DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

MASTER FILES
ROOM C-130

0401

SM/88/250

CONTAINS CONFIDENTIAL
INFORMATION

November 15, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Kingdom of the Netherlands - Aruba - Staff Report for the 1988 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with Aruba, which has been tentatively scheduled for discussion on Wednesday, December 14, 1988.

Mr. Riechel (ext. 4548) or Mrs. Liuksila (ext. 4547) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS - ARUBA

# Staff Report for the 1988 Article IV Consultation

Prepared by Staff Representatives for the 1988 Consultation with Aruba

Approved by Massimo Russo and J.T. Boorman

November 14, 1988

## I. Introduction

A staff team consisting of Mr. K. W. Riechel, Mrs. C. Liuksila, Mr. H. Bredenkamp, and Miss P. Emerson as secretary (all EUR), visited Aruba from October 12 to 19, 1988 to conduct the 1988 Article IV consultation discussions. In January 1986, Aruba became separated from the Netherlands Antilles and acquired independent status (status aparte) within the Kingdom of the Netherlands with complete monetary and fiscal autonomy.

During the mission the staff met with the Prime Minister, Mr. Eman, other members of the Government, the Governor of the Central Bank, Mr. den Dunnen, and representatives of the Administration and the Central Bank. Mr. G. A. Posthumus, Executive Director for the Netherlands, attended the principal policy meetings as an observer. At the conclusion of the previous consultation with Aruba (EBM/86/186; 11/21/86) Directors commended the authorities for their adjustment efforts but recommended that fiscal policies place a stronger emphasis on expenditure-reducing measures. Directors also felt that continued control of labor costs would be important to promote investment in tourism and the needed diversification of the economy. Directors welcomed the Central Bank's efforts to foster confidence in the new currency.

## II. Background

The economic fortunes of Aruba have taken a decisive turn for the better over the past two and a half years. At the start of status aparte in 1986, the economic situation was desperate and the outlook unpromising. The Lago oil refinery, which had in good years accounted for more than one third of government revenue and about 50 percent of foreign exchange earnings, had shut down; the tourism sector was in a slump owing to the sharp drop in Venezuelan tourists; the unemployment rate had risen to around 20 percent, despite a reduction of the labor force by almost 10 percent owing to emigration; the current account of the balance of payments had swung from a large surplus to a sizable deficit, and the budget deficit had almost doubled to an estimated 7 percent of GNP in 1985.

Against this background, the authorities implemented a series of major reforms. The centerpiece of these was a fiscal adjustment package, designed by a Fund staff team, and supported by financial assistance of f. 100 million from the Netherlands. The package was intended to restore fiscal balance by 1988. With extensive technical assistance from the Fund, a central bank was created and a new currency, the Aruban florin, was issued. The development strategy focused on the island's comparative advantage in the tourism sector and involved considerable government guarantees and an expansion of tourism infrastructure. Moreover, substantial wage cuts restored the competitiveness of the crucial tourism sector. These swift and decisive measures were instrumental in restoring confidence and in attracting foreign investors to Aruba.

The results have been truly impressive. After a sharp decline in 1985 and stagnation in 1986, real GDP growth in 1987 is estimated at around 14 percent (Chart 1). Over the last two and a half years a 50 percent expansion in tourism capacity to some 3,100 hotel rooms has been achieved and, thanks to effective promotional efforts, the number of visitor nights has kept pace with the increase in capacity. As a result, employment in construction and in the tourism sector increased sharply. Unemployment is estimated to have dropped to about 5 percent. Another positive effect has been the strong rise in net foreign reserves which increased between early 1986 and mid-1988 by more than Af. 100 million to Af. 150 million, or some four months of merchandise imports.

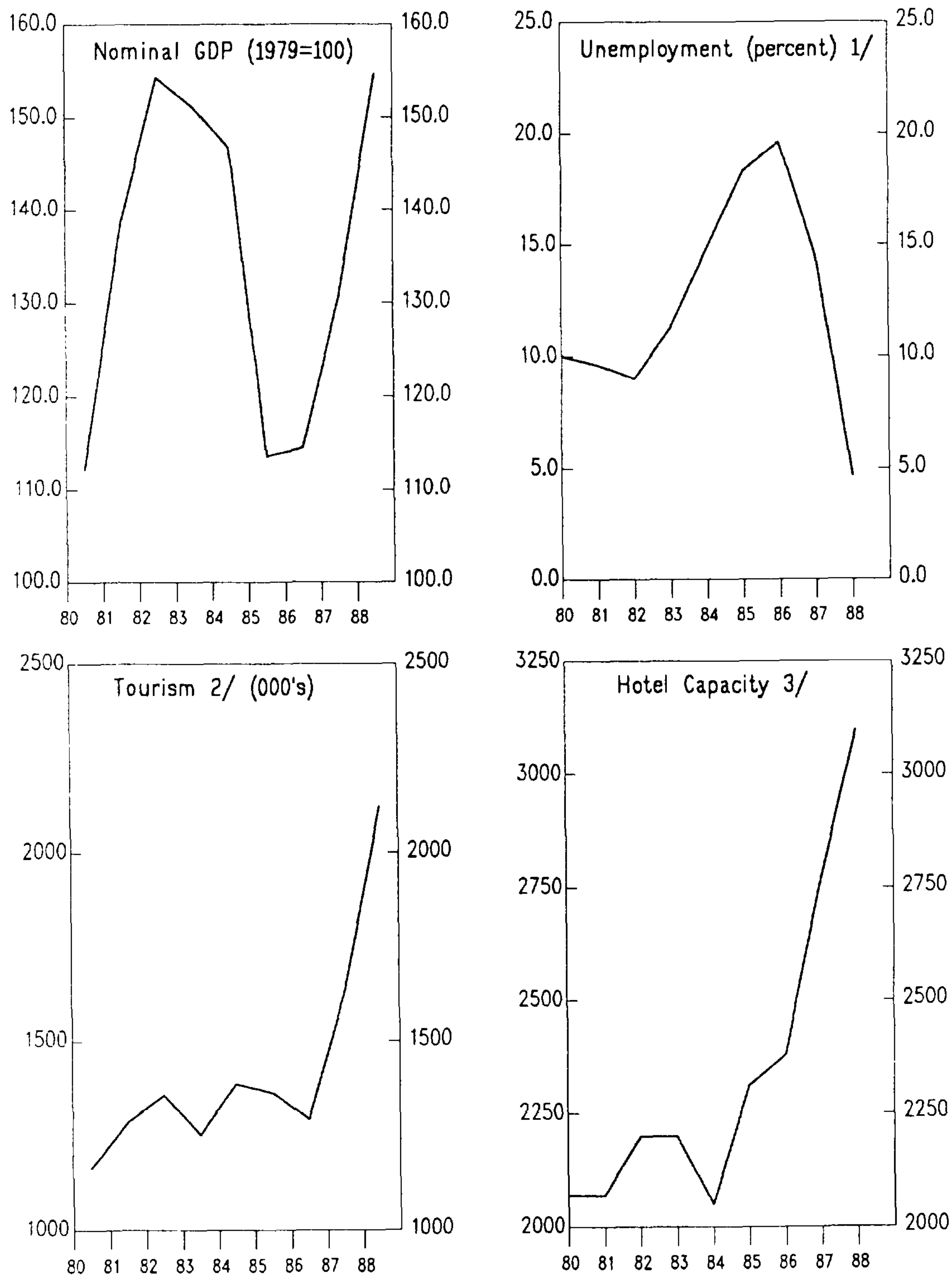
More recent developments point to increasing strains in the economy owing to the burst of activity. The dynamic growth of demand and imports has resulted in foreign reserve losses despite the exceptionally strong inflow of foreign exchange as a result of the foreign-financed construction boom and an unusually strong tourism season. In the labor market, some 400 unfilled vacancies (1 3/4 percent of labor force) are reported although difficulties in filling jobs in key sectors are just beginning to appear. As to price developments, inflationary pressures have not made themselves felt yet. The Aruban florin remains pegged to the U.S. dollar and consumer price inflation has followed closely developments in the United States, the dominant trade partner. Competitiveness remains stronger than it was some two to three years ago because of wage cuts of 30 percent and more in some sectors during 1985/86, and owing to the decline in the effective exchange rate in line with the U.S. dollar. Wage costs have so far shown only a moderate upward trend. However, wage claims in the construction sector, the sector in which labor shortages are most acute, are reported to have stepped up considerably.

