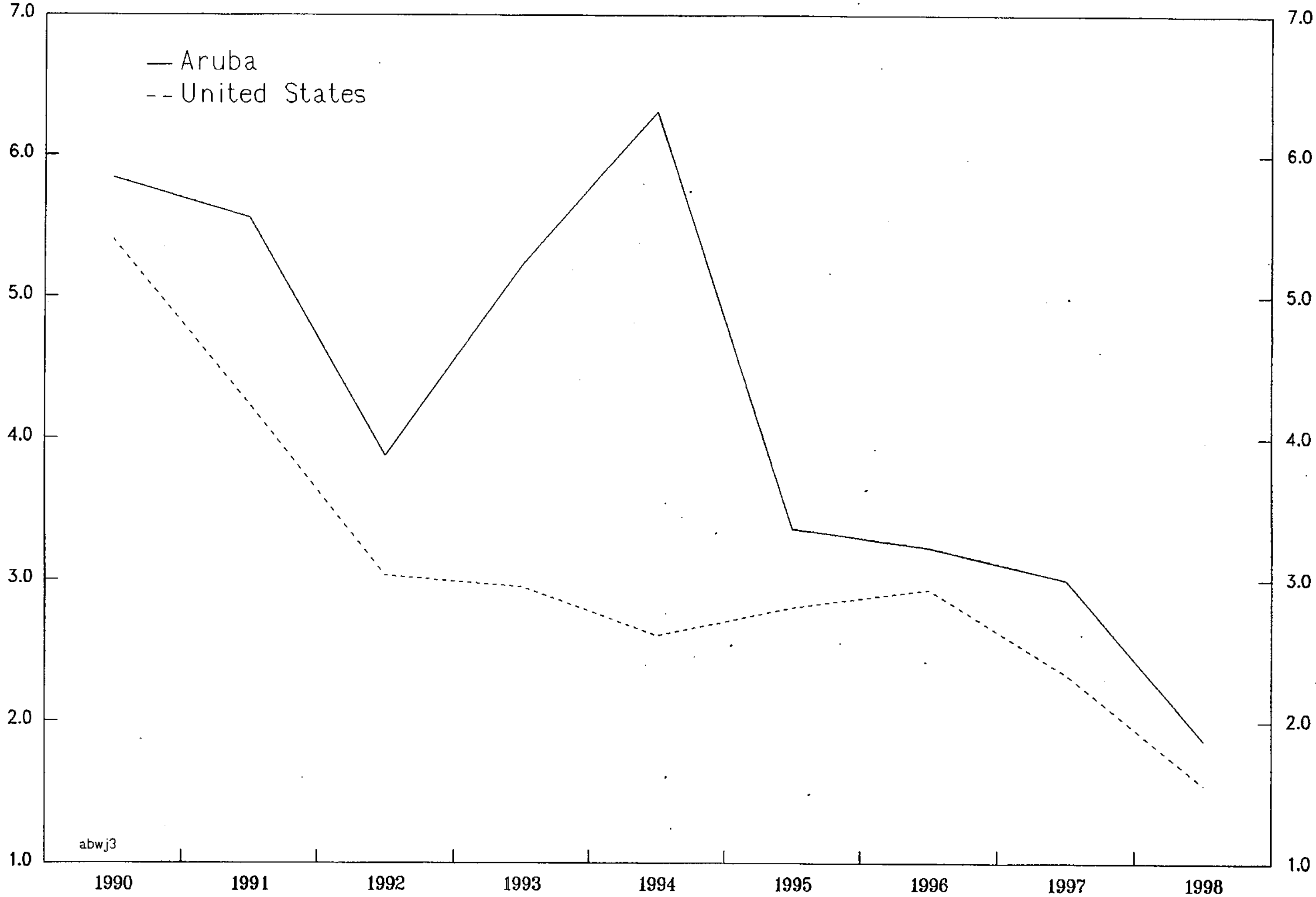
FIGURE 2
ARUBA
Indicators of Tourism Activity





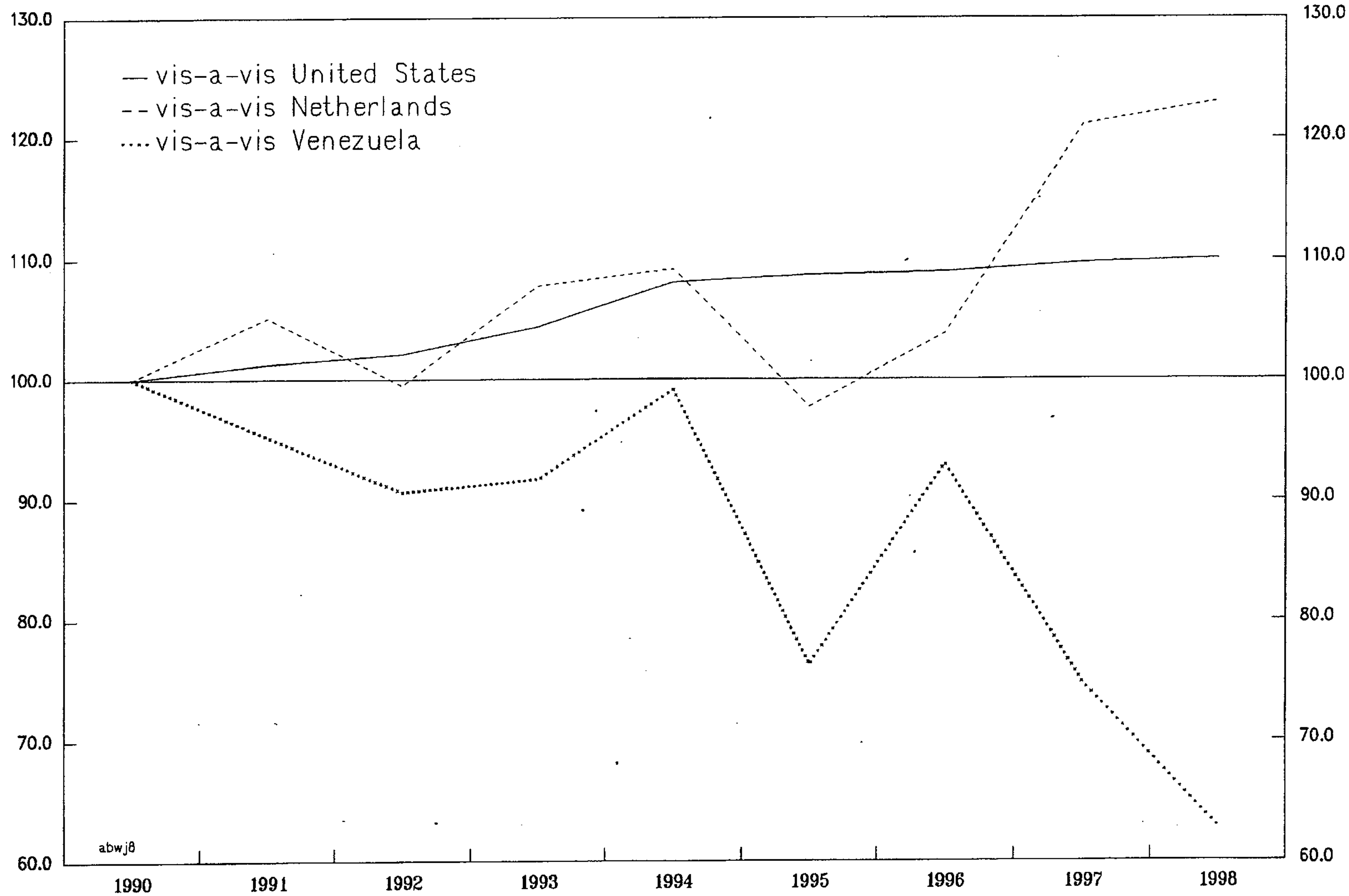
Source: Central Bank of Aruba; Quarterly Bulletin.

FIGURE 3
ARUBA
CPI Inflation
(Annual Averages, In Percent)



Source: IMF, International Financial Statistics.

FIGURE 4
ARUBA
Bilateral CPI-Based Real Exchange Rates
(Index,. 1990=100)

