The financial situation of Aruba and the role of financial supervision

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University of Aruba, February 27, 2015

It is a great pleasure to be here and it is a great honor to present a guest lecture at the University of Aruba. This is not my first time here. As far back as 1992, 23 years ago, I also gave a lecture at this University, about economic and monetary integration in Europe. Today my lecture will be to give an outsider perspective on the financial situation of Aruba and the role supervision can play.

I am sure these subjects, coming from me, won't come as a total surprise. These are subjects that, as you all know, have received considerable attention, in the media, in the political debate, but also on the streets and at work in Aruba. This lecture reflects the dual role the Cft plays in the Kingdom. As a supervisor, but also as an advisor. An advisor that can give an independent and outside perspective.

Just recently the IMF also gave an outsider perspective on Aruban policies. I have read the report with great interest since the IMF is also an independent advisor; an advisor I value strongly.

The government of Aruba, together with the social partners in a social dialogue, has developed an appealing perspective for the future of the economy. Yet, at the same time it faces some difficult challenges concerning the budget. In the face of a mounting debt burden, confidence in the economy needs to be restored. The main challenge the government faces right now is finding the right balance between economic reforms and stable government finance.

Among those economic reforms, which inside and outside observers have suggested, are improving the flexibility of the labor market, reducing the costs of doing business, passing entitlement reforms and reducing the number of public servants. This is quite an agenda, certainly when one considers that plans to boost the renewable energy sector are awaiting execution as well. This is also the advice the IMF gave just two weeks ago. It implies an enormous job for the government, but I believe it can be done as it is also on the agenda of many other countries.

As to the challenge to stabilize government finance, Aruba is neither alone. Actually, all countries within the Kingdom are facing the challenge to get their budget balanced. Budgetary challenges are a global phenomenon, but there seem to be two schools of thought how to address them. One school of thought calls for the reduction of budgetary deficits as soon as possible, even at the expense of temporary lower economic growth. The other school proposes the opposite, i.e. to increase fiscal deficits. The expectation is that this will stimulate economic growth which in turn will bring the budget back into balance. Although these are extremes and actual policies are more middle of the road, it is fair to say that Aruba by and large has chosen the latter path.

Over the past four years the fiscal deficit of Aruba has increased substantially; the average deficit over the period 2011-2014 was 8.4% of GDP. Average real economic growth over the same period was 2.2% annually. Even with this relatively satisfactory level of economic growth it could not be avoided that government debt surged to 80% of GDP.

How should one judge these developments? I believe it would be good to look at the economic situation of Aruba and the government's financial position from the perspective of the structural challenges the country faces and the search for the right balance between stimulating growth and a stable fiscal situation. I will develop this thought further before I move on and say one or two things about the role financial supervision can play.

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Graph 1 shows the economic growth in the past ten years in the different countries that together make up the Kingdom. The green line shows the growth of the Aruban economy. After a period of satisfactory growth between 2004 and 2008, the Aruban economy was confronted with a sharp decline in 2009 and 2010 due to the financial crisis. The shutdown of the oil refinery caused an additional set back - a 'double dip' - especially after the second and this time permanent shutdown of the refinery in 2012. These were important challenges from outside which needed to be addressed head-on by the government.

Graph 1

Source: CBCS, CBA and CPB

Taking a bird's eye view over a longer period we see sharp fluctuations in economic growth, both positive and negative. What we also see though - and what the IMF also signals - is that after a strong performance in past decades, each major recession was characterized by a decline of the structural level of economic growth. In the aftermath of the latest double-dip recession, Aruba's growth trend decreased markedly again. Aruba faces quite some headwind to longer-term growth.