Financial policies have contributed to the emerging strains in the economy. After an initial tightening in connection with the adjustment program of 1985/86, policies became increasingly expansionary and remained so until recently despite the surge in private sector activity. Fiscal policy in particular has become strongly

CHART 1

ARUBA

# Indicators of Activity




Sources: Dept. of Economic Affairs and staff estimates

1/ 1983 to 1985 represent estimates

2/ Number of overnight stays.

3/ Number of available hotel rooms

expansionary. Few of the expenditure reducing measures specified in the fiscal adjustment program for 1987/88 have been implemented. Moreover, a number of new priority areas have received substantial increases in budgetary allocations. Further, the "solidarity tax" on incomes that formed part of the adjustment program was halved to 4.1 percent in January 1, 1988. More recently, import duties on selected consumer durables have been lowered. As a result of these measures, the fiscal deficit more than trebled to 13 1/2 percent of GDP in 1987 and, excluding Dutch financial assistance, is expected to remain in 1988 more than twice as high as it was in 1986, despite a considerably more favorable economic climate. 1/

Monetary policy has also been quite expansionary, with both money and credit growth accelerating to above 40 percent in 1987, in part because of the rapid growth of consumer loans (Chart 2). To curtail monetary expansion, but also with a view toward fostering the emergence of short- and long-term financial markets, the Central Bank has encouraged the authorities to float Treasury bills and government bonds. However, given the large liquid reserves of banks with the Central Bank, this has resulted primarily in a portfolio shift. In early September 1988, the Central Bank therefore issued a directive for a curbing of bank lending to the private sector. This is expected to reduce the growth rate of bank lending to an average of 15-16 percent in 1988, roughly in line with nominal GDP growth and to halt the decline in foreign exchange reserves which began in May.

The economic outlook appears promising. A total of 3,400 hotel rooms, with an estimated value of some US$380 million or more than 60 percent of 1988 GDP, are under construction or consideration. Should all of these projects come on stream, hotel capacity would more than double again by 1991. Moreover, a number of projects in other areas, including transshipment, offshore banking, and some light manufacturing are under preparation. With these developments, real GDP can be expected to rise by some 35 percent during the coming four years with favorable consequences for employment, foreign exchange earnings, and the public finances. 2/ In fact, there is now more of a concern about absorptive capacity than about economic growth.

## III. The Policy Discussions

The staff mission discussed with the authorities two principal challenges they face over the next several years. The first and foremost of these is the short-term management of an economy that already shows signs of overheating. The second is the design of a

---

1/ For a detailed examination of the fiscal accounts and the importance of special factors see the accompanying Recent Economic Developments paper.

2/ Two medium-term scenarios that bear out these results are presented in Appendix I of this staff report.

long-term economic strategy that balances the requirements of comparative advantage with those of diversification while taking into account the resource constraints facing the island. The staff also discussed a third subject, tax reform, which had been brought up by the authorities.

1. Short-term demand management

The staff suggested that a shift in financial policies from stimulus to restraint was urgent. The ongoing expansion of both demand and imports was unsustainable. The staff also felt that emerging resource constraints, especially in the labor market, demanded immediate attention. Current labor shortages were just the beginning of an increasingly tight labor market. By 1990, at the height of the construction boom, some 4,000 additional workers would be needed to accommodate the demand for additional labor. While wage demands had so far turned out to be moderate, it was by no means assured that they would remain so in a situation of excess demand for labor of such proportions. It was imperative that all efforts be made to prevent an erosion of competitiveness and to assure that no resources would be diverted from the critical tourism sector.

The authorities agreed that there was a danger of overheating, and pointed to a number of restraining measures that had already been taken or were under consideration. First and foremost, they would cease to grant incentives (tax holidays and loan guarantees) for new hotel projects and would seek to phase construction activities. The biggest problem in this context was the current and prospective bottlenecks in the labor markets. A number of initiatives were underway to address this problem. First, the public sector's temporary work scheme (TAV) had been eliminated, releasing some 350 persons. Second, a strong effort to repatriate Arubans from the Netherlands was in full swing; some 400 workers had already signed up and a total of 1,000 could be expected over the next 12 months. Similar efforts were underway in St. Maarten and Curaçao. Third, various attempts would be made to raise female participation rates, including the expansion of day-care centers. Fourth, a voluntary redundancy program and a reduction in the normal retirement age for civil servants would release additional manpower for private sector activities. Finally, a scheme to obtain foreign construction workers on a temporary basis was being considered.