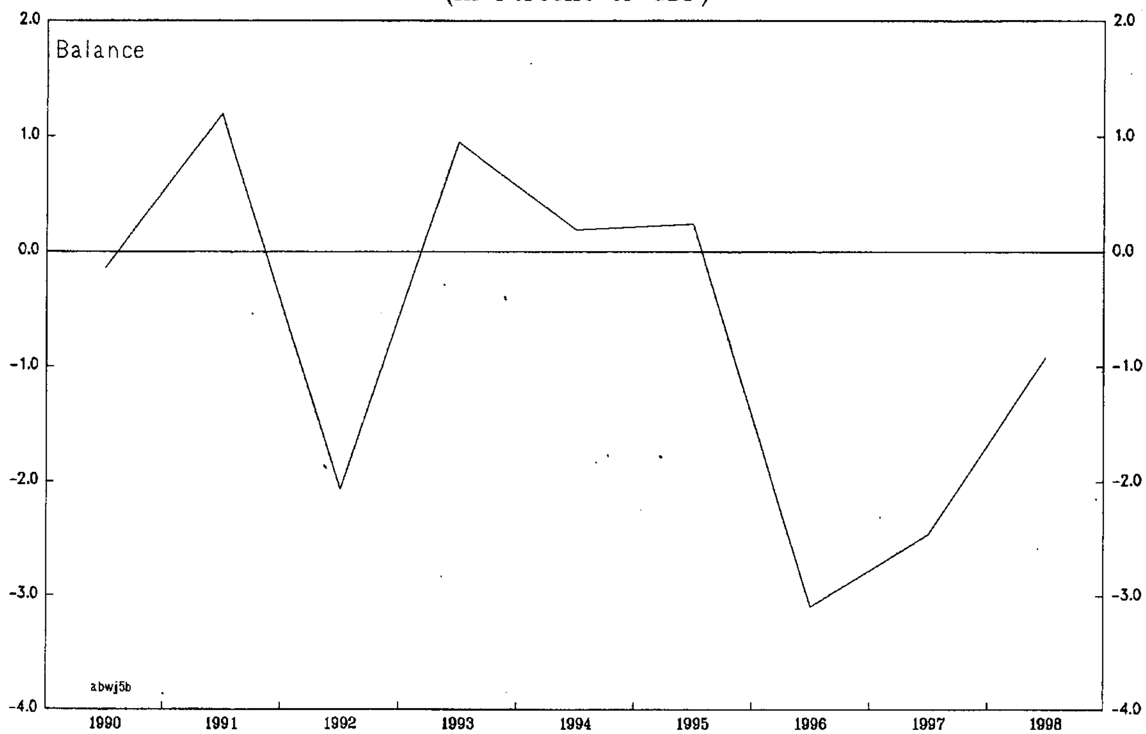


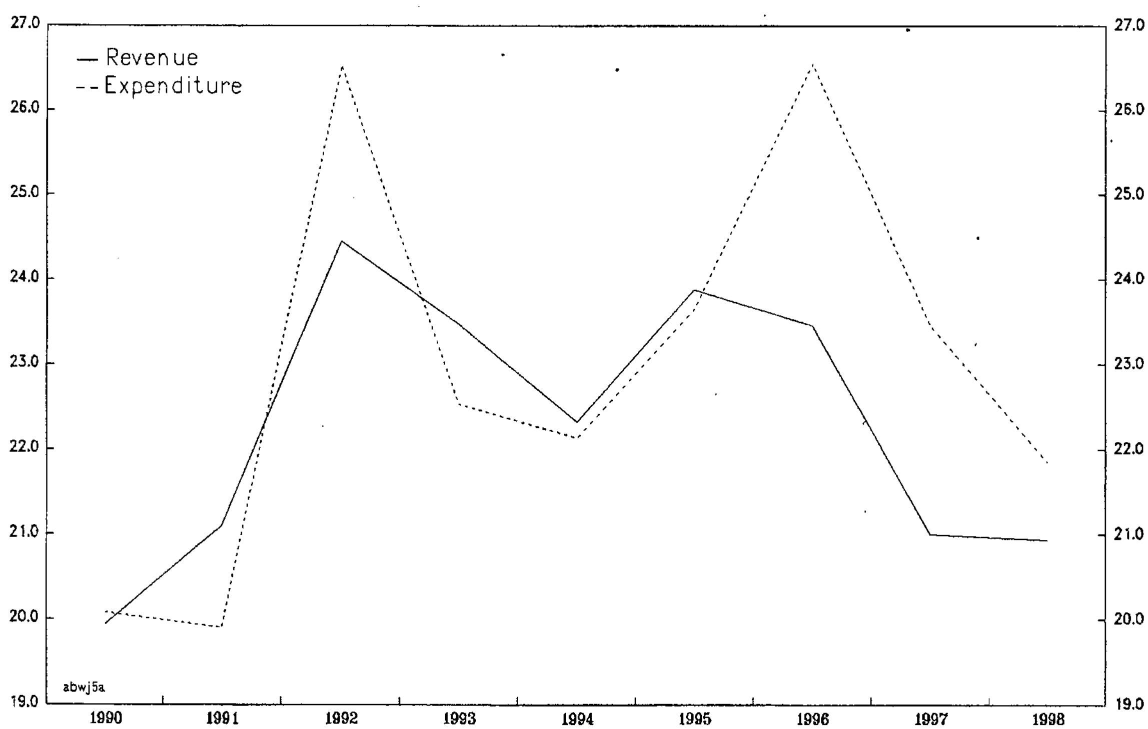
Sources: IMF, IFS, and Fund staff calculations.

FIGURE 5
ARUBA

Public Finance

(In Percent of GDP)

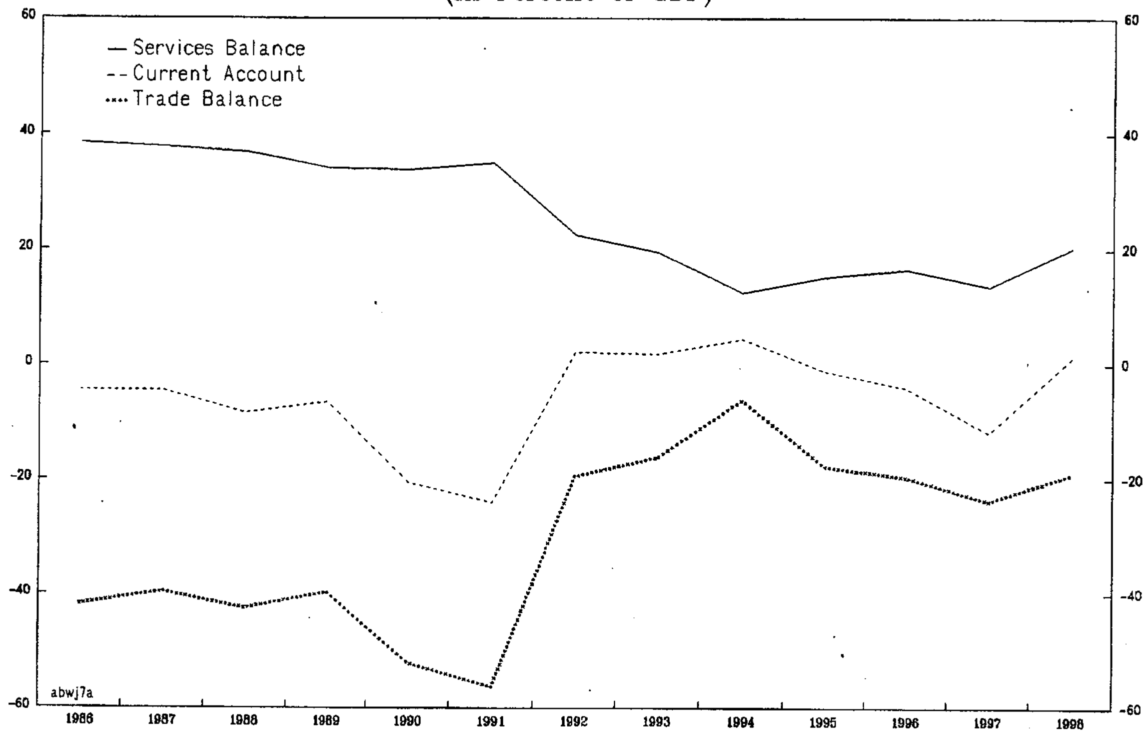


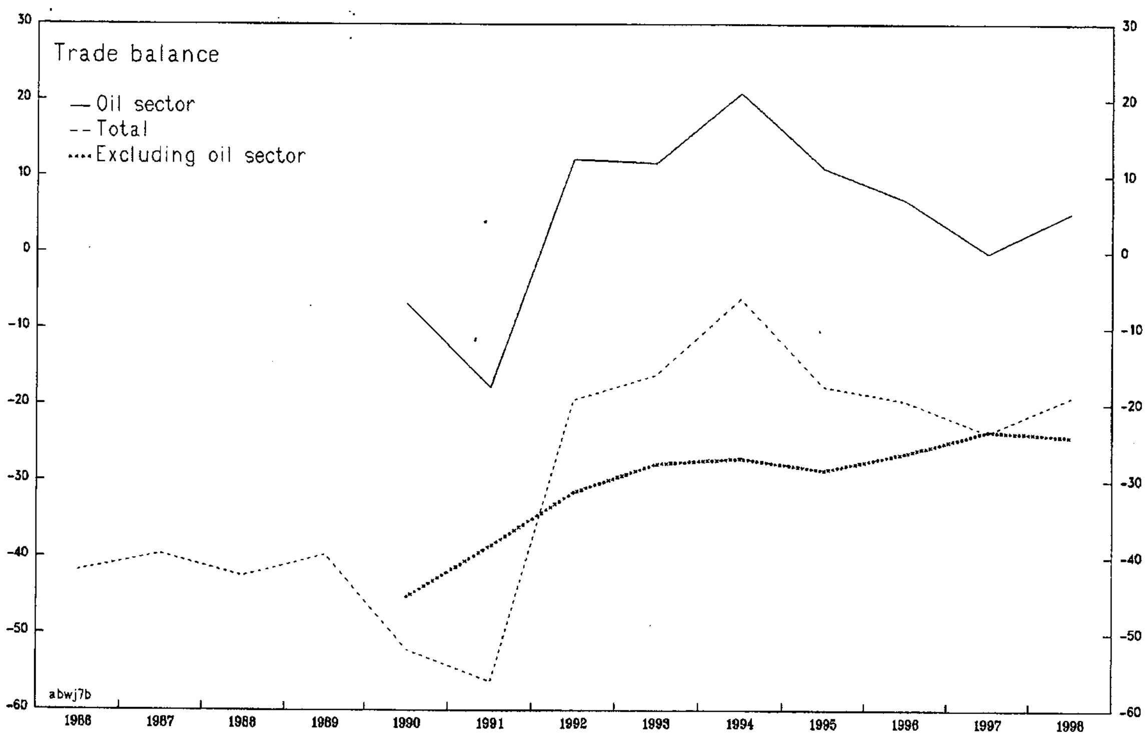


Sources: Central Bank of Aruba; Ministry of Finance; and Fund staff estimates.