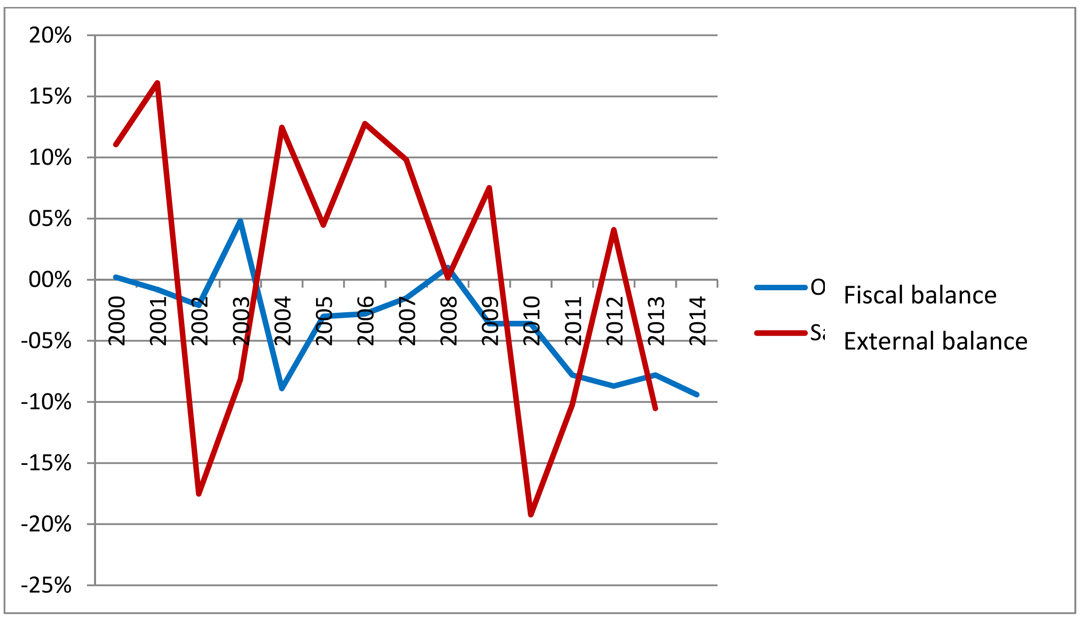
What this picture also shows is how sensitive the economy is for external shocks. In large part this is a reflection of the main product Aruba offers: tourism. In combination with a relatively large dependency on the North-American market this makes for a potentially fragile economy. The other countries in the Kingdom generally show a more stable development. For instance in neighboring Curaçao, the blue line, the financial crisis and the euro crisis that followed, had relatively little consequences for the economy. To be honest, the Curaçao economy hasn't grown much since the beginning of this century. But neither has the Aruban economy; over the past ten years, since 2004, the average growth of both countries has been a meager 0.5%. Over the same period Sint Maarten had an economic growth rate of 2% and the Netherlands of 1.2%.

In line with the IMF report, I believe Aruba is facing three structural challenges: the sensitivity for external shocks, the combination of a fiscal deficit and a deficit on the current account of the balance of payments, and, thirdly, the combination of low labor productivity and an aging population.

These structural challenges need to be addressed and this is what the Aruban government tries to achieve. The development of a new strategy in which renewable energy plays an important role, is part of this. Also, aiming at making the economy less vulnerable by focusing marketing activities towards Latin America is part of this. And finally, ambitious proposals to scale back government expenditures and bring government debt back to manageable levels are part of this.

The shutdown of the refinery has also made it clear how vulnerable the balance of payments situation is. Tourists bring in a lot of foreign exchange, but not enough to pay for all imports. A small island economy like Aruba is of course almost completely dependent on the outside world.