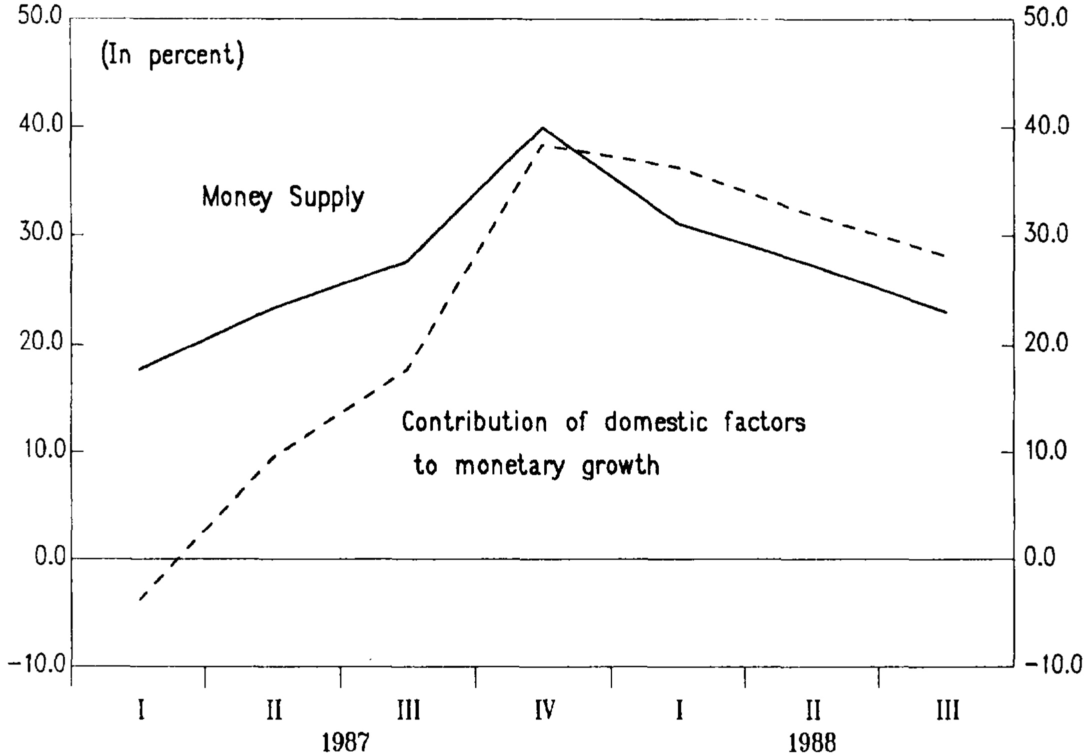
The staff welcomed these initiatives but felt that their success was less than assured. The challenge to tackle the labor market bottlenecks over the next several years was a tall order and, in any event, did not permit a policy-induced expansion of activities that would compete for scarce resources.

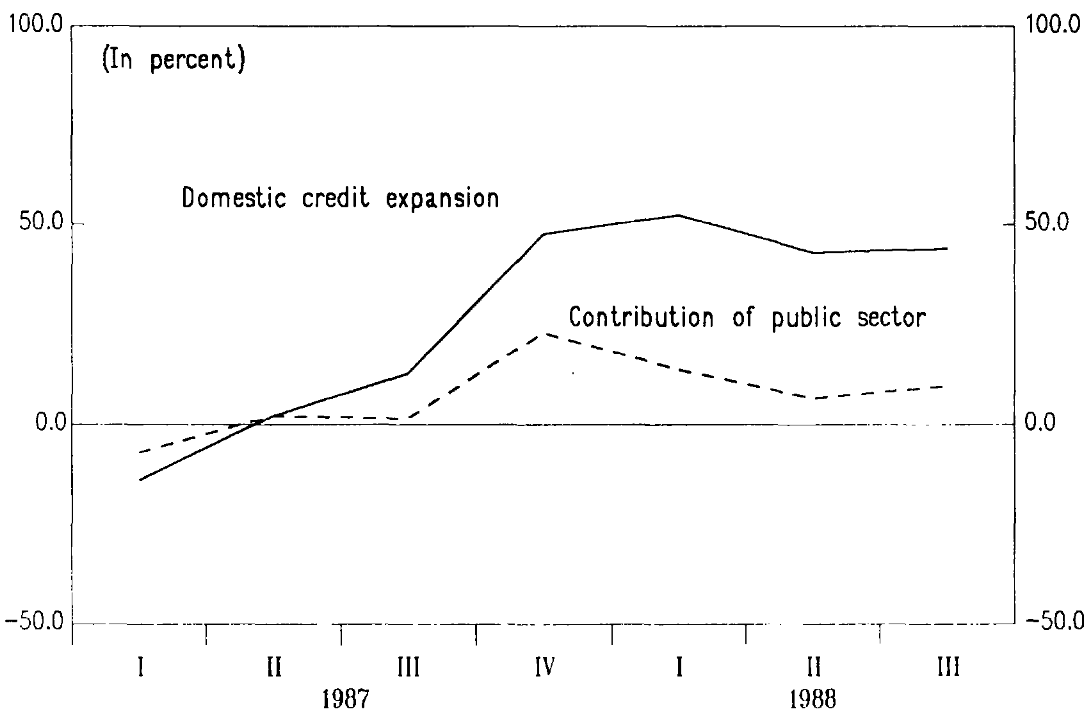
The authorities agreed that fiscal policy had been exceptionally expansionary in 1987, and that it had remained more expansionary in 1988 than planned. As regards 1987, they felt that the economy needed stimulus to overcome the severe recession. Moreover, a number of recent

CHART 2

ARUBA

# Monetary Developments 1/




Source: Central Bank of Aruba

1/ Percentage change over same period year earlier.

expenditure increases had been dictated by circumstances. For example, the boom in hotel construction had required a number of infrastructural measures, including an increase in promotional efforts to fill hotels. The Government had also sought to upgrade efficiency by hiring additional highly qualified staff and by office automation. However, a number of expenditure-reducing measures had also been taken. These included in particular the elimination of the temporary work scheme, reductions in staff at the lower end of the pay scale (some 100 jobs), cuts in selected current expenditure items, and the postponement of a number of investment projects. Moreover, expenditure control was being enhanced and the functioning of departments being screened.