FIGURE 6
ARUBA

Current Account Components
(In Percent of GDP)





Source: Central Bank of Aruba, Quarterly Bulletin.

Employment growth, which had averaged 8 percent per year in the early 1990s, eased to some 4 percent in 1995–97, and inflation stabilized at about 3 percent. In 1998, inflation declined further, to about 2 percent, owing to favorable movements in commodity prices, the appreciation of the U.S. dollar—and, consequently, of the florin—and a weakening of U.S export prices.[9]

7. **The outlook for satisfactory growth with low inflation was threatened by an undue relaxation of fiscal policy in 1996 and continued laxity through mid-1998.** The public accounts returned to deficits of more than 3 percent of GDP in 1996 and 2½ percent in 1997, reflecting a boost in expenditure (related inter alia to a multiyear back-pay scheme for government employees to compensate them for an earlier wage freeze) and a decline in the revenue ratio resulting from slippages in tax assessment and collection (Table 1).[10] These deficits were in large part financed by a steady accumulation of public sector payments arrears, evidence inter alia of emerging difficulties in obtaining domestic loan financing. At mid-1998, the stock of arrears reached Af. 190 million, or 6 percent of GDP, 30 percent of which was owed to commercial suppliers, 40 percent to the civil service pension fund, and the rest to other earmarked government accounts.

8. **Faced with these growing imbalances, the new government changed tack in June 1998, and took action to restore budgetary discipline.** It implemented emergency measures to rein in government spending, announced a hiring freeze, suspended indexation in pensions and the use of overtime in nonessential public services, prioritized investment plans, and established better procedures to discourage overruns in the budgets of individual ministries and accelerate tax assessment and collection. In the event, expenditure declined by 1½ percentage points of GDP, the run-up of arrears to suppliers was in part reversed, and the budget deficit was reduced to less than 1 percent of GDP. Furthermore, the government expressed its intention to adopt an ambitious, four-year program of fiscal adjustment,includ-ing a reduction in current spending as a percentage of GDP, full clearance of arrears by end-1999, reorganization of the civil service, and—in a second phase starting in 2000—a reform of the tax system.

9. **Social entitlements continue, though, to threaten the long-term sustainability of the public finances.** In the mid-1990s the retirement age under the universal scheme for old age insurance was lowered from 62 to 60 years, while benefits were doubled. Currently, they are equal to the average wage and, for a couple, are 40 percent higher than the minimum wage. These generous provisions have in part been made possible by favorable demographics arising from strong inflows of young workers. However, the envisaged slowdown in immigration—together with the aging of the population—undermines the viability of the scheme. As for the

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[9]Some 70 percent of the non-oil import bill of Aruba originates in the United States, the Netherlands, and Japan.

[10]A full breakdown of expenditure by components is available only from 1997 onwards. A partial breakdown for earlier years shows that the main cause of the 1996 increase in expenditure was in a line item calculated as a residual and, therefore, not identified.

Table 1. Aruba: Public Finances, 1992–99

(In percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999 Proj.
Revenue	24.5	23.5	22.3	23.9	23.5	21.0	20.9	21.7
Taxes	18.5	19.4	18.5	18.2	17.9	16.9	17.3	17.9
Nontax revenue	5.0	3.3	3.0	4.6	4.6	3.0	3.1	3.5
Grants	1.0	0.7	0.9	1.1	1.0	1.0	0.5	0.3
Expenditure	26.5	22.5	22.1	23.6	26.5	23.5	21.9	21.8
Current expenditure	...	...	...	...	...	20.4	19.2	19.5
Wage costs	10.1	11.5	9.1	9.8	8.5	9.3	8.8	8.9
Goods and services	5.7	4.7	5.5	5.2	5.9	5.5	4.0	4.3
Interest	0.8	0.6	0.7	0.7	0.7	0.8	1.0	1.2
Subsidies	...	...	...	...	...	0.1	0.1	0.2
Transfers	...	...	...	...	...	4.0	4.3	4.5
Other current expenditure	...	...	...	...	...	0.7	0.9	0.3
Capital expenditure	...	...	...	...	...	3.1	2.7	2.3
Balance	-2.1	0.9	0.2	0.2	-3.1	-2.5	-0.9	0.0
Financing	2.1	-0.9	-0.2	-0.2	3.1	2.5	0.9	0.0
Change in arrears to suppliers 1/	...	...	...	0.1	1.3	0.0	-0.9	-0.7
Change in arrears to APFA	...	...	...	-0.7	0.0	1.0	1.4	-2.2
Regular financing	2.1	-0.9	-0.2	0.4	1.8	1.5	0.4	2.9

Sources: Data provided by the authorities; and Fund staff projections.

1/ Including intergovernmental arrears.

pension system for civil servants, the retirement age is currently 55 and entitlements include benefits equal to 70 percent of the last salary in addition to the universal old age pension. The system is funded, but its actuarial liabilities currently exceed its assets by some 7 percent of GDP.

10. **Developments in Aruba's external current account are dominated by the large and variable gross flows in the petroleum-processing industry.** Thus, in 1997 the current account registered a deficit of about 12 percent of GDP as exports of refined products were delayed by work to upgrade capacity, while stocking of imported crude remained buoyant.[11] By contrast, the non-oil current account has improved steadily in recent years. Growth in tourism revenues continued to expand in 1997 and 1998 as spending per tourist increased sharply, suggesting that Aruba remains an attractive destination. With a pickup in exports from the oil sector, the 1998 current account is projected to record a surplus of about 1½ percent of GDP.

11. **The objectives of the Central Bank of Aruba have been to preserve the fixed exchange rate of the Aruban florin to the U.S. dollar and achieve a strong net foreign asset position for the consolidated banking system.** Through 1996, in the absence of sufficiently deep domestic money and security markets, monetary policy was implemented by imposing bank-by-bank ceilings on credit growth as well as cash reserve requirements and a system of capital controls.[12] The credit target was set with a view to maintaining the net foreign assets of the banking system at about 5–6 months of non-oil merchandise imports.[13] Although the ceilings on credit growth helped to promote capital inflows and a comfortable reserve position, they undermined financial intermediation, distorted banks' loan portfolios, and led to periodic buildups of commercial banks' liquidity, which—on occasion—were unwound through credit creation beyond the official limits. To improve the allocation of

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[11] Aruba's oil refinery is now owned by the U.S.-based company, Coastal Oil. It fills a specialized niche in the industry by distilling sulfur-rich *Maya crude* from Mexico and Venezuela into kerosene and diesel fuel for export to the United States and Europe. Because of the international scope of its operation, Coastal Oil does not draw on the domestic banking system for financing: the oil-related current account deficits are covered by private capital flows and do not affect the reserve position of the banking system nor—to a first approximation—the rest of the economy. See background paper for details.

[12] Licenses apply to certain capital inflows, including those related to foreign direct investment and external loans; there are still restrictions on residents' holdings of foreign assets, although these were liberalized in July 1998; and banks' net foreign positions are subject to a ceiling (the B-9 limit) for prudential reasons and to concentrate the bulk of foreign exchange in the central bank.

[13] The target for import cover has no strong justification except some historical significance. The inclusion of imports by the Free Zone in the import base is regarded by the authorities as underscoring the conservative nature of their objective, since three-fourths of Free Zone transactions are not in florins. The emphasis on net foreign assets of the banking system has a legal underpinning since, under the law, the central bank may exercise a priority claim over the banks' foreign exchange holdings. The central bank holds about 80 percent of the net foreign assets of the banking system or about Af. 440 million at end-1998.

loanable funds, in early 1997 the central bank suspended indefinitely the formal credit ceilings in favor of a less formal credit target and moral suasion, while reserving the option to reimpose controls or increase the cash reserve ratio in the event of excessive growth in monetary and credit aggregates. Reserve requirements were indeed raised from 6 percent to 7 percent in April 1998, following pressures on foreign exchange reserves from a pickup in capital outflows and a worsening current account.

12. **After having reached about five months of non-oil merchandise imports in the first half of the 1990s, net foreign exchange assets of the banking system fell below target in 1996–97, but recovered at end-1998 (Figure 7).** With broadly stable domestic money demand (Figure 8), trends in net foreign assets have mirrored those in net domestic assets. In 1996–97, banks'credit to the private sector expanded rapidly, leading to a contraction of net foreign assets in spite of reduced commercial bank lending to the government. Credit growth slowed down in 1998 following the monetary tightening, and net foreign assets recovered strongly, in part because of capital inflows linked to ongoing projects in the oil refinery, the power utility, and some hotels under renovation. As a result of these inflows, broad money increased by an exceptional 13 percent. At year-end, the net foreign exchange assets of the banking system reached over four months of (non-oil) merchandise import cover, and stood at about 1.8 times the monetary base.