Graph 2



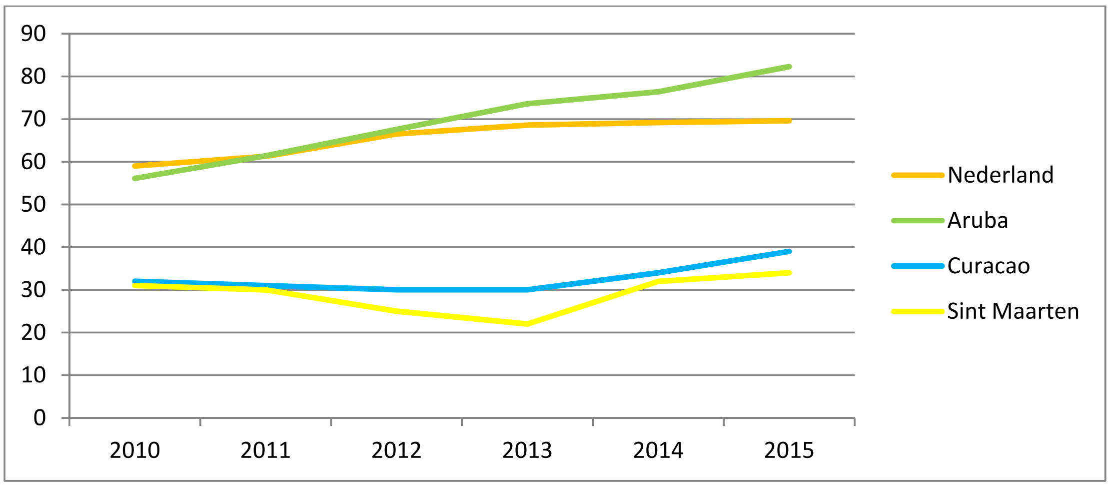
Graph 2 shows the development of the current account situation since 2000, together with the fiscal development. As can be clearly seen, the deterioration of the current account is for an important part caused by shutdown of the refinery. In the last five years, we see that this deterioration goes hand in hand with the fiscal deficit.

This situation of a double deficit makes it hard for any government to bring the economy back on a growth track. When the government raises expenditures, imports will increase as well and so will the current account deficit. Positive effects for the economy will last only for a short while and they will soon backfire because the flexibility in the government budget – as economists say: fiscal space - is gone. What remains are government finances in jeopardy and a shortage of foreign currency.

Here again a comparison with other countries in the Kingdom may be in order. What makes countries within the Kingdom special is that they all have small and open economies, relative to their peers. Being small and open implies that a fiscal stimulus will quickly leak abroad in the form of increased imports.

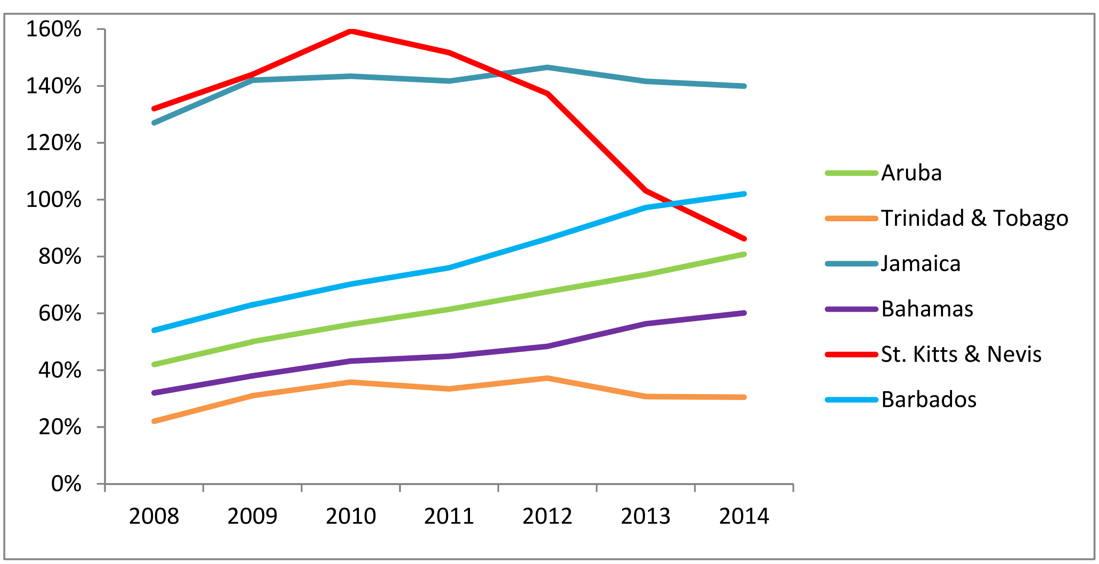
Budgetary policy within the Kingdom thus is not a good instrument to stimulate growth. To create sustainable and durable growth and thus to create jobs, investments in the private sector are needed. And investors will only put their money at risk if they can be confident that prudent fiscal policies are being followed. For they know that the deficits of today are the taxes of tomorrow. We, within the Kingdom, therefore appear more alike than we sometimes realize.