As regards 1989, the authorities acknowledged that the budget would again turn out to be expansionary, with the deficit rising from Af. 27 million in 1988, to Af. 46.2 million in 1989, essentially because of the elimination of the solidarity tax, which added some Af. 18 million to the deficit. On the other hand, revenues had been estimated very conservatively and it was expected that the cash deficit would drop from Af. 75 million in 1988 to Af. 50 million in 1989. If so, fiscal policy would turn out less expansionary than indicated by the budget for 1989. Finally, it was the intention of the authorities to reach budgetary balance by 1990.

The staff maintained that fiscal policy was too expansionary for the current and prospective conjunctural situation. Even with a strong endogenous revenue response, the cash deficit of the Government was likely to remain in the neighborhood of 6 percent of GDP. This net absorption of resources was too high given the dynamic growth of private sector activities. Moreover, in a number of areas, the government sector still needed trimming and streamlining. For both of these reasons, expenditure decisions--current and budgeted--needed to be reviewed carefully and every opportunity for cuts or postponement of current and capital expenditure needed to be explored. In addition, expenditure control had to be tightened considerably, as was apparent from the large overshooting in 1987 and 1988. The reassessment of the fiscal stance also needed to apply to the revenue side. Several recent measures were clearly at odds with the need to curb spending and the inflation of aspirations. These measures included in particular the decision to lower import duties on consumer electronics and the planned elimination of the solidarity tax, effective January 1, 1989. Together these measures injected stimulus equivalent to as much as 1 1/2 to 2 percent of GDP into the economy. In fact, given the absence of a sales tax and given also the inapplicability of the usual protectionist arguments (since there is little domestic production of commodities), an increase rather than a reduction in selected import duties would have been more appropriate, and should be seriously considered. The authorities explained that the reduction of import duties had been primarily motivated by the concern to stimulate tourism. They also stated that the decision to eliminate the solidarity tax was irreversible, as it had already been postponed by a year.

In the area of monetary policy, the most important measure to control overheating of the economy had been the recent introduction of credit guidelines, the authorities said. This measure was expected to reduce sharply the expansion of credit to the private sector. The guidelines called for a reduction in the growth of bank lending to enterprises, financial institutions, and individuals to 5 percent in the second half of 1988 against a growth of 32 percent in the preceding 12 months. As part of the guidelines, bank loan commitments had been frozen at the end-August 1988 level. However, banks would be allowed to honor their commitments to the extent that these were financed by longer-term foreign resources. Banks had been asked to hold back especially on consumer loans. While the credit guidelines were a gentlemen's agreement and not part of the legal instruments of the Central Bank of Aruba (CBA), the measure could be supported by government decree if this became necessary. The credit guidelines would probably be renewed in 1989, as economic activity was likely to remain buoyant and demand unduly strong.

The staff welcomed the decision to restrain monetary expansion but questioned whether credit control measures were the best means to control spending over the medium term. In particular, if credit controls were applied over a longer term, this would tend to impair an efficient allocation of credit and engender financial disintermediation. Moreover, credit controls would hamper rather than foster the strengthening of savings, not least because competition between banks for deposits would evaporate at a time when several new banks had just started to fight aggressively for market shares. These problems could be avoided if policies relied instead on a combination of tighter interest rate management and an active use of required reserves of banks. An easing of the restraint of banks' maximum net foreign asset positions (the so-called B-9 position) could also be helpful to the extent that banks' investment portfolios would be shifted to foreign assets.

The authorities of the CBA believed that, despite the de facto capital controls in the form of the B-9 position, a small country like Aruba had little scope for an independent interest rate policy. They also doubted that increases in the official interest rates would lead to higher deposit and lending rates, and thus stimulate savings and curtail credit demand. They agreed, however, that credit control measures were a second-best solution and hoped to ease them to the extent that the fiscal position improved. As to influencing domestic credit supply through a change in banks' maximum net foreign asset position, an increase in the B-9 position was not currently contemplated given the recent drop in official reserves. More generally, the authorities felt that most of the foreign exchange reserves of the country should be held by the CBA. This position was not in conflict with the liberal approach to foreign exchange transactions that would remain intact.

## 2. Medium-term economic strategy

The authorities explained that their medium-term strategy was now firmly oriented toward achieving a greater degree of diversification of the economy. A fully satisfactory growth of tourism arrivals was assured and no further hotel projects would be sought for the time being. A stabilization of tourism revenues was actively being pursued through regional diversification and an upgrading of tourism facilities, with its related broadening of income strata and reduction in the income elasticity of tourism earnings. Attention was therefore increasingly turning to other areas where several projects were under preparation that would over time reduce the dependence on tourism. Some of the more important projects under consideration included the use of the harbor facilities of the now closed refinery for transshipment; the enlargement of the free zone; the establishment of Aruba as a financial centre, partly through the establishment of new tax-free offshore banking activities (AVV); the setting up of communications services; the creation of some light manufacturing; and the sale of oil exploration rights.

The staff questioned whether all of these projects could be pursued simultaneously without diverting much-needed resources from the critical tourism sector, especially during the construction phase. The authorities felt confident that they could ensure sufficient labor supply. They recalled the steps they had already taken in this area (see above). For construction workers their preference was for temporary foreign workers for whom no permanent economic and social infrastructure had to be built up. As to other potential bottlenecks, the airport's capacity would be increased through the planned extension of the runway (for which the financing was assured). It was true that sufficient air transportation for an expanded tourism capacity was not yet assured, but the authorities were confident that this could be achieved. They were also confident about the supply of water and electricity. Capacity constraints in water supply would probably not be reached before mid-1990. Electricity supply was assured, although it needed to be upgraded. Taking the two together, investments of some Af. 150 million would become necessary over the next several years.