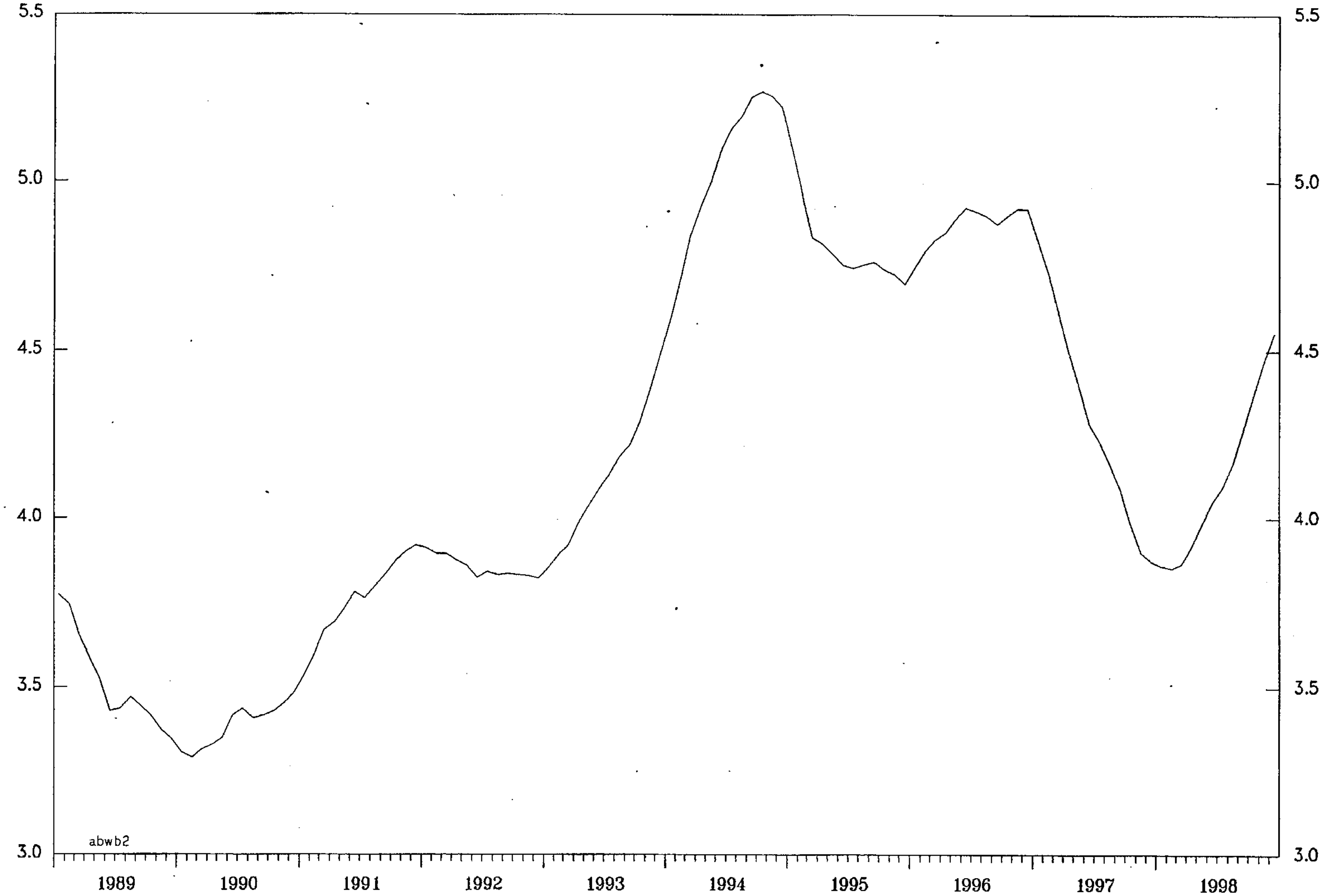
13. **The outlook is for real GDP growth in 1999 of about 4 percent, on upbeat prospects for tourism, thanks to expanded airline service and marketing efforts.** Inflation is likely to remain subdued, although ongoing wage negotiations in the public sector and recent settlements in the oil sector raise some concern. The risks to the outlook are on balance on the downside and stem from a possible weakening of the demand for travel in the United States and Venezuela—the main points of origin for recreational travel to Aruba—and from cost pressures in the tourist sector that may not be absorbed by further reductions in profit margins.[14]

III. POLICY DISCUSSIONS

14. The discussions confirmed that the key challenge for the future is to reposition public finances on a sustainable course, lest the environment of satisfactory growth and low inflation be put at risk. There was agreement that this policy orientation would need to encompass reforms in social entitlements. The credibility of the peg of the Aruban florin to the U.S. dollar remains unchallenged and competitiveness in the tourism sector does not seem to have materially deteriorated. Inroads have been made into addressing outstanding structural issues, but more remains to be done, especially as regards the privatization agenda and weaknesses in Aruba's statistical system.

[14] Absence of national accounts series, recent employment data, and information on investment plans precludes the elaboration of a meaningful quantitative medium-term framework.

FIGURE 7
ARUBA
Import Cover Ratio
(International Reserves in Months of Non-Oil Imports) 1/

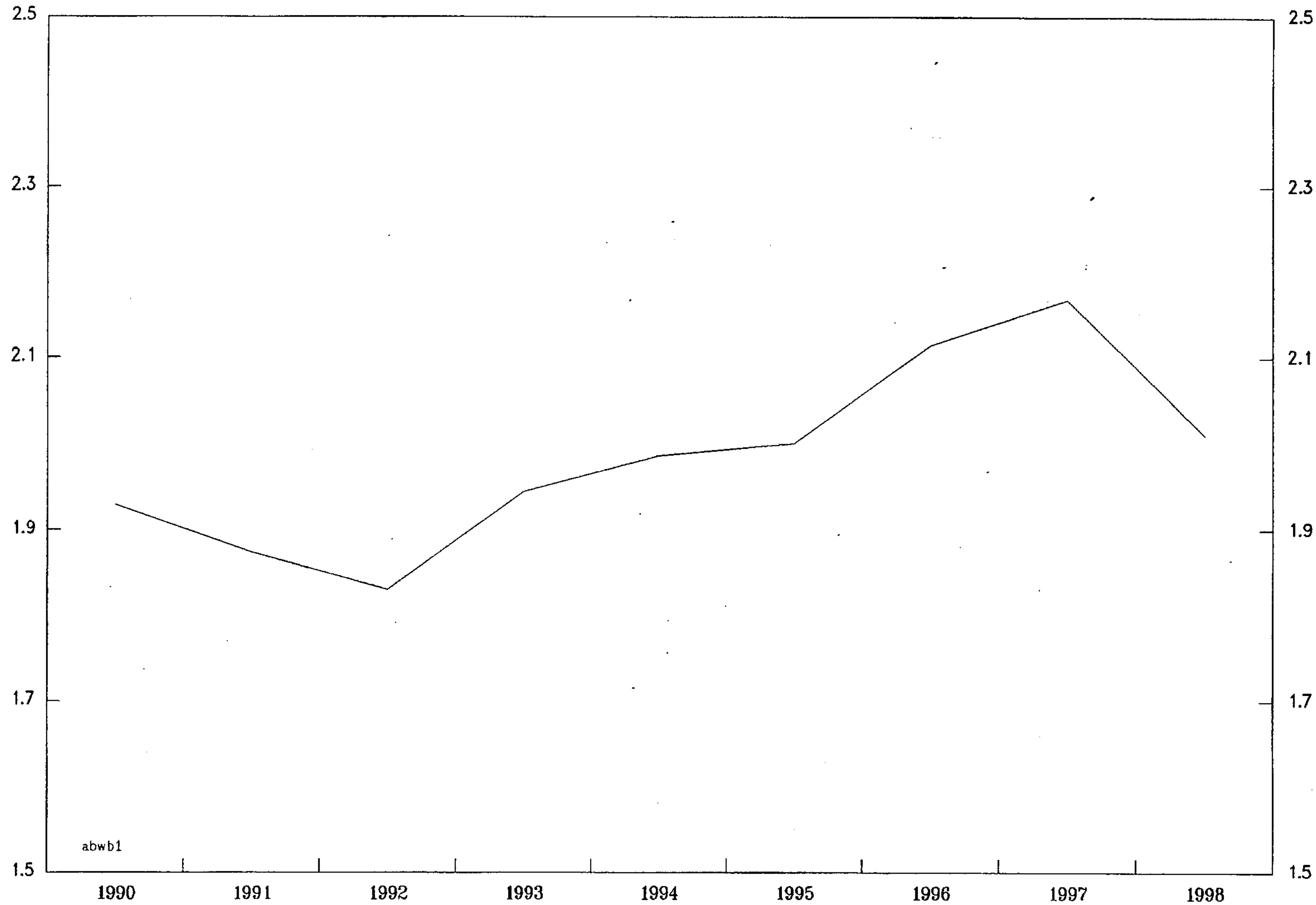


Source: Data provided by the authorities.
1/ Ratio of 12-month moving average of net foreign assets of the banking system to non-oil merchandise imports.

FIGURE 8

ARUBA

Velocity of Broad Money 1/



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

1/ Ratio of GDP to period average stock of broad money.

A. Public Finances

15. **The authorities outlined the steps—already taken or planned—to restore lasting budgetary discipline. For 1999, the linchpin of their strategy in the approved budget was a continuation of the broad-based expenditure restraint started in mid-1998.** Growth in personnel costs (which account for almost 50 percent of current spending) was to be maintained below the growth in nominal GDP (projected at about 5 percent), while spending on goods and services—which had been cut substantially in 1998—had to remain tightly controlled. Furthermore, the government was taking action to recover overdue tax and nontax liabilities, to boost revenues in the absence of any tax measures in the budget.[15] The official projection for the 1999 outturn calls for a small surplus of about ½ percent of GDP, after the settlement of arrears to commercial creditors.[16]

16. **The staff welcomed the thrust of the 1999 budget, although it cautioned the authorities that their objective reflected optimistic revenue projections; in its view, even the less ambitious—but more realistic—goal of budget balance would be adequate for the current year.** A containment of the civil servants' wage bill as a share of GDP appeared justified in light of the role played by the Netherlands in the provision of some public goods to Arubans, the high share of public sector employment in total employment (at about 15 percent), and the broad scope for streamlining public administration. In this connection, the mission endorsed the strategy of extending the hiring freeze and letting attrition reduce any overstaffing, while selectively reallocating jobs in favor of some critical services. It observed, however, that the budgetary provision of an Af. 7 million (or ¼ percent of GDP) increase for the payroll in the ongoing wage negotiations reflected a policy of pay increases inconsistent with economic fundamentals, and seemed at odds with the necessary adjustment effort or with the need to foster wage moderation outside the public sector. The advanced state of the negotiations made it unlikely, however, that the government's offer could be revised. In addition, the staff advised the government that ill-targeted incentive schemes to encourage early retirement—which in the recent past had failed to produce the desired results—be avoided. As regards the initiative to clear tax arrears stretching back several years, the staff thought that the authorities might be overestimating the yield from stepped-up efforts to reduce backlogs in tax collection, especially for nontax revenues—a concern shared by some officials in the tax department. While additional measures might be needed in case of a severe shortfall, the staff argued that a balanced budget was an adequate—and attainable—objective for 1999 under current policies.

