STATE OF THE ECONOMY

Centrale Bank van Aruba

Economic Review 2013

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Centrale Bank van Aruba **January-December 2013***

Contents

Overview:

The Aruban economy picked up in 2013, bolstered by a strong performance in the tourism sector. This outcome affected domestic consumption levels, as evidenced by the higher levels of import duties and turnover tax receipts of the government, relative to the same period of 2012. Furthermore, tourism demand contributed to service exports, further boosting economic expansion. On the other hand, increased tourism and domestic demand led to higher import levels, while investments contracted, the latter due to delays in various projects. Both of these factors had a dampening effect on economic growth.

The 12-month inflation trend continued its downward trajectory for most of 2013, only picking back up in the latter part of the year as the effect of the water and electricity tariff reductions, of respectively, August and November 2012, on inflation had fully worked out by November 2013. Nonetheless, inflation remained in negative territory by end-2013.

Government finances remained vulnerable in 2013, with a fiscal deficit of Afl. 331.8 million on a cash adjusted basis (7.2 percent of GDP) pushing up debt levels to Afl. 3,419.6 million, equal to a debt–to-GDP ratio of 74.0 percent of GDP.

Net foreign assets (NFA) fell in 2013 but continued at an acceptable level when benchmarked against the critical norms used by the CBA to assess the adequacy of this indicator, including the number of months of current account payments covered by the net foreign assets.

** Cutoff date for this publication was July 04, 2016. For the complete set of data reference is made to the Annual Statistical Digest 2015 publication, and for the external sector reference is made to the external sector first quarter 2016 publication. Both publications are available on the CBA's website at www.cbaruba.org.*

I. Introduction

The Aruban economy rebounded in 2013 after a contraction in 2012. The most recently available macroeconomic data and calculations by the CBA indicate that nominal GDP expanded by 1.8 percent in 2013 (4.2 percent in real terms) (Table 1). This outcome was driven mainly by the strong performance of the tourism sector, with the U.S. and Venezuelan markets remaining the principal sources of the growth in tourism.

In turn, the expansion in tourist arrivals likely increased employment, and thus, positively impacted domestic consumption. This impact is supported by several indicators of consumption, including the turnover tax, imports, and expenditure by Aruban households abroad, all of which recorded increases in 2013. Nonetheless, the growth in consumption, along with the larger tourism demand, in turn pushed up import levels, which mitigated the economic growth to some extent. In addition, delays in various projects caused a drop in investments, which further hampered economic growth.

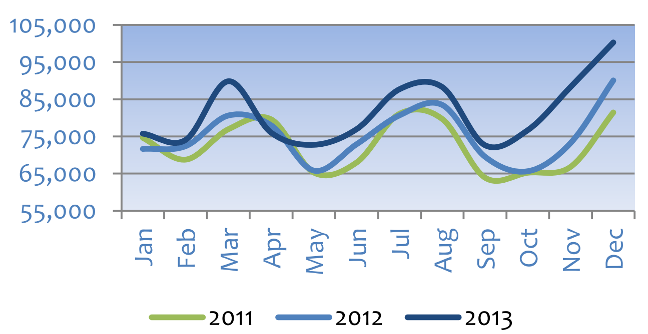
Table 1: Real GDP in percentage change

	2011	2012	2013
Real GDP	**3.5**	**-1.4**	**4.2**
Real Consumption	**1.8**	2.2	3.4
Real private consumption	**3.9**	0.4	4.0
Real public consumption	**-3.2**	6.7	1.9
Real Investment	**1.5**	-8.4	-8.2
Real private investment	**2.9**	-12.3	-3.5
Real public investment	**-21.3**	69.8	-56.6
Real Imports	**8.8**	-4.2	0.4
Real Exports	**14.0**	-5.8	6.0