The staff shared the authorities' concern regarding the island's dependence on tourism. Tourism was a source of income that was potentially volatile given its traditionally high income and price elasticities. 1/ The problem of volatility was aggravated by the great volume of government guarantees on hotel projects. The staff therefore welcomed the authorities' search for a diversification of sources of income. The staff felt, however, that the small size of the island and its severe resource constraints limited the scope for economic

---

1/ An evaluation of income and price elasticities in tourism is contained in Appendix I of the accompanying Recent Economic Developments paper.

diversification. Nor was it evident that Aruba possessed a comparative advantage in areas outside tourism. In such a situation, the promotion of economic diversification was likely to entail inefficiencies and possibly the need for protection and government support. On the basis of this reasoning, the staff therefore explored whether the economic diversification pursued by the authorities should not be supplemented by "income diversification." Income diversification would take the form of financial contingency reserves invested in such a way that returns would have a low or inverse correlation with incomes generated on Aruba, notably incomes in tourism. 1/ The building up of such contingency reserves would require the generation of private and public sector savings. If this could be pursued over the next several years, an added advantage would be that it would siphon off spending at a time when overheating was an obvious problem. Finally, the official pension schemes had large actuarial deficits for which provisioning was an obvious policy prescription. The staff calculated that, with policies which encouraged private and public sector savings, contingency reserves of about 17 percent of GDP could be built up over the period 1989-92. 2/

The authorities felt that the idea of income diversification was worth exploring, although it could not be considered a longer-term substitute for economic diversification. Some felt that a building up of official foreign exchange reserves to about six months of imports--against a current unofficial target of three months--could be part of such a process. However, more thought had to be given to this subject, which could also encompass new thinking about supplementing existing social insurance schemes and about fiscal and monetary incentives to private savings. Finally, to the extent that current efforts to refinance government guaranteed debt yielded tangible results, the high risk involved in tourism expansion could be reduced.

### 3. Other subjects

Turning to tax reform, the authorities explained that they were seeking a reform of the present tax system with the objective of simplifying it, taxing tourism expenditure at a higher level, and making Aruba more attractive for foreign investment and perhaps also for settlement by foreigners. For an in-depth examination of options for tax reform, they had requested technical assistance from the Fund's Fiscal Affairs Department.

The staff welcomed the tax reform plans because the present system was indeed highly complex and placed too much emphasis on direct taxes, notably on wage incomes. There were indications that the high rates and

---

1/ A note on the staff's concept of "income diversification" is given in Appendix II of the accompanying Recent Economic Developments paper.

2/ For a presentation of these calculations, see the medium-term scenarios in Appendix I of this Staff Report.

the steep progressivity of direct taxes had begun to negatively affect work incentives and that the modest size of indirect taxes had undermined savings. A correction of these disincentives would be highly desirable because it would support the needed cooling of demand and alleviate the tightness in the labor markets. As to an increase in revenues, the staff felt that a first line of action should be the elimination of tax holidays and other tax breaks because the economy did not need additional tax stimuli of this sort over the foreseeable future.

On exchange rate policy the authorities confirmed their intention to maintain the link with the U.S. dollar. This link had served the country well so far and did not threaten to impair competitiveness over the near future; indeed, the contrary was more likely. As to trade and exchange restrictions, the authorities reiterated their liberal approach. Most trade restrictions, which had been inherited as a result of their former link with the Netherlands Antilles, would be phased out. Existing regulations on current foreign exchange transactions would continue to be administered liberally and would not involve the Fund's jurisdiction.

## IV. Staff Appraisal

Over as short a span as two and a half years, the Aruban economy has turned around from bust to boom with growth rates now in double digits and unemployment virtually eradicated. This remarkable achievement can in large measure be ascribed to the swift and decisive adjustment measures that were taken by the authorities in 1985-86, notably the initial implementation of a strong fiscal adjustment program and the establishment of a credible and well-functioning central bank with a high degree of autonomy. Moreover, considerable wage concessions during 1985-86 have restored the island's competitiveness and have also contributed to the return of confidence.

The economic situation of Aruba is thus enviably good at present. However, such an environment is not without challenges. First, there is an urgent need for a shift in demand management from stimulus to restraint because expenditure and imports are growing at an unsustainable rate and labor market shortages are starting to put upward pressure on wages with consequent risks for the competitiveness of the economy. Swift and forceful monetary and fiscal policy measures are necessary if inflationary pressures with their attendant loss of competitiveness and employment are to be avoided. The implementation of a credit guideline is welcome under the current circumstances. If action is needed over a longer period, as seems likely, the use of discount and advances rates, backed up if needed by bank reserve requirements, would appear to be preferable.

The greatest need for a tightening of policy exists, however, with respect to fiscal policy. In the current economic situation the expansion of the fiscal deficit and the related claim on scarce resources remain too high. The same justification that may have existed for fiscal stimulus in 1986-87 is clearly calling for a sharp reduction in expenditure growth now. Furthermore, as the 1985-86 experience has proven, decisive action in financial policies is also important for international confidence. The failure to achieve a better financial balance may prejudice efforts to refinance the large government guaranteed debt. In this case a vicious circle of high deficits and high debt guarantee payments might ensue.

A number of welcome measures have already been taken but they remain clearly insufficient since the budget will remain expansionary in 1989 on both the revenue and the expenditure side if current budgetary intentions are actively pursued. On the revenue side, the intention to eliminate the solidarity tax, effective next year, and the reduction in import taxes on household electronics are at odds with the need for tighter demand management. In fact, the option of temporarily raising selected import duties for the control of excess spending should be given serious consideration. On the expenditure side, a considerable strengthening of monitoring and control throughout the year is urgently needed. Difficult choices will then have to be made about expenditure cuts. Even projects that in the long term are clearly desirable because they contribute to the diversification of the economy may have to be postponed. The emerging labor shortages are a matter of particular concern. Efforts undertaken so far to alleviate this problem are encouraging but are not likely to prove sufficient to allow for all activities to receive the same attention. The authorities must make their own contribution in this area by reducing the government payroll more quickly so as to release much-needed manpower for deployment in the private sector.

For the medium term, a principal challenge lies in the stabilization of income and foreign exchange earnings through the creation of a broader spectrum of foreign exchange earnings. The economy will remain susceptible to considerable swings in incomes because of its heavy reliance on the potentially volatile tourism sector. The attendant risks for the economy are aggravated by the large debt guarantees of the authorities for tourism projects. There is also a need to prepare for the inevitable downturn of activity after the hotel boom.