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[15]The notional tax receivables are estimated by the government at about Af. 600 million, of which only Af. 200 million can realistically be collected. This amount is the target of the SAB (Sanering Achterstanden Belastingen) initiative in the Tax Department, a newly launched three-year project to eliminate the backlog in tax collection. For 1999 the government expects to receive about Af. 70 million from overdue tax and nontax payables.

[16]The official budget includes some financing items among current expenditures and implies a deficit on the order of 1 percent of GDP. The fiscal data in this report reflect a reclassification done by the staff.

17. **Nonetheless, the discussions revealed that a balanced budget in 1999 would be put at risk if the authorities went ahead with the scheduled consolidation of the existing public health insurance funds into a single-payer scheme (AZV).** The consolidation was seen by the authorities as a prelude to the adoption of universal health coverage, and the catalyst for prospective economies arising from administrative centralization and better cost control. The staff noted, though, that uncertainty about some key parameters of the new scheme created a potential for open-ended obligations to the consolidated health care fund AZV that would hamper the restoration of fiscal discipline.[17] It suggested postponing the transfer until the new administrative responsibilities (which did not appear to be well understood by the parties concerned) had been clarified, and the standard benefit package and the associated premiums fully specified. The authorities generally acknowledged these difficulties and took note of the staff recommendation, but a final decision to delay the new scheme has not been taken at the time of this writing.

18. **As for the plan to extinguish the arrears accumulated in recent years, the authorities were implementing approaches tailored to the type of creditor.** In the case of overdue payments to the pension fund for civil servants (APFA), the settlement under negotiation would involve the conversion of the arrears into a long-term bond, and a transfer of ownership of government assets (notably, public land and equity in the water and power utility). Arrears to commercial creditors would be settled in the course of 1999 by cash payments or, when applicable, by offsetting tax payables; and contributions to earmarked extrabudgetary funds (the sinking fund for the amortization of government debt, and a reserve fund against contingent liabilities from outstanding loan guarantees) would be resumed in the context of a realistic schedule of future payments.

19. **The staff welcomed the resolve of the authorities to reestablish good governance and stressed that the credibility of their policy hinged importantly on a prompt clearance of arrears.** It noted that the arrangement under discussion with APFA promised to lay the groundwork for further divestment of the government from land ownership and utility operation as well as for the development of a domestic capital market. By contrast, the staff expressed reservations about the approach of offsetting payables to suppliers with their unpaid tax liabilities on the grounds that it seemed nontransparent and open to abuse or litigation.

20. **The authorities planned to continue fiscal consolidation over the medium term and achieve budgetary surpluses on the order of 2 percent of GDP by 2002.** To that end, they intended to further reduce the wage bill, in part by reforming the public sector pension system, and to increase the tax share in GDP. There was agreement that a prudent fiscal stance was justified in light of the recent difficulties in financing even small deficits, the need to make provisions for unforeseen contingencies arising inter alia from outstanding

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[17]These obligations would arise from the transfer from the Social Insurance Bank (SVB) to AZV of liabilities related to health care insurance for private employees. At current premium rates, AZV would experience a severe financial shortfall, which, under the law, would have to be covered by budgetary resources not provided for in the 1999 budget.

government guarantees, and the importance of bolstering confidence in the sustainability of the exchange rate peg. However, the staff was less sanguine than the authorities in its medium-term revenue projections and more cautious on the feasibility of large expenditure cuts. In its opinion, an overall budget surplus of about 1 percent of GDP would seem as both a realistic and a sufficient medium-run objective. A surplus of this magnitude would allow the authorities to make provisions for prospective demands on the budget and to replenish the government reserve accounts that had been depleted in the recent past. As for a pragmatic policy framework for the longer term, the staff thought that a good case could be made for adopting a balanced budget rule over the business cycle (Box 1 and Table 2).

Box 1. Aruba: What is an Appropriate Long-Run Fiscal Position?

With the consolidation of the public finances underway, an important question facing the Aruban policymakers concerns the fiscal strategy to follow in the long run. In this connection, two considerations appear prominent.

- First, recent experience has shown that Aruba has difficulty financing domestically even small deficits, as illustrated by the buildup of public sector payment arrears in 1996-98.
- Second, while the credibility of the fixed exchange rate should allow Aruba to borrow abroad, such a course of action does not appear very prudent for a small undiversified economy that remains vulnerable to external shocks.

With such financing constraints limiting severely the size of financeable deficits—and political economy considerations calling for a simple and transparent policy framework—a **balanced budget rule** over the cycle may well provide the necessary guidance to avoid a politically induced deficit bias.

Table 2. Aruba: Medium-Term Fiscal Scenario 1/

(In percent of GDP)

	1999	2000	2001	2002
Revenue	21.7	21.3	21.2	21.1
Taxes	17.9	17.7	17.7	17.7
Nontax revenue	3.5	3.4	3.4	3.4
Grants	0.3	0.2	0.1	0.0
Expenditure	21.8	21.2	20.6	20.1
Current Expenditure	19.5	18.9	18.3	17.8
Wage costs	8.9	8.6	8.3	7.9
Goods and services	4.3	4.1	3.9	3.8
Interest	1.2	1.1	1.1	1.0
Other	5.1	5.1	5.1	5.1
Capital expenditure	2.3	2.3	2.3	2.3
Balance	0.0	0.1	0.6	1.0
Memorandum item:				
Debt	32.3	30.3	28.0	25.4

Sources: Data provided by the authorities; and Fund staff calculations.

1/ Assumes real freeze of wage bill and goods and services; constant share in GDP of other current expenditure and capital expenditure; some revenue decline resulting from one-off collection increase in 1999; and further decline in development aid from the Netherlands.

21. **As part of their medium-term policy agenda, the authorities saw the need for a more rational program of public investment and a reform of social entitlements.** In their view, significant steps had already been taken on these two fronts with the establishment of the Official Investment Committee to prioritize projects, and the elaboration of a reform plan for the pensions of civil servants. In particular, the proposal for a new APFA pension scheme promised immediate budgetary savings through a reduction in premiums compensated by a gradual increase of the retirement age, a tightening of eligibility requirements, and the inclusion in total benefits of the general old-age insurance scheme (AOV).

22. **There was agreement that a reassessment of investment priorities and an easing of the burden on public finances from social entitlements was necessary, in light of unfavorable demographic trends.** In the staff's view, the government was well advised to take a conservative approach to defining its public investment agenda, especially given the recent—and prospective—reductions in development aid from the Netherlands. In this

context, the establishment of the auditing committee to evaluate the budgetary impact of projects was an advance over previous practices. The staff pressed the authorities to be more ambitious in the reform of the pension systems and suggested that the retirement age be gradually increased to 65 years not only for civil servants but also for private employees—a step that would reduce the burden on the budget by decreasing the high share of nonwage personnel costs in current expenditure, and would ensure that universal AOV benefits remained affordable. For APFA, the staff urged a speedy implementation of the reform plans under consideration, while for private sector employees it proposed a two-tier system—consisting of the present basic minimum pension for all eligible residents financed by mandatory contributions, and of supplementary old-age insurance purchased on a voluntary basis from private funds.

23. **Over the medium term, the authorities intended to address poor compliance and other deficiencies in the tax system with a comprehensive reform, including a shift from direct to indirect taxation.** Initiatives under consideration comprised the adoption of self-assessment procedures for income and business taxes, and the introduction of a general sales tax. Since the details had not yet been worked out, the staff limited its comments to the general observation that any reform should be designed to increase the elasticity of revenues, keep distortions to a minimum, and broaden the tax base to counter the secular decline in the revenue ratio.[18] As a more readily taken measure, the staff urged the authorities to refrain from granting further tax holidays. In this connection, the staff stressed that the 12-year tax exemption recently granted to Coastal Oil should not create a precedent for the renewal of exemptions for other enterprises. In working out their strategy for fiscal reform, the authorities were also advised to avoid retroactive implementation of tax changes that—as past experience had shown—could complicate tax administration considerably.

B. Monetary Policy

24. **The staff and the authorities agreed on the continuing appropriateness of the fixed exchange rate and the current peg to the U.S. dollar, given the overwhelming importance of the United States as a trading partner and a sustainable competitive position.** The peg had provided a valuable nominal anchor for the conduct of policy and its credibility had been bolstered by a comfortable reserve position. The competitiveness of Aruba in the upscale tourist market to which it caters was regarded by the authorities as unchallenged by cheaper—but less sophisticated—tourist destinations in the region, as evidenced by steady occupancy rates and sustained earnings. The staff did not disagree, but noted that lack of competitiveness indicators based on unit labor cost or real wage developments complicated the assessment. In this connection, it warned that increases in labor costs ahead of productivity gains would eventually undermine this situation, as profit margins in the industry were—reportedly—already compressed.

[18] Largely because of the increased share in GDP of activities sheltered from taxation, Aruba's total revenue to GDP ratio decreased from about 29 percent in 1986 to 21 percent in 1997. This stemmed fully from a reduction in the tax revenue share in GDP, while the income share of nontax revenues and grants remained broadly stable over this period.