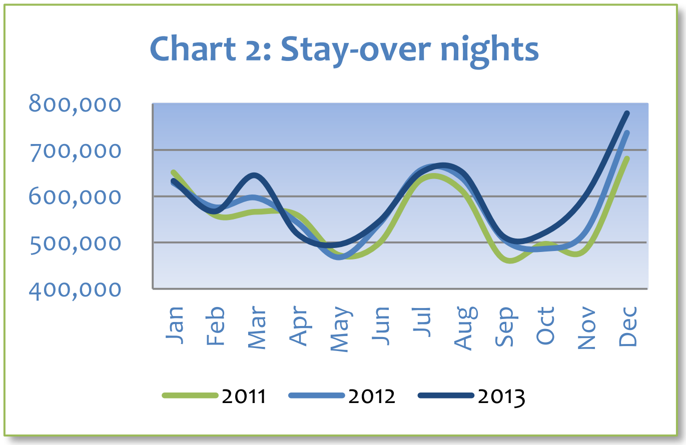
II. Real sector developments

Tourism recorded a strong performance in 2013. Stay-over arrivals increased 8.3 percent (+75,322 visitors), allowing Aruba to welcome close to one million visitors in 2013 (979,256 stay-over tourists) (Chart 1). Increased seat capacity from Latin America and the United States contributed to this positive outcome. The last quarter of 2013 stood out in particular, as stay-over visitors surged by 36,355 (Venezuela: +26,791 visitors) compared to the fourth quarter of 2012, accounting for almost half of the total growth in 2013. Venezuela remained the main driver behind the expansion in stay-over visitors for the third consecutive year, with an additional 44,819 guests (59.5 percent of total growth), thereby increasing its market share to 19.2 percent. The U.S. market also gained momentum in 2013, after two successive years of declines in stay-over arrivals. Improved economic activity in the United States, along with increased seat capacity, helped push up visitor numbers from this market (+4.8 percent or 25,346 additional visitors). Interestingly, with overall arrivals from the United States reaching 556,296 visitors in 2013, this market surpassed even the pre-crisis level of 2008. However, the diversification efforts of the Aruba Tourism Authority (ATA) have contributed to a steady decrease in the U.S. market share in recent years. To illustrate, in 2004, the US market share was 73.5 percent; in 2013, it represented only 56.8 percent. The ATA's endeavors to diversify the tourism markets are commendable because they mitigate the tourism market vulnerability of Aruba.

Chart 1: Stay-over visitors



The gains made in the Venezuelan and U.S. markets were slightly dimmed, however, by a lackluster performance in both the European market (-3.2 percent) and the rest of the world (-3.6 percent). The decrease in European stay-over visitors was caused mainly by a drop in the number of tourists from both the United Kingdom and the Netherlands.



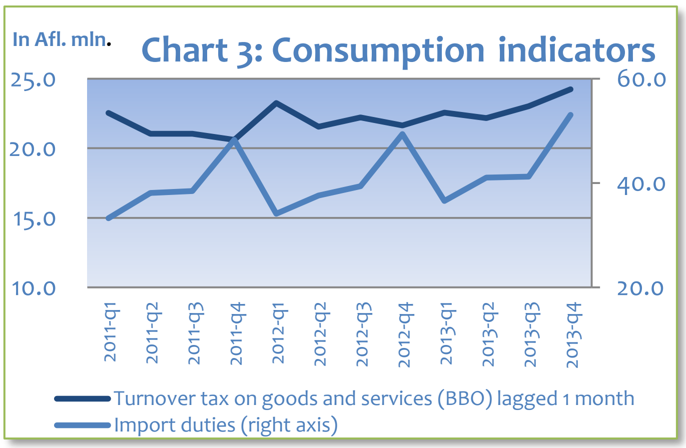
Total visitor nights rose by 3.2 percent in 2013, lagging behind the growth in stay-over visitors (Chart 2). This outcome can be explained by a change in the composition of source markets, as the majority of the growth in arrivals was driven by the Venezuelan market, and in general, Venezuelans stay less time than the overall average. The average stay of visitors from Venezuela dropped to 5.6 nights, compared to an average of 6.3 nights a year earlier. Furthermore, U.S. visitors also stayed fewer nights on average, relative to the previous year. Moreover, arrivals from Canada and Europe were down by 3.4 percent and 3.2 percent, respectively, contributing as well to the weaker growth in visitor nights compared to that of stay-over visitors, as these visitors tend to stay longer than the overall average.