The authorities' efforts in promoting economic diversification are impressive and should show welcome results. It is, however, not obvious that Aruba possesses a comparative advantage in many areas outside tourism. Care has to be taken that new activities are competitive internationally without the need for protection and government support. Moreover, given the emerging resource constraints, the timing of diversification projects may have to be brought in line with realistic schedules. Finally, even with economic diversification, the economy will remain highly dependent on tourism.

The dependence on the potentially volatile tourism sector and the constraints on economic diversification argue for the generation of financial contingency reserves. Income diversification with its related broadening and stabilization of sources of incomes and foreign exchange earnings could be a useful complement to the ongoing economic diversification. A requirement would be the generation of public and private savings during years of strong economic growth. A tight fiscal policy over the next couple of years would also be helpful from a cyclical point of view. As to private savings, incentives need to be stepped up in a number of areas. This may have to include a more active interest rate policy but could also take the form of fiscal incentives. Finally, existing compulsory savings schemes such as social and health insurance schemes could be strengthened to raise the level of private savings.

The review of the tax system, which the Government has commissioned with a view toward raising efficiency and revenue, is welcome and necessary. Its principal intention should, however, not be to raise more resources but to correct the incentive system. Work and savings incentives need to be strengthened for both structural and cyclical reasons. In any event, care has to be taken to safeguard the competitiveness of the principal sectors of the economy.

The exchange rate link with the dollar has served the economy well and appears to be appropriate under current circumstances and over the foreseeable future. The staff welcomes the authorities' liberal approach toward trade and exchange restrictions on payments and transfers for current international transactions.

It is recommended that the next Article IV consultation with Aruba be held on a 24-month cycle.

## Aruba: Medium-Term Scenarios

### 1. Purpose

In addition to providing a medium-term projection for the economy of Aruba, this appendix attempts to assess the order of magnitude of contingency reserves that could be built up over the coming years if a policy of fiscal restraint and encouragement of private savings were to be pursued.

### 2. Framework 1/

Two scenarios are presented: a "baseline scenario" and a "stronger adjustment scenario." Both scenarios make the assumption that the current tax system with its relatively low income elasticities will remain in place 2/ and that the Aruban florin will remain pegged to the U.S. dollar at its current rate.

The key characteristic of the Aruban economy over the next four years through 1992 is the boom in hotel construction and the attendant increase in tourism and related services. Hotel rooms are expected to rise from about 3,100 in 1988 to 6,500 in 1992, involving a volume of construction of more than 60 percent of 1988 GDP. This expansion will result in a large increase in foreign exchange inflows, initially owing to construction activity and later as a reflection of the growth of value added in tourism. It is estimated that net foreign exchange earnings from the latter source will more than double between 1988 and 1992. The related rise in domestic incomes is expected to entail a substantial increase in domestic spending. However, for three reasons the upturn of domestic demand and imports is not expected to offset entirely the growth in foreign exchange earnings, even in the baseline scenario. First, the usual lags that follow a rapid expansion of incomes are expected to hold for private sector demand; second, past experience attests to an underlying positive savings propensity of Arubans; and third, the authorities' policy intentions about public sector deficit and spending do not seem to point to an increase in the

---

1/ Staff calculations are based on a small multiplier model. Results in this model are then checked against independent projections of detailed fiscal and current account balance tables. The solution to both is then found in an iterative process.

2/ This is a simplifying assumption because the nature and importance of the tax reform envisaged by the authorities is not yet known.

share of government expenditure in GDP; in particular, the low income elasticity of government revenue is fully borne out in the projection and serves as a constraint on spending. 1/

In contrast to the baseline scenario, the stronger adjustment scenario makes the assumption that the authorities will actively attempt to generate contingency reserves and to control potential overheating of the economy through a contractionary fiscal policy that increases taxes and curtails current and capital spending. 2/ Moreover, a considerable strengthening of the private sector savings motive through monetary and fiscal policy measures is expected to achieve a decline in the absorption propensity from 97 percent to 94 percent. Fiscal policy is projected to turn more expansionary again after the hotel construction boom of 1988-90, while private sector savings incentives are assumed to remain in place.

### 3. Results

Both scenarios suggest that, quite independent of economic policy measures, a rather strong cumulative growth of output can be expected for the period 1989-92 because growth is predominantly "exogenous" (Table 1). However, as hotel construction winds down and the rise in tourism levels out with no more hotels coming on stream, a significant slowing of real GDP growth or even a temporary decline is a distinct possibility, unless (a) additional activities can be attracted to the island; (b) hotel room occupation rates rise rather substantially; or (c) the import propensity of domestic demand drops significantly. None of these assumptions has been made.

In the baseline scenario, real GDP will grow by 33 percent over 1989-92. This growth is driven by a rise in the "exogenous" part of exports of goods and services (net) of more than 80 percent. However, owing to an initial large deficit and to the strengthening of domestic demand, the current account will only gradually move into a surplus and will be roughly in balance over the period 1989-92 as a whole. Small

---

1/ The following fiscal policy measures are assumed: (1) a faster and stronger reduction in government payroll than in the baseline scenario, such that by 1992 the number of government employees is reduced by 470 people, or some 10 percent of the staff, with most of the adjustment occurring during 1989-90; (2) a stabilization of purchases of goods and services during 1989-90 at the 1988 level and a more dynamic growth thereafter; (3) a phasing of capital spending with restraint during 1989-90 and expansion during 1991-92 and beyond; (4) an increase in selected import duties with an average effect of a 10 percent rise in rates; and (5) the postponement of the planned elimination of the solidarity tax to 1991.