Graph 3



Government debt in Aruba increased sharply in the last couple of years. In 2008 government debt was still close to 40% of GDP. Together with the effects of the financial crisis in 2008, the debt to GDP ratio soared both in both Aruba and in the Netherlands. In 2011 government debt in Aruba passed the Dutch level and since then Aruba has the highest debt level of the Kingdom. It topped the 80% mark in 2014.

Graph 4



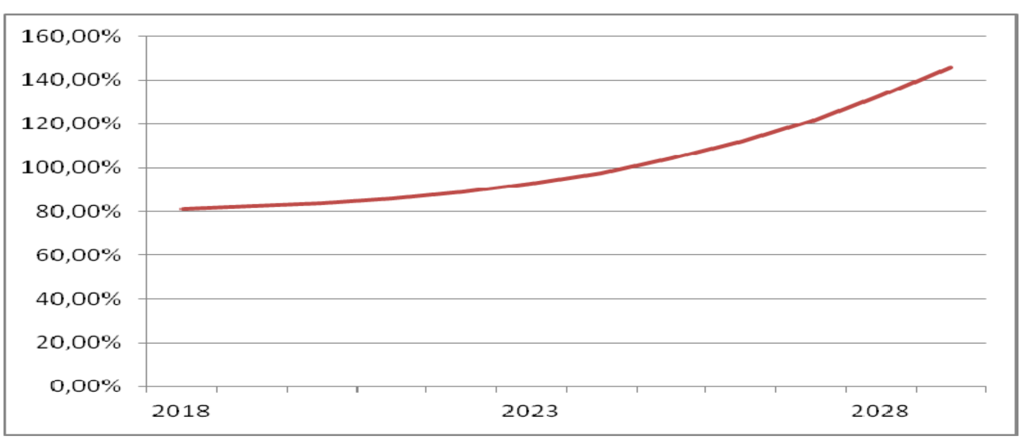
Graph 4 shows that in the Caribbean region Aruba is becoming one of the countries with an excessive debt as well. Examples from the region show how important it is for countries to control their public debt position. Barbados, Jamaica and St. Kitts and Nevis ran into problems because of an uncontrollable debt. Financial markets have been reluctant to grant further loans because of a lack of trust in the possibilities to repay their loans. This became manifest in low credit ratings of Barbados and Jamaica at B/B- right now. In St. Kitts and Nevis a program of debt reduction, including support of the IMF, and fiscal restructuring was necessary to stabilize the situation.

Facing the shocks Aruba was confronted with, an increase in public debt is to be expected and quite understandable. We see this increase everywhere. The resulting debt level however and the fact that the debt is still increasing, makes the situation rather unique. The idea that the government should stimulate the economy by spending more has its limitations. But even so, now that the business cycle goes up again, it is about time for the government to control its finances again. To this end government has indicated a time path to get the budget in order. I will come back to this.

It is to be expected that the economy will show some continued growth in the next couple of years, largely based on a strengthened sentiment in the United States. However, the structural growth path will not reach the levels Aruba perhaps grew accustomed to in the latter part of the last century.

Economic growth will lead to higher tax incomes for the government, but in itself this will not be sufficient to reduce the budget deficit since public expenditures will grow faster if no measures are taken. This is largely because salaries of public servants, pension entitlements, health care expenditures, and interest payments all show a higher 'automatic' growth rate than the economy and this will lead, if unchecked, to a sharp increase in public debt. Graph 5 shows what happens with the public debt if this automatic growth is not dealt with.