Occupancy rates for 2013 also registered a contraction, decreasing from 79.0 percent in 2012 to 77.3 percent in 2013, according to the Aruba Hotel and Tourism Association. This decrease can be explained by a larger share of stay-over visitors opting to vacation in either apartments or private homes (2012: 15.5 percent; 2013: 18.6 percent).

Cruise tourism performed well in 2013, increasing by 106,259 to a total of 688,568 passengers, while the number of ship calls rose by 64 ships (+21.8 percent).

The overall positive developments in the tourism sector led to an expansion in tourism receipts of 6.6 percent in 2013, compared to a year earlier. This is the fourth consecutive year with a recorded increase in tourism receipts.

Higher domestic household consumption levels further spurred economic activity. The elevated consumption level (+1.5 percent) was largely brought about by the performance in the tourism sector. Indicative of this development are the 3.8 percent growth in the turnover tax receipts and the 7.1 percent expansion in import duties in 2013, relative to 2012 (Chart 3). The patterns of receipts for both the turnover tax and import duties are similar to that of stay-over arrivals and tourist nights, suggesting that tourism influenced these indicators more heavily in 2013 than in the previous two years, implying that these increases cannot be attributed solely to domestic consumption. Moreover, merchandise trade imports, another indicator of consumption, rose on a yearly basis by 3.2 percent in 2013. It should be noted that the expansion in domestic consumption goes hand in hand with a rise in imports, as Aruba, a small open economy, is heavily dependent on imports to meet its domestic demand.



Moreover, the number of residents traveling abroad rose by 0.5 percent in 2013, further proof of increased consumption activity. According to data recorded in the balance of payments, resident tourism spending abroad grew by 15.3 percent for the year 2013.

Nonetheless, the rise in consumption and tourism exports was countered by a drop in investments. This drop was due to delays in a number of projects, including the renovation and expansion of the hospital and the green corridor, the moving of the container harbor/port, the second windmill park, the Waste to Energy project, and the Hard Rock Hotel project. Construction activity data for 2013 shows an increase of +9.9 percent in the number of construction permits granted, primarily for the construction of houses (+23.3 percent), relative to the same period of 2012. Even so, the total value of construction permits fell by Afl. 84.1 million (-19.0 percent), mostly due to the decrease in the value of construction permits for apartments. Furthermore, cement imports, fell by 0.8 percent in 2013.

Nonetheless, the number of electrical installations approved grew by 12.8 percent in 2013. The business perception survey results show that businesses were more optimistic with regard to current economic conditions, as the index rose from 104.0 in 2012 to 105.2 in 2013. This rise was due mainly to the financial intermediation sector, and the transport, storage and communication sector. In contrast, the short-term future economic conditions saw a decline as the corresponding index moved to 104.3 in 2013, down from 107.5 in 2012. This decline was due primarily to the manufacturing sector (excluding Manufacture of refined petroleum products), which moved for the first time from a neutral to a pessimistic outlook.

Deflationary effects persisted in 2013. The 12-month inflation trend continued its downward path for most of 2013, hitting a low in July 2013 at -3.1 percent, as the effects of the water and electricity tariff reductions in, respectively, August and November of 2012 still weighed on the 12-month inflation rate (Chart 4). However, a reversal in the trend was noted as of August 2013, because the previously mentioned tariff reductions no longer slowed down the general price level. This allowed the 12-month average inflation rate to slowly pick back up, but these increases were not enough to bring the inflation rate out of negative territory. Other components in the inflation basket remained more or less neutral, suggesting that demand was still insufficient to induce upward price pressures, as the economy is still below its potential output. All in all, the average inflation reached -2.4 percent in 2013, while the average core inflation reached 0.2 percent in 2013. The latter reflected marginal average price increases in the components of beverages and tobacco products, restaurants and hotels, and miscellaneous goods and services.