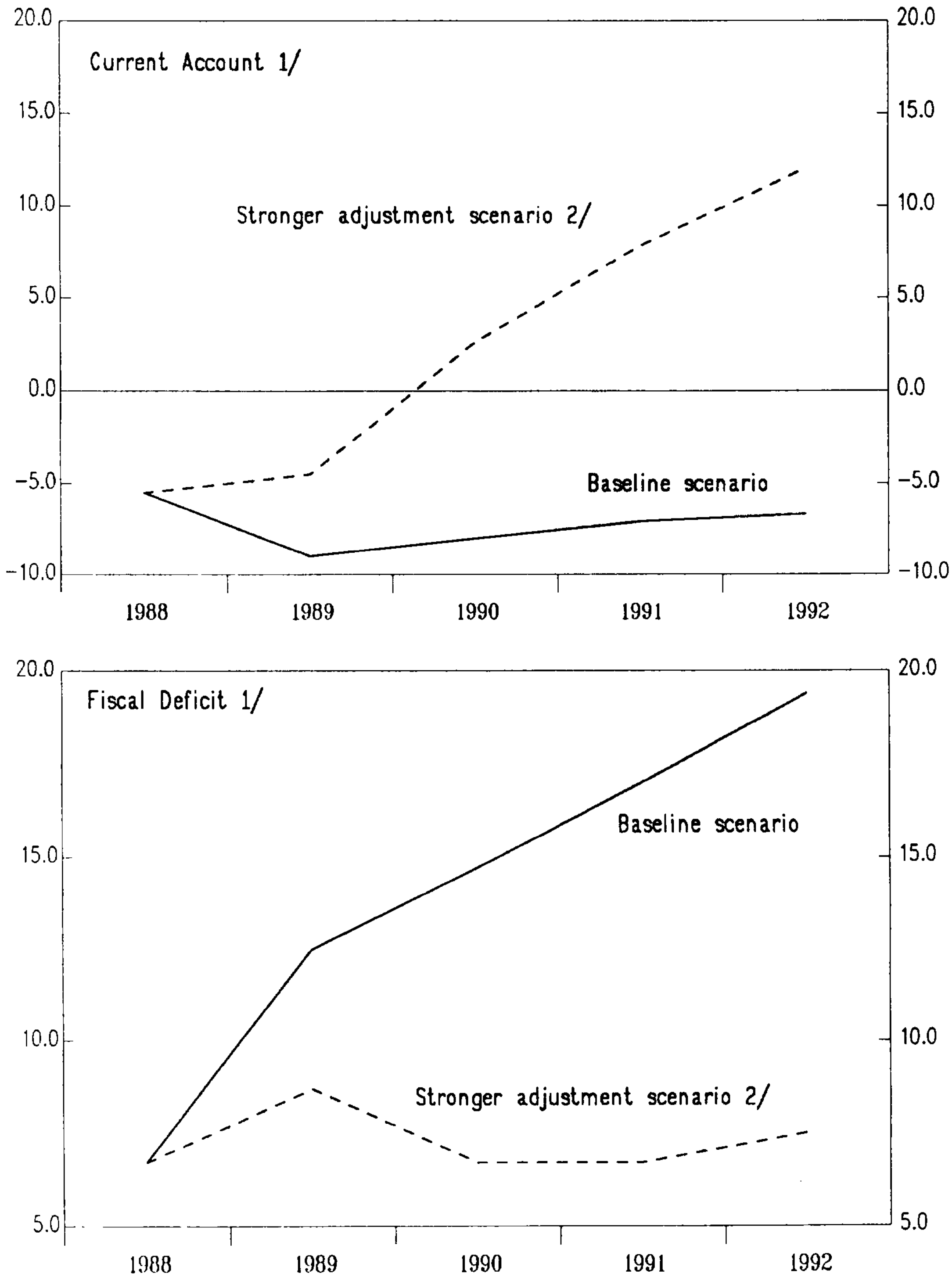
2/ For 1989, fiscal developments are expected to be in line with budgetary intentions. For 1990-92, real expenditure are projected to rise roughly in line with the growth observed for 1986-89.

surpluses would be generated in the private sector, with the public sector moving gradually into balance over time. Inflation is expected to remain fairly moderate. Nevertheless, reflecting the strains on domestic resources, it is expected to move somewhat above the U.S. level.

The principal differences between the baseline and the strong adjustment scenario lie not so much in the growth of output or inflation but in the financial balances (Table 1 and Chart 3). In the strong adjustment scenario, the cumulative financial savings of the country, as measured by the sum of current account surpluses, amount to 17.4 percent of GDP, against a cumulative deficit of 1.2 percent in the baseline scenario. This result is achieved through a combination of higher private and public sector savings, with public sector savings contributing the largest part to the difference between the two scenarios (11.9 percentage points, out of 18.6 percent of GDP). Within public sector savings, in turn, the largest part of the difference results from cutting or postponing expenditure (7.2 percentage points).

Although the strong adjustment scenario is primarily illustrative, it demonstrates quite clearly the scope for an accumulation of contingency reserves during the upcoming years of buoyant activity. These reserves could be used to stabilize incomes in periods of economic slowdown or adverse exogenous shocks.

CHART 3
ARUBA
## Medium-Term Scenarios
## (In percent of GDP)




Source: Staff projections

1/ Cumulative.
2/ The stronger adjustment scenario assumes measures to contain the fiscal deficit and measures to strengthen private sector savings.

Table 1. Aruba: Medium-Term Scenarios

| | 1988 | 1989 | 1990 | 1991 | 1992 | Cumulative 1/ 1989-92 |
|---|---|---|---|---|---|---|
| A. Baseline Scenario | | | | | | |
| Real GDP 2/ | 14.3 | 11.4 | 20.6 | 2.9 | -1.9 | 33.0 |
| Inflation 2/ | 3.5 | 5.5 | 6.0 | 6.0 | 6.0 | 5.9 |
| Current account 3/ | -5.5 | -3.5 | 1.0 | 0.9 | 0.4 | -1.2 |
| Private sector balance | 0.1 | 1.3 | 2.4 | 2.4 | 2.0 | 8.1 |
| Public sector balance | -5.6 | -4.8 | -1.4 | -1.5 | -1.7 | -9.3 |
| Revenue | 24.0 | 21.0 | 20.0 | 19.2 | 19.1 | 79.3 |
| Expenditure | 29.6 | 25.8 | 21.4 | 20.7 | 20.8 | 88.6 |
| B. Stronger Adjustment | | | | | | |
| Real GDP 2/ | 14.3 | 9.5 | 20.5 | 6.3 | -0.1 | 36.2 |
| Inflation 2/ | 3.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 |
| Current account 3/ | -5.5 | 1.0 | 7.1 | 5.2 | 4.2 | 17.4 |
| Private sector balance | 0.1 | 2.0 | 4.3 | 4.4 | 4.2 | 14.9 |
| Public sector balance | -5.6 | -1.0 | 2.8 | 0.8 | -- | 2.6 |
| Revenue | 24.0 | 23.0 | 22.0 | 19.5 | 19.5 | 84.0 |
| Expenditure | 29.6 | 24.0 | 19.2 | 18.7 | 19.5 | 81.4 |
| Memorandum items | | | | | | |
| Hotel rooms | 3,097 | 4,093 | 6,506 | 6,506 | 6,506 | 210.1 4/ |
| Foreign exchange inflows 5/ | | | | | | |
| from hotel construction | 75.5 | 97.3 | 36.0 | -- | -- | ... |
| from tourism | 303.3 | 380.2 | 578.0 | 641.2 | 660.4 | 217.7 4/ |

Source: Staff calculations.