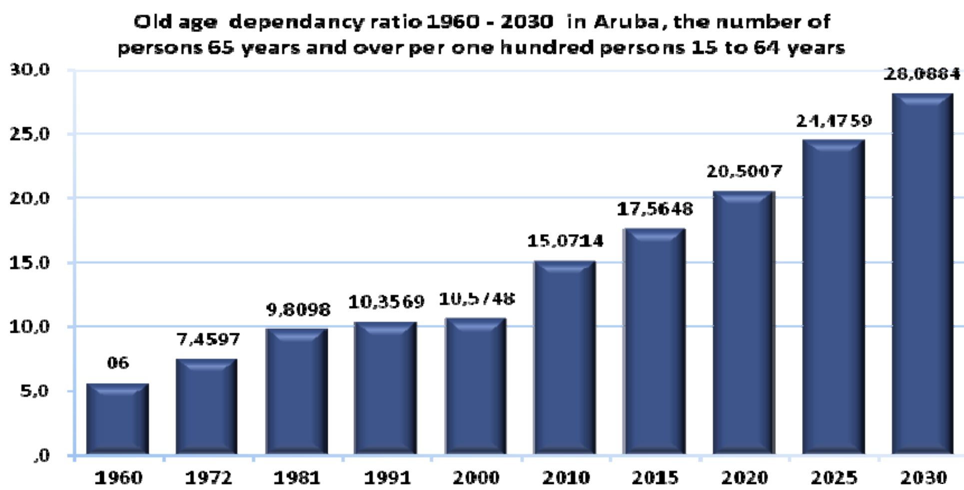
Graph 5



Let me say a few more words on demographics. One of the reasons for government finance to be in structural jeopardy has to do with the aging of the population. The average age of the population of

Aruba increases rapidly. Less and less active people work to look after the people that don't work anymore; the burden on them in terms of taxes and premiums will increase. Recent calculations of CBS Aruba show that the number of people older than 60 will double in the next twenty years and the number of people older than 70 will even triple in the same period.

Graph 6



Because of this demographic trend pressures on taxes, social security and health care all will increase as the expenditures of the SVB, the pension funds and AZV will rise. In 2014 the government has already undertaken drastic but necessary first steps to get this under control by taking measures with respect to the AOV age and the pension fund for public servants. Even so, it will take till 2024 before the pension age will be 65, which is a relative slow pace compared to other countries. The AZV is in more safe water by the 1% health tax, but structurally there is still no solution for rising health care costs. A cut in entitlements will be necessary.

These structural challenges need to be dealt with. Therefore, attempts to diversify the economy and reduce the dependency on fossil fuels are welcome. Investments are necessary but they need to be smart. Because of the double deficit, government activities need to be directed towards activities and sectors that substitute imports and encourage exports.

An important contribution to this end would be made by changing the composition of government expenditures. The deficits that caused the current government debt are mostly the result of increased government consumption and not of increased government investment.

Government expenditures grew by 21.5% between 2009 and 2014 while at the same time taxes and social premiums increased by only 12.5%. Especially expenditures for public servants increased strongly with 20%, because of an increasing number of public servants as well as rising incomes of public servants. Interest payments on government debt even grew more strongly by 50% in this same period. This underlines that interest payments themselves have become part of the problem.

On the other hand, government hardly invested much more during this period. Investments that have taken place have been largely financed by the FDA-fund; approximately ANG 60 million per year. Despite these investments, public investment only stands at a meager 1.5% of GDP.

So, the chosen recipe to cope with the crisis has been to increase consumption to keep the economy afloat instead of one time investments that would have increased potential growth rates after the crisis. The government deficit and the deficit on the current account would have profited from this alternative approach. The emphasis given on consumption explains why cutting back on expenditures is such a challenge now after the crisis.

In more than one way the current situation in Aruba resembles the situation Aruba was in just after receiving the autonomous status in 1985-1986. The refinery closed in that period just as it did recently and the economy deteriorated rapidly just as did in recent years, leaving the government without tools to intervene.

In those year in the mid-eighties Aruba has shown a remarkable resilience to, in a way, reinvent itself. The population was willing to take a step back and accepted a solidarity fee in the income tax. This fee was a lot to ask from the population, and many Arubans still remember those years rather vividly as a difficult period. I realize this very well, but Aruba in the end came out much stronger.

Today, facing the situation Aruba is in, a gesture of solidarity may once again be needed. Unlike 1985-86, however, it would seem more logical to temporarily introduce a solidarity fee in indirect taxation, just like the health tax that was introduced last year. It is a relatively simple measure that doesn't cost a lot a time to implement and brings immediate results. It would also heed IMF advice which advocated a rise in indirect taxation relative to direct taxation. It can help bring fiscal balance back in a speedy manner and this would help restore trust among international investors.