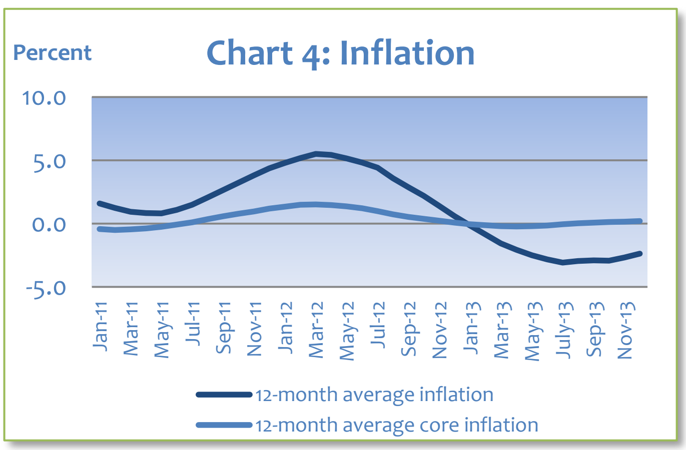


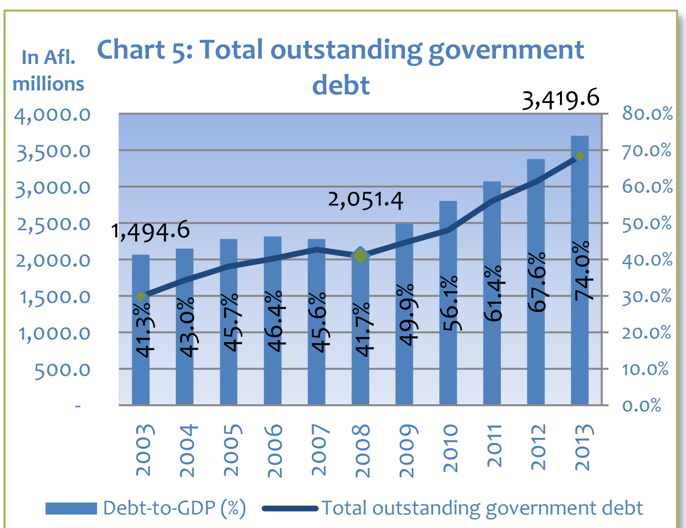
Chart 4: Inflation

III. Fiscal developments

Despite better economic performance, government finances remained vulnerable in 2013. Relative to 2012, total government revenue registered an Afl. 122.2 million (+12.0 percent) expansion to Afl. 1,142.9 million in 2013. This increase was brought about, for the most part, by a growth in non-tax revenue (+Afl. 100.0 million), attributed mostly to incidentals, such as the partial payment received for the sale of the hospital in 2012, dividend payments received, and a one-off contribution of the Dutch government to the development fund (FDA). In addition, tax revenue rose by Afl. 22.1 million reflecting gains in all components, except for taxes on income and profit. The latter fell slightly by Afl. 7.5 million, due to drops in the wage tax (-Afl. 8.9 million) and income tax (-Afl. 1.6 million), that were partially offset by the rise in profit tax (+Afl. 3.0 million). The drop in wage tax was due to the incidental lay-off package received by former employees in the oil sector in the last quarter of 2012. The increase in the tax revenue was mainly the result of increases in import duties (+Afl. 11.5 million), in part as a result of increased consumption, and taxes on services (+Afl. 8.6 million). When compared to the amended government budget approved in Parliament in December 2013, realized total government revenue fell below the budgeted amount (-Afl. 29.6 million), due to lower than expected tax revenues (-Afl. 49.0 million), partly compensated by higher than projected non-tax revenues (+Afl. 19.4 million). The shortfall in realized tax revenue was largely the result of lower than budgeted wage tax, turnover tax, and excises. On the other hand, the higher nontax revenue was mainly due to the incidentals mentioned above.