1/ Average for inflation rate (CPI).
2/ Percentage changes.
3/ In percent of GDP.
4/ Change in percent over 1988-92
5/ In millions of Af., net of related imports.

Fund Relations with the Kingdom of the Netherlands,
Aruba

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 on 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.

The Board conducted the last Article IV consultation on Aruba at EBM/86/186 (November 21, 1986) on the basis of staff report SM/86/257 (10/20/86) and recent economic developments SM/86/263 (10/27/86). Due to staffing problems, the 1988 Article IV consultation was postponed and a notification of delay was issued to the Executive Board (EBD/88/263).

## Aruba - Basic Data 1/

| | |
|---|---|
| Population (end-1987) | 59,881 |
| GDP per capita (1987) | US$8,518 |
| Social indicators (1986) | |
| Literacy rate | 95 percent |
| Life expectancy | 72 years |
| Infant mortality (aged under one) | 1.1 percent |

| | 1986 2/ | 1987 2/ | 1988 3/ | 1989 3/ |
|---|---|---|---|---|
| Real economy (change in percent) | | | | |
| Real GDP | -1.0 | 10.3 | 14.3 | 11.4 |
| CPI | 1.8 | 3.5 | 3.5 | 5.5 |
| Unemployment rate (percent of labor force) | 19.6 | 14.5 | 4.7 | 0.2 |
| Public finance (in percent of GDP) | | | | |
| Revenue | 26.7 | 25.4 | 24.0 | 21.0 |
| Expenditure | 31.8 | 38.8 | 30.7 | 26.8 |
| Fiscal balance | -5.1 | -13.4 | -6.7 | -5.8 |
| Financed by: | | | | |
| Development aid 4/ | 2.5 | 2.7 | 2.6 | 2.4 |
| Other | 2.6 | 10.7 | 4.1 | 3.4 |
| Balance of payments (in millions of US$) | | | | |
| Exports | 29.6 | 45.1 | 47.5 | 62.5 |
| Imports | 210.4 | 246.0 | 296.0 | 354.6 |
| Trade balance | -180.8 | -200.9 | -248.5 | -292.1 |
| Net services and transfers | 164.2 | 182.1 | 215.1 | 267.2 |
| Of which: | | | | |
| Tourism (net) | 145.8 | 187.0 | 230.9 | 292.2 |
| Current account balance | -16.6 | -18.8 | -33.4 | -24.9 |
| In percent of GDP | -3.7 | -3.7 | -5.5 | -3.5 |
| Change in reserves | 51.3 | 13.1 | -4.4 | ... |
| Monetary aggregates (percent change over 12 months) 5/ | | | | |
| Net foreign assets | 255.3 | 18.0 | -12.0 | |
| Domestic credit | -12.8 | 47.5 | 46.6 | |
| Public sector | -157.9 | 108.4 | 119.7 | |
| Private sector | -1.4 | 20.1 | 31.7 | |
| Money and quasi-money | 12.3 | 40.0 | 24.6 | |
| Money | 21.6 | 56.6 | 3.2 | |
| Quasi-money | 8.5 | 32.5 | 34.8 | |

| | 1986 2/ | 1987 2/ | 1988 3/ |
|---|---|---|---|
| Interest rates 5/ | | | |
| 12-month time deposits | 7.3 | 7.5 | 7.4 |
| Lending rate | 11.0 | 10.3 | 10.2 |
| External public debt (percent of GDP) | 30.1 | 35.4 | 32.6 |
| Debt service ratio 6/ | 3.5 | 4.1 | 3.3 |
| Exchange rates: | | | |
| U.S. dollar | The Aruban florin is pegged to the US dollar at Af. 1.79 = US$1. | | |
| SDR (end of period) | 2.19 | 2.54 | 2.31 |

1/ Aruba became a separate entity within the Kingdom of the Netherlands in 1986. Data prior to status aparte are not presented here because they are not comparable with those after separation from the Netherlands Antilles.
2/ In part preliminary estimates.
3/ Staff projections.
4/ Excluding extraordinary budgetary assistance.
5/ Through August 1988 for monetary and interest rate data.
6/ Amortization and interest as a percentage of total current foreign exchange inflows. Virtually all external public debt is in the form of "soft" loans from the Netherlands. Data on private external debt are unavailable, but such liabilities are thought to be small.

## Aruba - Statistical Issues

### 1. Outstanding Statistical Issues

Balance of payments

Aruba does not provide balance of payments data on a regular basis. However, the drawing-up of report forms to collect balance of payments data in the format used by other countries is now under way.

### 2. Coverage, Currentness, and Reporting of Data in IFS

A page for Aruba was included in IFS for the first time in May 1988.

The table below shows the currentness and coverage of data published for Aruba in the November 1988 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Centrale Bank van Aruba which, during the past year, have been provided on a timely basis.

Status of IFS Data

| | | Latest Data in November 1988 IFS |
|---|---|---|
| Real Sector | - National Accounts | n.a. |
| | - Prices: (CPI) | September 1988 |
| | - Production: (number of tourist nights) | July 1988 |
| | - Employment | n.a. |
| | - Earnings | n.a. |
| Government Finance | - Deficit/Surplus | n.a. |
| | - Financing | n.a. |
| | - Debt | n.a. |
| Monetary Accounts | - Monetary Authorities | August 1988 |
| | - Deposit Money Banks | August 1988 |
| | - Other Banking Institutions | n.a. |
| Interest Rates | - Discount Rate | August 1988 |
| | - Bank Lending/Deposit Rate | August 1988 |
| | - Bond Yields | n.a. |
| External Sector | - Merchandise Trade: Values | Q3 1987 |
| | Prices | n.a. |
| | - Balance of Payments | not published in IFS |
| | - International Reserves | September 1988 |
| | - Exchange Rates | September 1988 |