25. **The authorities noted that the implementation of monetary policy had moved significantly away from reliance on administrative instruments, and that they intended to discontinue reference to the informal aggregate ceiling on credit growth in the near future.** In their view, moral suasion and the use of reserve requirements would be sufficient to manage domestic liquidity, given the close similarity between the conduct of the Central Bank of Aruba and that of a currency board. Moreover, the authorities felt that the scope for further broadening the array of indirect monetary tools beyond reserve requirements was limited by the underdevelopment of domestic financial markets, and any relaxation of the prudential requirements that still forced banks to surrender the bulk of foreign exchange to the central bank would undermine its profitability and—in their opinion—its independence.

26. **The staff acknowledged that the Central Bank of Aruba had skillfully managed domestic liquidity in an open environment and in spite of widespread dollarization.** It commended its prudent monetary conduct, which had prevented monetary financing of the fiscal deficit, thus safeguarding the credibility of the florin-U.S. dollar peg. The staff welcomed the authorities' intention to remove the official credit ceilings, thus setting the stage for greater competition in banking, and shift to cash reserve requirements as the main tool for monetary management. While appreciating the difficulty of making rapid inroads on this front, the staff nonetheless thought that a case could be made for exploring the use of alternative market-based instruments (including open market operations), which might be needed to respond to any sudden deterioration of the relatively benign setting in which policy had been conducted so far. Moreover, some instrument redundancy appeared justified in light of the shortcomings of reserve requirements as a tool for short-term liquidity management.

C. Structural Issues

27. **The authorities thought that the Aruban *banking sector* was generally sound.**[19] One of the smaller banks was experiencing difficulties but—according to the authorities—these difficulties were likely to be resolved in the course of the year and did not pose a systemic threat. The supervisory capabilities of the central bank had been strengthened by the 1998 adoption of a new regulatory framework based on Dutch legislation. The law provided the supervisors with the powers and information needed to closely monitor onshore and offshore banks, and to take prompt action, if required. Similar laws were being drafted so as to formalize supervision of (onshore and offshore) insurance companies by the central bank and supervision of other offshore finance companies by the Aruban Financial Center. The staff concurred that adequate capitalization, conservative management, and a good track record of the supervisory authority supported the above assessment of Aruba's banking

[19] Aruba's banking sector consists mainly of eight local banks, two of which specialize in mortgage lending, and two offshore banks which operate under consolidated supervision of their worldwide operations. There are strict requirements for the establishment of offshore banks. Other aspects of offshore (nonbank) finance are less tightly controlled. For example, there are thousands of so-called Aruba tax-exempt companies (AVVs) that operate free of taxation and supervision, mostly as investment funds. See background paper for details.

system. It welcomed the recent or imminent legislative changes and agreed with the authorities that these promised to enhance the transparency and integrity of the financial sector. In this connection, the authorities stressed that noteworthy progress had been made with a recent revision of the directives to deter and detect money-laundering, and more stringent enforcement of procedures to prevent illegal activities in the Free Zone trade. As for Y2K readiness, the central bank had pursued the matter vigorously and was confident that Aruba's financial and business sectors would be Y2K-compliant by mid-1999—an opinion shared by officials of the island's Chamber of Commerce.

28. **The authorities indicated that Aruba had generally liberal *external policies*.** All remaining exchange restrictions on current account transactions—relating to payments for invisibles—had been eliminated by January 1997, and as of July 1998, licenses were no longer required for capital transactions up to Af. 500,000 (Af. 200,000 for natural persons). Larger capital movements, however, still required approval by the central bank. The staff encouraged the authorities to pursue their liberalization efforts, including phasing out the restrictions on the portfolio composition of financial institutions. As regards trade policy, the authorities noted that the current statutory tariff schedule had an average rate of about 7 percent and a relatively small dispersion, and it would likely be further streamlined in the context of the future tax reform. Finally, the authorities commented that there was still one import quota in force to protect the domestic production of eggs, and that the restrictions recently imposed by the European Union on imports from its overseas countries and territories (OTC) had a negligible impact on the island's employment.

29. **In the authorities' opinion, significant progress had been made in carrying out their *privatization* agenda.** The sale of a majority interest in the national carrier, Air Aruba, to a foreign private airline had been a noteworthy recent achievement. The authorities added that a plan for the privatization of the telecommunication monopoly was to be discussed soon, and that they were actively pursuing ways to outsource some services currently provided by public sector employees, with a view to reaping budgetary savings and increasing efficiency. The staff countered that more could be done to reduce public sector involvement in the economy. In particular, it suggested that divestment from the Radisson Hotel should be a high priority, inter alia, because of the burden that it continued to impose on the public purse.

30. **The authorities illustrated their *development and diversification strategy* for the economy.** A first order of business was to continue promoting Aruba as a high-end tourist destination in the United States and in Europe, where a regional marketing office had recently been set up. In their view, diversification would eventually come with the planned expansion of the Free Zone—which aimed at establishing itself as a natural intermediate station for trade between Europe and Latin America—and the likely take-off of the financial sector as a specialized provider of captive (company-related) insurance. The staff suggested that the authorities' objectives could be better fostered if the Aruba Tourism Authority—whose budget had been slashed in 1998 as part of the public expenditure retrenchment—were endowed with an independent status and with own revenue sources (notably, the yield from the room and gambling taxes) to better carry out its marketing strategy. As for the

instruments to promote the diversification of the economy, the mission advised to eschew recourse to loan guarantees and other fiscal incentives, which in the past had created huge contingent liabilities and still risked undermining the medium-term viability of public finances.[20] In this connection, the staff urged the authorities to resume regular contributions to the earmarked contingency account as soon as possible.

31. **The authorities said that at present *environmental issues* did not loom large in the policy agenda.** Although Aruba currently had a lax regulatory framework, environmental damage seemed restricted to minor oil seepage into the ground around the refinery. Efforts from Coastal Oil appeared to be underway to redress the situation. There was no risk of water contamination but the health hazards remained unknown. A draft law to strengthen the protection of the environment was being prepared for parliamentary consideration in midyear and the staff encouraged the authorities to ensure its conformity with the highest international standards.

32. **The staff commented that Aruba's statistical base had improved markedly in recent years, yet effective surveillance and policy design were still hampered by lack of timely data on key indicators of real activity.** Noteworthy achievements had been the introduction of a system for tracking government expenditures, the establishment of a preliminary framework to compute national income accounts, and a more regular compilation of (non-oil) trade data. The authorities expressed their intention to begin reporting a wider range of data to the Fund for its statistical publications, and to participate in the near future in the IMF's General Data Dissemination System, as a formal commitment to further enhance Aruba's statistical capabilities. However, they agreed with the staff that data deficiencies—including the lack of national accounts, and indicators of real activity and labor market developments—were still a serious obstacle to policy design. The authorities noted that staffing problems in the statistical bureau were in part responsible for slower-than-expected progress in correcting the situation.

III. STAFF APPRAISAL

33. For much of the past decade, Aruba's performance has been characterized by strong economic growth and moderate inflation, underpinned by generally sound and stability-oriented monetary and fiscal policies. It is commendable that the risks posed to the continuation of this performance by the deterioration of the public finances between 1996 and mid-1998 are now in the process of being addressed, and the economy seems once again poised on a balanced path of satisfactory growth and low inflation. Looking ahead, the achievement of the 1999 budget objectives will be critical to ensure that the public finances remain on a sustainable course.

34. **In mid-1998, the Aruban authorities correctly recognized that restoration of fiscal discipline had become the key priority, and decisive action was taken.** Spending was reined in, efforts were started to clear the backlog in overdue taxes, and the buildup of

[20] There are still three hotel guarantees outstanding for a total of about US$150 million.

arrears was reversed. As a result, the 1998 deficit (inclusive of the change in arrears) amounted to about 1 percent of GDP, well below the 1997 level of some 2½ percent of GDP.

35. **The challenge facing the authorities is to consolidate the gains achieved thus far and persevere in their pursuit of a prudent fiscal stance, lest the environment of satisfactory growth and low inflation be put at risk.** With continuing fiscal discipline, it should be possible to further reduce the fiscal deficit in 1999, and bring the public finances close to balance. Clearing arrears to commercial suppliers in a transparent and efficient way should be the first order of business, as a convincing demonstration of restored good governance. As for the arrears to the civil service pension fund (APFA), the strategy of settling outstanding liabilities through a combination of loans and the transfer of public assets—including shares in some public utilities—seems promising and should be worked out without delay.

36. **In the near term, the brunt of the adjustment will continue to be borne by expenditure measures, but will need to be accompanied by initiatives in tax reform.** The authorities are correctly aiming at an enduring reduction in public sector employment, a containment in wage costs, and a more realistic and better phased public investment program. For a credible fiscal correction, however, it should be made clear that the measures envisaged are not open to reversal. In particular, the government is well advised to hold the line in the ongoing wage negotiations, and to reassess its investment priorities in light of prospective cuts in development aid from the Netherlands. The initiative to clear the multiyear backlog of tax assessments and speed up collection of tax arrears is timely. Yet, as the authorities recognize, it is no substitute for a far-reaching reform to permanently increase the elasticity of the tax system and strengthen tax administration. In particular, the projected yield from clearing tax arrears appears ambitious, especially for nontax revenues, and the authorities should stand ready to take additional action in case of a shortfall. The authorities should also refrain from granting further tax holidays, since these incentives imply an open-ended commitment of fiscal resources that Aruba can ill afford.

37. **The prospects for the 1999 fiscal outturn are clouded by potential obligations to a new health care fund, arising from the consolidation of several funds into a single-payer scheme.** The restoration of fiscal discipline would suffer a setback if such payments were to fall due, and the authorities should give serious consideration to postponing the transfer of responsibilities until the viability of the new system is assured.