Government expenditures were somewhat higher than a year earlier. Total expenditures on a cash-adjusted basis amounted to Afl. 1,437.1 million in 2013, an increase of 1.7 percent (+Afl. 24.4 million) in comparison to 2012. The rise in expenditures was mainly attributed to higher interest costs (+Afl. 18.0 million) resulting from an increasing debt burden. Also, the expansion in personnel-related expenses (+Afl. 14.2 million), higher goods and services costs (+Afl. 16.5 million), and increased investment outlays (+Afl. 4.7 million) pushed up total expenditures. Lower transfers to the AZV (-Afl. 10.2 million) and a drop in items not included elsewhere (-Afl. 1.3 million), partially offset the growth in expenditures.

The significant gain in total government revenues in 2013 helped to lower the government deficit relative to 2012. The government registered an Afl. 331.8 million deficit in 2013 (7.2 percent of 2013 GDP), an Afl. 84.3 million reduction from the Afl. 416.1 million deficit recorded in 2012 (9.2 percent of 2012 GDP). However, the realized 2013 deficit was higher than the budget deficit approved by parliament in December 2013 (Afl. 308.2 million). Persistent gaps between government revenues and expenditures as well as adverse economic conditions have led to a growing government debt burden in recent years. Government debt reached a record high of Afl. 3,419.6 million in 2013 or 74.0 percent of GDP (Chart 5), up from Afl. 3,067.8 million in the previous year (67.6 percent of 2012 GDP). This increasing debt burden may render government finances unsustainable in the future (see Box 1). A high debt level impairs the government's ability to respond effectively to future economic shocks and adverse events, thereby exacerbating the economy's vulnerability to shocks, such as interest rate hikes and economic contractions. However, the efforts already undertaken by the government to achieve fiscal sustainability, such as the Balanced Budget Agreement and recent tax reforms, are not only commendable, but also highly necessary (see Box 2). In addition, the recent reforms in the general old age pension scheme (AOV) help to reduce fiscal risks and strengthen government finances. Nonetheless, in view of the fiscal consolidation necessary for the government to achieve a balanced budget, it is crucial that the government continues



its efforts to put government finances on a sustainable path in the medium to long term. Further reforms in the social security and the general health insurance system are also necessary to reach this goal.

Box 1: Balanced Budget Agreement

In November 2013, the ministers of the new government signed a protocol with regard to the budgetary policy for the period 2013-2017. The objective of this protocol is to gradually reduce the government financial deficit until reaching a balanced budget in 2016. The intention is to incorporate the latter rule in the Constitution. The government intends to implement a trend-based budgetary policy containing the following main provisions:

1. Separation of government revenues and expenditures implying, on the one hand, that revenue windfalls may not be used for additional spending and, on the other hand, that spending need not be reduced if there are revenue setbacks.
2. A nominal expenditure ceiling of Afl. 1,350 million for the whole term of the new government; in this context, further reforms in the social security and pension systems will be discussed in the Social Dialogue. Windfalls on the expenditure side may be used for compensation of expenditure setbacks, but not for new policy.
3. Meeting setbacks in a ministry within the ministry's own spending limit.
4. A minimum level of government revenue of Afl. 1,150 million in 2014, increasing in line with economic growth in the following years.

Source: "Balanced Budget Akkoord, protocol inzake het begrotingsbeleid 2013-2017 van het Kabinet Mike Eman II van 5 November 2013."

