Kingdom of the Netherlands—Aruba: Concluding Statement of the 2015 Article IV Mission

February 13, 2015

The economy is recovering from a double-dip recession caused by the global financial crisis and the shutdown of the oil refinery. These shocks have substantially increased public debt—over 80 percent of GDP in 2014—and eroded fiscal space. To address these fiscal challenges, the authorities have undertaken major entitlement reforms and are aiming to reach a small fiscal surplus in 2018. Without further measures, however, the pace of fiscal consolidation is expected to slow and public debt will continue to rise over the medium term. The authorities emphasized that their medium-term fiscal adjustment plan contains the necessary measures needed to meet their targets. Increasing labor market flexibility and reducing the costs of doing business would improve Aruba's competitiveness and help its resilience to external shocks. The authorities' growth pillar anchored around renewable energy offers promising potential.

The economy is set to recover gradually

1. Aruba is recovering gradually from a severe double-dip recession. After a strong recovery in 2013 with growth above 4½ percent, the pace of activity moderated in 2014. Despite very strong tourism growth, the loss in momentum reflected a broad-based contraction in domestic demand due to waning confidence, fiscal policy uncertainty, and investment delays. Headline inflation has recently been hovering below 1 percent. The current account (CA) deficit is estimated to have narrowed to −7½ percent of GDP in 2014 with the non-oil CA in surplus, largely reflecting developments in the tourism sector.

2. Growth is projected to rise to 2¼ percent in 2015. The tourism sector—the mainstay of the Aruban economy—is expected to continue to grow, albeit at a slower pace than over the past two years. At the same time, domestic demand is slated to recover appreciably as policy uncertainty subsides and a few key public-private partnership (PPP) projects move forward (Green Corridor, Ring Road 3).

3. Risks to the near-term outlook are mainly external. The closure of the oil refinery implies a narrower economic base and even greater dependence on tourism. This concentration risk is compounded by the fact that about 60 percent of tourism originates from the United States, implying that the Aruban economy is highly sensitive to economic activity in the U.S. A deepening of Venezuela's economic crisis is also a risk given that it is Aruba's second most important source of tourism. Over the medium-term, while renewable energy investments could boost growth prospects, the lifting of the U.S. travel ban to Cuba could have lasting adverse effects on Aruban tourism.

Ambitious measures needed to rebuild fiscal policy space

4. Following a rapid deterioration during 2009-2012, the fiscal deficit narrowed to 5¼ percent of GDP in 2014. While revenue performance was largely in line with expectations, expenditure restraint in the purchase of goods and services together with the APFA pension reform yielded important savings. Nevertheless, public debt surpassed 80 percent of GDP last year.

5. The authorities undertook major structural reforms in 2014 to address the fiscal challenges. First, as a result of the general (AOV) pension reform, premiums were raised and a gradual increase in the minimum retirement age (to 65 years) was initiated. Second, the capital shortfall of the public administration (APFA) pension system was made whole, the accrual period and franchise contributions were modified and, as with the AOV, the retirement age will gradually increase. Third, a levy was introduced to partially offset the fiscal costs of the health care system (AZV).

6. Meaningful fiscal consolidation is planned to take hold this year. The authorities' proposed budget plan aims to reduce the 2015 deficit to 3¾ percent of GDP. Savings are expected to come mostly from entitlement reforms, supported by a reduction in the number of public sector employees.

7. Ambitious structural measures and determined implementation are needed to reverse the adverse debt dynamics over the medium term. Aruba's exposure to external shocks, a narrow economic base, a fixed exchange rate regime, and sizable interest burden call for the creation of fiscal space to improve resilience against shocks. The authorities' ambitious medium-term adjustment path (culminating with a small surplus in 2018) is therefore welcome. Indeed, fiscal efforts should be sustained at least until 2020 to attain a surplus of 1½ percent of GDP, which will help bring public debt down to about 70 percent of GDP. However, these objectives will most likely not be achieved with current measures. Without additional measures, deficits would remain elevated, and debt would continue to rise over the medium term. Expeditiously establishing a strong and effective medium-term fiscal framework would enhance the credibility of these plans. The authorities emphasized that their medium-term fiscal adjustment plan contains the necessary measures needed to meet their targets.

8. Achieving these fiscal targets will require both revenue and expenditure measures, including additional entitlement reforms. Additional revenue measures are needed given the size of the authorities' planned adjustment. In particular, international comparison suggests that there is scope for increasing revenue from indirect taxes. On the expenditure side, given the large size of the wage bill (50 percent of tax revenue), a key priority is to introduce measures to reduce wage-related expenses. Steadfast adherence to the consolidation plan would also appreciably reduce interest expenses. Further measures are needed to ensure that the health care system (AZV) becomes self-financing.

Monetary policy should continue to support the recovery

9. The current accommodative monetary stance remains appropriate. Credit growth continues to be anemic with low demand and tighter lending standards. Aruba's foreign exchange reserves, which cover about 3¾ months of imports and 35 percent of broad money, seem adequate to safeguard the pegged exchange rate. Therefore, given projected low inflation and moderating growth rates, as well as evidence of slack, there is no need for reducing monetary accommodation at this juncture. Should demand pick up and signs of overheating appear (such as rapid credit growth, though this is a very low risk at this point), the authorities should stand ready to mop up excess liquidity by increasing the reserve requirement ratio.

10. The banking sector has withstood the double-dip recession well. Commercial banks' return on equity was 18½ percent in 2014, afforded by sizeable interest rate margins which reflect, in part, an oligopolistic market structure. The capital adequacy ratio has been on the rise since 2011 and surpassed 24 percent as of 2014, well above the regulatory minimum of 14 percent. The non-performing loans (NPL) ratio declined to around 6 percent in 2014. After significant efforts to enhance the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework, Aruba was removed from the Financial Action Task Force (FATF) follow-up process.

A steady recovery needs safeguarding competitiveness

11. Aruba appears to have maintained its competitiveness in tourism. Its Caribbean market share in stay-over tourism has been growing which, along with Aruba's reputation as a high-end destination and the predominance of time-share participants, continues to provide revenue stability. In addition, the authorities' marketing efforts, access to new U.S. hubs, and additional airlift capacity from South America have improved resilience. Increasing labor market flexibility and reducing the costs of doing business would not only further improve Aruba's competitiveness, but would also help its adjustment to external shocks and facilitate diversification.

Continued efforts are needed to raise Aruba's growth potential and diversify its sources

12. After a strong performance in past decades, each major recession was characterized by structurally lower growth. In the aftermath of the latest double-dip recession, Aruba's growth trend decreased markedly again, mainly because of a structural decline in productivity, partly reflecting the closure of the oil refinery. Aruba faces several headwinds to longer-term growth, including population aging and rigid labor market regulations.

13. The looming demographic challenges and declining productivity call for labor market action. Aruba needs comprehensive labor market reform to increase both participation and productivity. But even with reforms that increase labor market flexibility (and reduce the costs of doing business), bleak demographic prospects imply a need to rely on migrant workers, arguing for the development of sustainable migration policies.

14. Developing the renewable energy sector offers potential. Given Aruba's natural resources, a growth pillar anchored around developing the renewable energy sector offers a plausible long-term path for economic diversification. However, skilled-labor shortages may pose a challenge to the success of this initiative. These projects should be financed through FDI as much as possible.

The mission team is grateful to the authorities and other counterparts for their gracious hospitality and for the highly cooperative and candid discussions.

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