38. **More broadly, reforms in social entitlements are needed to safeguard the public finances over the longer term, in the face of unfavorable demographic trends.** Aruba's general pension systems need to be put back on a sustainable footing. The pensionable age should be gradually increased to 65 for all employees; in addition, the government's reform proposal for the civil service pension fund APFA—at the moment actuarially underfunded—should be implemented soon, while the current mandatory basic pension scheme for private sector employees could be supplemented by additional benefits financed through voluntary contributions.

39. **The current peg of the Aruban florin to the U.S. dollar continues to be appropriate, given the overwhelming importance of the United States as a trading partner and a stable competitive position.** The Central Bank of Aruba has skillfully managed domestic liquidity in spite of widespread dollarization, and fostered a measure of fiscal discipline by avoiding monetization of the deficit. The imminent removal of official credit ceilings and the shift to cash reserve requirements as the main tool for monetary management are welcome steps that may set the stage for greater competition in banking. The authorities should, nonetheless, continue efforts to broaden the array of market-based monetary instruments at their disposal, despite the difficulties arising from the underdevelopment of the domestic money and security markets. Indeed, steps in this direction will foster financial deepening.

40. **As regards structural issues, noteworthy progress has been made, but more remains to be done.** The prudential supervision and regulation of the banking sector has been strengthened with the enactment of a new banking law. It is important that the ancillary laws covering other onshore and offshore institutions be adopted soon to enhance the transparency and integrity of Aruba's financial sector. The authorities are to be commended for generally liberal external policies. Their efforts to further liberalize capital account transactions should continue, as monetary conditions and progress in financial regulation allow. Finally, the government should avoid further recourse to loan guarantees to promote the diversification of the economy, move speedily to enact environment protection legislation, and further reduce its involvement in commercial ventures. In particular, efforts to privatize the Radisson Hotel and the telecommunication company should be stepped up, and the Aruban Tourist Authority could usefully be endowed with an independent status and with own revenue sources.

41. **Aruba's statistical base has improved significantly in recent years, but data deficiencies remain a serious obstacle to effective surveillance and policy design.** Special priority should be given to finalizing the national income accounts for 1995, 1996, and 1997, compiling price and wage indices in the tourist sector, and developing more frequent labor market statistics. The authorities are to be congratulated on their intention to participate in the near future in the IMF's General Data Dissemination System, and to start more regular and timely reporting of trade flows to the IFS.

42. It is proposed that the next Article IV consultation discussions continue to be held on the 24-month cycle.

Aruba - Basic Data

Area	180 square kilometers
Population (end-1997)	92,000
GDP per capita (1997)	US$18,000
Social indicators (1995)	
Literacy rate	97 percent
Life expectancy	74 years
Infant mortality (aged under one)	0.6 percent

	1992	1993	1994	1995	1996	1997	1998	1999 Proj.
	(Change in percent)							
Real economy								
Real GDP	6.1	7.7	8.7	2.6	5.8	4.2	2.8	4.0
Nominal GDP	9.9	13.0	15.0	6.0	9.0	7.2	4.9	5.5
Tourist nights	3.6	3.2	5.1	5.7	5.4	2.6	1.1	...
Tourism earnings	14.5	4.9	0.3	11.2	17.8	8.9	5.0	...
Real tourism earnings	10.7	-0.3	-6.0	7.8	14.6	5.9	3.1	...
Registered unemployment rate (percent of Aruban labor force)	0.6	0.5	0.5	0.7	0.7	0.6	...	...
Inflation (period average)								...
CPI (Aruba)	3.9	5.2	6.3	3.4	3.2	3.0	1.9	...
CPI (Curaçao)	1.4	2.0	1.8	2.8	3.6	3.3	1.0	...
CPI (U.S.)	3.0	3.0	2.6	2.8	2.9	2.3	1.6	...
Real exchange rate index (1990=100) 1/	102.1	104.3	108.1	108.7	109.0	109.7	110.1	...
	(In millions of US dollars)							
Balance of payments								
Current Account	22	22	60	-15	-62	-196	22	...
(In percent of GDP)	2.1	1.9	4.5	-1.1	-4.0	-11.9	1.3	...
Of which: non-oil	-27	-18	-54	-25	-3	-17	48	...
(In percent of GDP)	-2.6	-1.5	-4.1	-1.8	-0.2	-1.0	2.8	...
Trade balance	-198	-187	-82	-250	-302	-391	-329	...
Oil sector	124	135	278	155	104	-4	89	...
Free zone	12	29	13	16	40	47	34	...
Other	-334	-351	-373	-420	-446	-435	-452	...
Services	230	226	167	215	255	223	351	...
Of which: tourism revenues	445	467	468	521	613	668	702	...
Income	-10	-12	-14	-9	-12	-17	5	...
Current Transfers	-1	-5	-11	28	-4	-11	-5	...
Financial and capital account	-4	10	-60	62	29	180	32	...
Errors, omissions, and revaluations	5	2	-2	-4	8	-3	-3	...
Change in reserves (minus = increase)	-23	-33	2	-42	25	18	-51	...

	1992	1993	1994	1995	1996	1997	1998	1999
				(Percent change)				
Monetary aggregates								
Net foreign assets	22.1	14.9	7.8	6.3	-9.4	-9.2	40.6	...
Net domestic assets	7.7	1.5	15.7	4.6	11.2	11.1	1.9	...
Domestic credit	9.8	2.6	17.2	4.5	13.4	8.3	5.8	...
To private sector	8.6	7.7	17.0	7.2	10.5	5.5	5.7	...
Money and quasi-money	12.5	6.4	12.6	5.2	3.2	4.6	13.1	...
Money	5.5	14.1	16.8	-1.4	2.2	6.3	13.5	...
Quasi-money	16.3	2.6	10.3	9.1	3.7	3.7	12.8	...
				(In percent of GDP)				
Public finances central government								
Revenue and grants	24.5	23.5	22.3	23.9	23.5	21.0	20.9	21.7
Expenditure	26.5	22.5	22.1	23.6	26.5	23.5	21.9	21.8
Balance	-2.1	0.9	0.2	0.2	-3.1	-2.5	-0.9	0.0
Government debt								
External	19.0	16.7	16.3	15.9	12.9	10.1	11.1	10.9
Domestic	19.2	20.4	19.0	22.2	22.5	23.4	23.0	21.4
				(In percent)				
Interest rates								
Deposit rate	5.7	4.2	4.4	4.3	4.2	4.4	4.4	...
Lending rate	10.6	10.6	10.6	10.6	10.3	10.0	10.0	...
Exchange rates:								
U.S. dollar	The Aruban florin is pegged to the U.S. dollar at Af. 1.79 = US$1							
SDR (end of period)	2.46	2.46	2.61	2.66	2.57	2.42	2.52	...

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

1/ Relative to the U.S. dollar. CPI based. Period average.

Aruba—Fund Relations

Aruba is part of the Kingdom of the Netherlands, which consists of the Netherlands Antilles, Aruba, and the Netherlands itself. The Kingdom of the Netherlands is an original member of the Fund. On February 15, 1961, the Kingdom formally accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement for all territories. The initial par value of the Netherlands Antillean guilder which at the time also circulated in Aruba—NA f. 1.88585 = US$1—was established with the Fund on December 18, 1946. The authorities communicated to the Fund a rate of NA f. 1.79 per US$1 to take effect as a central rate on December 23, 1971. Since then, the Netherlands Antillean guilder has been pegged to the U.S. dollar at this rate. With the separation from the Netherlands Antilles and the acquisition of an autonomous status (*status aparte*) within the Kingdom of the Netherlands on January 1, 1986, Aruba introduced its own currency, the Aruban florin, which is also pegged to the U.S. dollar at Af. 1.79 per US$1.

In setting up a new central bank and introducing a new currency, Aruba obtained extensive technical assistance from the Fund's Central Banking Department. Moreover, a Statistical Review Mission of the Bureau of Statistics provided technical assistance in the area of the organization of fundamental statistics. Finally, in 1989 a special mission of the Fiscal Affairs Department submitted a report on the scope and nature of a possible tax reform.

The Board concluded the last Article IV consultation discussions for Aruba on May 19, 1997 (EBM/97/51) on the basis of staff report SM/97/106 (4/30/97) and recent economic developments SM/97/109 (5/2/97).

Aruba—Statistical Issues

Notwithstanding a marked improvement in Aruba's statistical base in recent years, lack of timely data on key indicators of economic activity still hampers the effectiveness of surveillance and policy design. In particular, serious deficiencies in the coverage, quality, periodicity, and timeliness of real sector statistics remain be addressed.

The *consumer price index* is reported to STA by Aruba's Central Bureau of Statistics (CBS) with a lag of six weeks. However, other *indicators of competitiveness*, such as import and export deflators, wholesale prices, and data on wage developments are not yet available, with the exception of data on minimum wages. The authorities intend to compile soon wage and price indices in the tourism sector, in light of its importance in the economy.

Regular *national accounts data* are not available. Missions make their own estimates of national accounts based on a model that is shared with the authorities. Provisional national accounts for 1994 were, however, published in 1996. A framework for the regular compilation of these statistics is being established, and partial accounts for 1995, 1996 and 1997 are to be released in 1999.

Unemployment information is gathered every three years from a labor force survey that follows ILO guidelines, but may overestimate average unemployment because of seasonal effects. The Labor Department publishes more frequently a *registered unemployment rate* that only covers Aruban registered unemployed. This measure may underestimate effective unemployment because of the lack of coverage of immigrants and the lack of incentives for registration.