Box 2: Defining fiscal sustainability

Sound or sustainable public finances can be defined in several ways. For instance, a straightforward way to define fiscal sustainability is a situation in which the ratio of government debt to GDP is stable or moving down over the longer term (Bernanke, 2011)[a]. The International Monetary Fund (IMF, 2007) states that a set of policies is sustainable if a borrower is expected to be able to continue servicing its debt without an unrealistically large future correction to the balance of income and expenditure[b]. In spite of diverse definitions of fiscal sustainability, broad consensus exists that fiscal sustainability entails fiscal policies that sustain economic growth[c], maintain solvency (implying that the government can continue servicing its public debt without requiring an unrealistically large correction to its future revenues or primary expenditure path), create stable taxes, and are fair across generations (Schick, 2005)[d]. However, in a small and open economy with a fixed exchange rate, the key element of fiscal sustainability is the foreign exchange constraint (Belgrave et al., 2011)[e].

The foreign exchange constraint denotes that a minimum level of reserves is needed to stabilize market expectations about the exchange rate. According to Belgrave et al. (2011), it is the one criterion that truly determines fiscal stance, since this limit kicks in far sooner than any overall limit of the ability to service the overall debt. For example, fiscal deficits can become unsustainable much earlier than reaching any prudent debt to GDP ratio if the debt service requirements deplete the country's foreign exchange reserves. Moreover, dwindling reserves could create uncertainties about the stability of the exchange rate, leading to capital outflows and the inability to (re)finance loans on the international capital market.

[a] Bernanke, B. S. (2011). Fiscal Sustainability. Annual Conference of the Committee for a Responsible Federal Budget. Washington D.C.

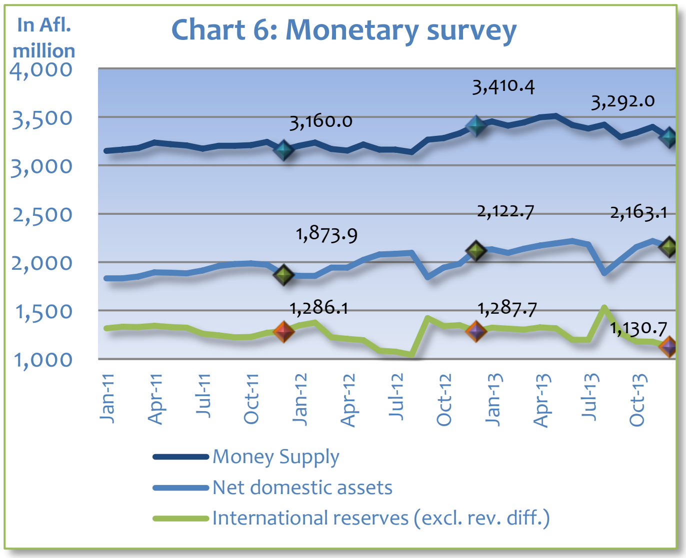
[b] IMF. (2007). Manual on Fiscal Transparency. Glossary. Washington D.C.: International Monetary Fund.

[c] For the specific case of the Caribbean region, Greenidge, Graigwell, Thomas, and Drakes (2012) conclude that public debt beyond the 55 percent of GDP threshold becomes a drag on economic growth. Greenidge, K., Thomas, C., Drake, L., & Graigwell, R. (2012). Threshold Effects of Sovereign Debt: Evidence from the Caribbean. International Monetary Fund working paper.

[d] Schick, A. (2005). Sustainable Budget Policy: Concepts and Approaches. OECD JOURNAL ON BUDGETING, 107-126.

[e] Belgrave, A., LaCorbiniere, J., Worrel, D., & Applewhaite, D. (2011). Fiscal Sustainability in an Open Economy with an Exchange Rate Peg. Options for the Caribbean After the Global Financial Crisis. Bridgetown, Barbados.

IV. Monetary developments



Monetary developments in 2013 were dominated by developments in the net foreign assets. Money supply decreased by Afl. 118.4 million (-3.5 percent) to Afl. 3,292.0 million as a result of a net outflow of foreign funds brought about, for the most part, by the external transactions of the oil sector (Chart 6). The suspension of refining operations of the oil sector resulted in significantly lower exports and imports related to the refining activities. Nonetheless, the imports of fuel oil and gasoline for domestic use, combined with the lower exports, resulted in a net outflow of foreign funds by the oil sector. The latter net outflow resulted in a fall in the net foreign assets (excluding revaluation differences of gold and foreign exchange holdings) of Afl. 157.0 million to Afl. 1,130.7 million, as opposed to a marginal increase of (+Afl. 1.6 million) in 2012. The net foreign assets (including revaluation differences of gold and foreign exchange holdings) have been showing a downward trend since February 2012, interrupted only by the inflows following several external bond issues by the government. Nonetheless, as per December 2013, net foreign assets (including revaluation differences of gold and foreign exchange holdings) remained at an adequate level when benchmarked against the critical norms used by the CBA to assess the adequacy of the NFA, including the number of months of current account payments covered by the net foreign assets.

On the other hand, net domestic assets recorded an expansion of Afl. 38.6 million, to Afl. 2,161.3 million, which partly offset the drop in net foreign assets. The smaller growth in domestic assets in 2013, when compared to 2012 (+Afl. 248.8 million), was due mainly to the drawing down of government deposits held at the commercial banks in 2012 (Afl. 140.9 million withdrawal), while in 2013 government deposits grew by Afl. 28.5 million. The rise in net domestic assets was brought about by a rise in claims of the banking sector on the private sector of Afl. 142.7 million, which was partly mitigated by the mentioned growth in government deposits and other domestic factors. The private sector expansion edged up chiefly by increased commercial loans (+Afl. 90.8 million) and housing mortgages (+Afl. 55.4 million), while growth in consumer credit fell marginally (-Afl. 0.4 million).

In 2013, the Monetary Policy Committee (MPC) maintained both the reserve requirement and the advance rate unchanged. The MPC of the CBA held six meetings throughout the year, and the decisions to keep these rates unchanged at, respectively, 11 percent and 1 percent were based on available domestic indicators and developments in the international economic environment at the time. The committee also took into consideration that net foreign assets continued at an adequate level when benchmarked against GDP and money supply, as well as the number of months of current account payments covered by the net foreign assets throughout the monitored period. Furthermore, domestic price pressures remained muted, while domestic credit growth remained within acceptable levels.

The quality of the commercial banking sector's loan portfolio remained on average more or less the same in 2013. The average nonperforming loan (NPL) ratio increased marginally to 7.4 percent from 7.3 percent in 2013, still remaining well below its peak in 2010 (average NPL 9.4 percent). The NPL ratio fluctuated between 6.9 percent and 8.4 percent throughout the year, closing the year at 7.0 percent. This ratio has been showing a decreasing trend since its peak in January 2011 (10.9 percent). However, in the beginning of 2013 it began exhibiting an increasing pattern, reaching its highest point at 8.4 percent in May 2013. Afterwards, it continued to drop steadily, reaching 7.0 percent at the end of 2013. The decrease was attributed to repayment on loans, as well as the restructuring of certain NPL's.

Other prudential indicators remained adequate throughout 2013. The banks' risk-weighted capital asset ratio stood at 22.7 percent in the fourth quarter of 2013 (required minimum=14.0 percent), up from 19.4 percent in the same period of 2012. The loans-to-deposit ratio was 72.9 percent (maximum=80.0 percent) in the last quarter of 2013, higher than in the relevant period of the previous year (2012-Q4: 68.2 percent). On the other hand, the prudential liquidity ratio of the commercial banks decreased for the fourth consecutive quarter, reaching 24.3 percent (minimum requirement=15.0 percent) in the final quarter of 2013 (2012-Q4: 27.6 percent).