Data on *exports and imports of merchandise* in the IFS are not up to date. The latest reported statistics refer to 1991. However, the CBS has cleared the backlog, and statistics for 1995-97 and the first three quarters of 1998 have been published. The data will soon be submitted to IFS.

Aruba does not report *government finance statistics* to STA, either for publication in the *GFS Yearbook* or for the *IFS*. However, a computerized system for tracking government finances was introduced in 1997, and the authorities have begun compiling statistics on a GFS basis, which should allow regular reporting to the Fund in the near future.

There are no major outstanding issues for *money and banking statistics*, nor for the capital account of the *balance of payments*. The Central Bank of Aruba reports reliable monetary data to STA on a timely basis.

The *balance of payments* is prepared on a monthly and quarterly basis and is published in the *Quarterly Bulletin* and *Annual Report of the CBA*. Starting July 1, 1996, the CBA began compiling balance of payments data according to the fifth edition of the *Balance of Payments Manual (BPM5)*. The balance of payments data for previous periods have been reclassified accordingly (up to 1992).

Regarding *data dissemination*, the Aruban authorities intend to participate in the IMF's General Data Dissemination System in the near future.

Technical Assistance Missions in Statistics (1994–present)

Subject	Staff Member	Date
None		

Aruba: Core Statistical Indicators as of End-February 1999

	Exchange Rate 1/	Intl. Reserves	Central Bank Balance Sheet	Reserve Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/Debt Service 4/	Overall Govt. Balance	GDP/GNP 5/
Date of latest observation	2/28/99	Dec. 98	Dec. 98	Dec. 98	Dec. 98	Dec. 98	Dec. 98	1998Q3	1998Q3	1998Q3	1998Q3	n.a.
Date received	2/28/99	2/18/99	2/18/99	2/18/99	2/18/99	2/18/99	2/18/99	1/29/99	1/29/99	1/29/99	1/29/99	n.a.
Frequency of data	daily	monthly	monthly	monthly	monthly	monthly	monthly	quarterly	quarterly	quarterly	quarterly	n.a.
Frequency of reporting	daily	monthly	monthly	monthly	monthly	monthly	monthly	quarterly	quarterly	quarterly	quarterly	n.a.
Source of update	CB 2/	CB	CB	CB	CB	CB	CB	CB	CB	CB	CB	n.a.
Mode of reporting	-	3/	3/	3/	3/	3/	3/	3/	3/	3/	3/	n.a.
Confidentiality	no	no	no	no	no	no	no	no	no	no	no	n.a.
Frequency of publication	-	monthly	monthly	monthly	monthly	quarterly	monthly	quarterly	quarterly	quarterly	quarterly	n.a.

1/ Fixed exchange rate against the U.S. dollar since 1986; the Fund would be notified in case of a parity change.
2/ For government.
2/ CB = Central Bank.
3/ Publication.
4/ For government only.
5/ Data in staff papers are estimates.

INTERNATIONAL MONETARY FUND
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International Monetary Fund
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Aruba

On May 7, 1999, the Executive Board concluded the Article IV consultation with Aruba.[1]

Background

In 1998, Aruba's real GDP grew at an annual rate of some 3 percent, while inflation remained subdued at about 2 percent. Comparable rates of satisfactory growth and low inflation have characterized the island's development since the mid-1990s, following a period of double-digit growth when an investment boom in the hotel sector brought about the transformation of Aruba into a tourism-based economy.

The outlook for satisfactory growth and low inflation had been threatened, however, by an undue relaxation of fiscal policy in 1996 and continued laxity through mid-1998. Deficits of more than 2½ percent were recorded in 1996 and 1997, reflecting a boost in expenditure and slippages in revenue collections. These deficits were in large part financed by the accumulation of public sector payments arrears, the stock of which reached more than 5 percent of GDP by mid-1998.

In order to restore budgetary discipline, a significant fiscal correction was undertaken in 1998, mostly through expenditure restraint. By year-end the budget deficit was reduced to less than 1 percent of GDP, and the buildup of arrears was partly reversed. Fiscal adjustment continued in the context of the 1999 budget, which aims to bring the public finances close to balance, in part as a result of stepped-up efforts to clear a multiyear backlog in tax collections. The outstanding arrears are also expected to be cleared in the course of 1999.

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[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. In this PIN, the main features of the Board's discussion are described.

The objectives of the Central Bank of Aruba have continued to be the preservation of the fixed exchange rate of the Aruban florin to the United States dollar and the achievement of a strong net foreign asset position for the consolidated banking system. These assets fell below four months of (non-oil) merchandise import cover in early 1998, reflecting in part rapid domestic credit growth. In order to stem the loss of net foreign assets, the central bank–which had progressively moved away from the use of direct instrument of monetary policy–tightened monetary conditions in April 1998 by raising cash reserve requirements, setting the stage for a recovery of net foreign assets position at year end.

In 1998 the supervisory capabilities of the central bank were strengthened with the enactment of a new regulatory framework embodying the Basle Committee Core Principles for Effective Banking Supervision, and similar laws concerning the insurance industry are been finalized for parliamentary consideration.

Aruba's non-oil current account improved markedly in 1998 and registered a surplus of about 3 percent of GDP, as a result of strong earnings from tourism. Aruba has generally liberal external policies. In July 1998, the capital account was further liberalized, as licenses were discontinued for transaction below Af. 500,000 (Af. 200,000 for natural persons.)

The outlook for GDP growth in 1999 is about 4 percent, on upbeat prospects for tourism. Inflation is likely to remain subdued. In the future, economic growth in Aruba will depend on upgrading the quality of tourism and promoting the diversification of the economy, against the backdrop of stability-oriented fiscal and monetary policies.

Executive Board Assessment

Executive Directors noted that, for much of the past decade, Aruba's performance had been characterized by strong economic growth, moderate inflation, and a high level of employment underpinned by generally sound financial policies. However, this positive performance had been threatened by fiscal laxity in recent years. Directors stressed that the main challenges facing the authorities are to consolidate the ongoing efforts to return the public finances firmly to a sustainable course and to address outstanding structural issues.

Directors commended the authorities for the decisive action undertaken from mid-1998 to correct the fiscal imbalances. They welcomed the significant reduction of the deficit in 1998, and urged steadfast budgetary discipline to achieve a balanced budget in 1999. In this regard, they noted that the plans under way to control spending, including those to contain the public sector payroll and to rationalize the public investment program, were key to ensuring achievement of the fiscal objective for 1999. Moreover, Directors welcomed the authorities' efforts to strengthen tax administration and their intention to broaden the tax base. They felt that this was essential if fiscal consolidation over the medium term was to be achieved. In this connection, they urged the authorities to refrain from granting further tax holidays and loan guarantees, as they created open-ended fiscal commitments. In addition, Directors strongly endorsed the authorities' objective to clear domestic payments arrears by year-end, stressing the importance—for the restoration of good governance—of a prompt and transparent implementation of current plans.

Directors indicated that fiscal sustainability in the presence of unfavorable demographic trends would require far-reaching reforms in social entitlements, including in the pension and health systems. In this connection, they underscored the need to gradually increase the retirement age for all employees, and cautioned against the adoption of a new health scheme before its financial viability was ensured.

Directors agreed that the present exchange rate peg of the florin to the U.S. dollar had served Aruba well, and commended the central bank for its management of domestic liquidity, which had safeguarded confidence in the fixed exchange rate. They welcomed the recent measures taken by the authorities to increase reliance on market-based monetary policy instruments. Directors also welcomed the adoption of the legislative framework to strengthen the supervisory powers of the central bank on onshore and offshore financial institutions, as well as the measures taken to prevent money laundering. They noted that these measures would further enhance the transparency and integrity of Aruba's financial sector, in particular, and, more generally, their overall economic policies.

On structural issues, Directors commended Aruba for its generally liberal trade policies, and welcomed the relaxation of restrictions on some capital account transactions. In welcoming the recent privatization of the national airline, Directors emphasized the scope for further reducing the public sector's involvement in tourism and telecommunications.

Directors noted that deficiencies in Aruba's statistical base remained a serious obstacle to effective surveillance and policy design, and called for additional improvements, especially in the preparation of national accounts and labor market statistics.

Public Information Notices (PINs) are issued, 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. As part of a pilot project, the staff report for the 1999 Article IV consultation with the Kingdom of the Netherlands-Aruba is also available.

Aruba: Selected Economic Indicators

	1995	1996	1997	1998
Domestic Economy				
Change in real GDP	2.6	5.8	4.2	2.8
Unemployment rate	0.7	0.7	0.6	...
Change in consumer prices (end of period)	3.1	3.1	2.8	1.5
	In millions of U.S. dollars 1/			
External Economy				
Exports, f.o.b	1,347	1,733	1,725	1,108
Imports, f.o.b.	1,597	2,035	2,116	1,438
Current account balance	-15	-62	-196	22
Direct investment	-1	84	198	85
Portfolio investment	-17	-6	45	-35
Capital and financial account balance	62	43	176	65
Official reserves	221	195	177	228
Current account balance (in percent of GDP)	-1.1	-4.0	-11.9	1.3
Of which: non-oil sector	-1.8	-0.2	-1.0	2.8
Change in real effective exchange rate (in percent) 2/	0.5	0.3	0.6	0.3
	In percent of GDP 1/			
Financial variables				
General government balance	0.2	-3.1	-2.5	-0.9
Gross national saving	...	...	...	...
Gross national investment	...	...	...	...
Change in broad money (in percent)	5.2	3.2	4.6	13.1
Interest rate (in percent) 3/	4.3	4.2	4.4	4.4

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

1/ Unless otherwise noted.

2/ (+) = appreciation.

3/ Deposit rate.