V. External sector developments

The developments in international reserves resulted from the transactions in the balance of payments (BOP). In 2013, the BOP, which records the economic transactions between Aruba and the rest of the world, registered an Afl. 157.0 million deficit, mainly as a result of the deterioration of the current account balance, which was partly mitigated by a surplus on the financial account.

The current account recorded an Afl. 592.9 million deficit in 2013, compared to an Afl. 158.9 million surplus in 2012. This increased deficit was attributed mostly to lower exports in the oil sector, as in the first quarter of 2012 the refinery was still operational. Oil exports had been decreasing since the fourth quarter of 2011, as narrowing sour crude oil differentials hurt the refinery's profitability and in turn its output. This situation ultimately led to the decision to cease refining operations at the end of March 2012. In addition, higher imports of goods by the non-oil sector (+Afl. 102.0 million), as a result of increased domestic and tourism demand, contributed to the deficit. On the other hand, the Afl 164.5 million (+6.6 percent) increase in tourism receipts contributed positively to service exports and mitigated to some extent the worsening of the current account. Nonetheless, the rise in resident tourism travel payments abroad (+Afl. 70.0 million), along with higher government services payments (+Afl. 18.3 million), partly offset this gain in tourism receipts.
The capital and financial account posted a surplus of Afl. 443.4 million in 2013 (2012: Afl. 156.4 million deficit). This surplus was mainly the

result of an Afl. 397.3 million net inflow of direct investment in 2013, as opposed to an Afl. 571.5 million deficit in 2012. The decrease in payments on trade credit received in the oil sector largely led to this turnaround in direct investment. Portfolio investment recorded a net inflow of Afl. 128.8 million in 2013 (2012: Afl. 262.4 million) due to the foreign bond issue by the government (Afl. 411.8 million). The net inflow on the portfolio account was lower in 2013 than in 2012 due to the lower external borrowing of the government (2012: Afl. 445.8 million) as well as higher repayments on government foreign bonds. Furthermore, other investment posted a deficit of Afl. 88.9 million in 2013, while recording an Afl. 147.6 million surplus in the corresponding period of 2012. This reversal was the result of trade credit repayments received by the oil sector in 2012 that did not occur in 2013.

The current situation of the balance of payments is unsustainable in the long run. In the past, refining activities of the oil sector contributed positively to the overall balance and were sufficient to compensate for the oil imports for domestic use. However, the transshipment operations, which have replaced refining activities, are conducted on a much smaller scale and do not generate nearly as much foreign exchange. Hence, the inflow of foreign exchange from transshipment activities is not sufficient to compensate for the outflows related to the imports of oil products for domestic use. The result is a net outflow of foreign funds in the oil sector and a negative effect on the overall balance. The island's domestic demand for oil is thus felt more significantly in the absence of refining operations. It is of the utmost importance to find structural policy solutions to correct this imbalance in the balance of payments. For example, reducing Aruba's dependency on oil is one aspect that must be addressed diligently to attend to the significant outflow of foreign exchange due to the closure of the oil refinery.

VI. Conclusion

A strong performance in the tourism sector drove the expansion in the Aruban economy in 2013, despite a contraction in investments and higher import levels. Nonetheless, the state of the economy remains delicate since the refinery ceased its refining operations in 2012. The tourism sector has been robust in the last couple of years; however, tourism is primarily dependent on two main markets, making it vulnerable to changes in demand from these markets. Furthermore, the rapid rise in government debt over the last few years is not sustainable in the long run, and the balance of payments has had a structural imbalance since the cessation of refining activity.

Going forward, it is important to continue the diversification efforts of the ATA, as well as try to target tourists with a higher spending pattern. In addition, the government has recognized the importance of reaching a balanced budget in the medium-term; however, further efforts are needed to render government finances sustainable in the future. Last, the imbalance in the balance of payments has to be addressed promptly by finding structural policy solutions to reduce the burden on the foreign reserves. Reducing Aruba’s dependency on oil, as well as building additional economic pillars, are key priorities for Aruba’s economic resiliency in the future.