In this respect it is important to see what rating agencies have to say about Aruba. In 2013 Standard & Poor's downgraded Aruba from A- to BBB+. Fitch followed suit in 2014. Aruba has the lowest rating in the Kingdom, comparable though to Sint Maarten's Baa1 rating from Moody's.

What do these ratings tell us? A rating stands for the level of trust international capital markets have in the creditworthiness of a country. The challenges facing Aruba which I have just described, in particular the large fiscal deficit and the rising government debt have been a major reason for the rating agencies to downgrade Aruba's rating.

However, an important factor, still upholding Aruba's rating, is that Aruba is a part of the Kingdom of the Netherlands. Both Standard and Poor's and Fitch make this very explicit. The political stability provided by being a part of the Kingdom is of utmost importance for the capital markets. The importance of the expectation that the Kingdom will prevent individual countries from running into default, cannot be underestimated. So money is expected to be relatively safe here. This is a direct advantage of being part of the Kingdom.

Another positive factor has been that the government made hard commitments to restore a balanced budget and reduce government debt. Of course, living up to that commitment is key.

Comparing Aruba's rating internationally, we see that Aruba of course outperforms countries like Argentina and Venezuela. Both countries forfeited their access to the international credit markets.

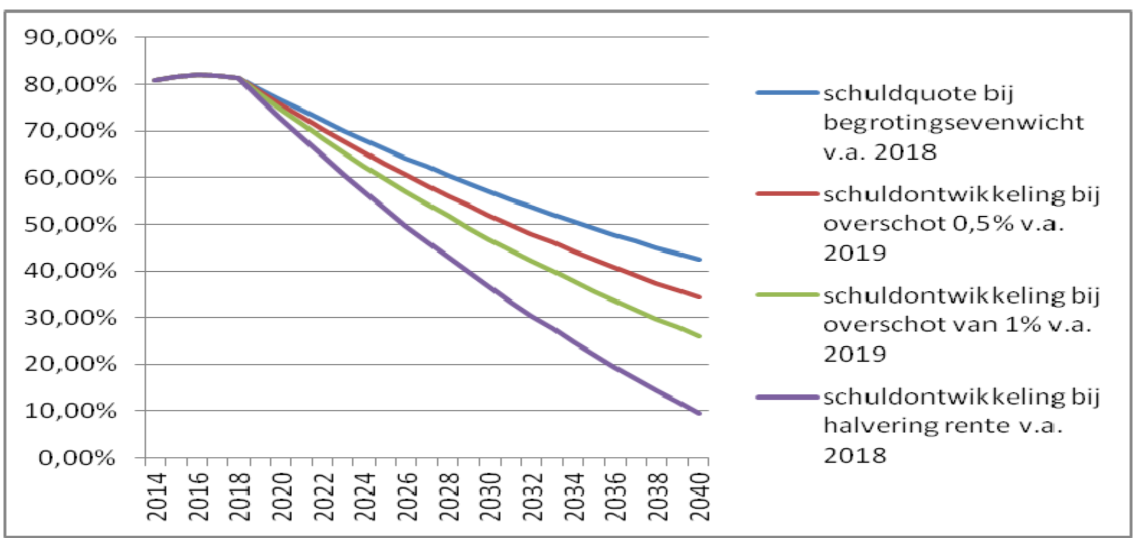
Aruba's position can best be compared with that of Brazil or the Bahamas. But the target should of course be set higher, for example the level of Colombia or Panama; both countries with an A-rating and thus lower interest rates that don't have to worry about their access to the capital markets.

Restoring trust is necessary, certainly when government finances are at stake. Even if the government realizes the goals of the balanced budget agreement, it will still take a long time before debt will be reduced to sustainable levels.

What is a sustainable level? International institutions consider a level of 40% of GDP for small island economies as an indication of a sustainable level of debt. This is still far off from the present level and one can therefore understand why the IMF advised in its latest report that government should strive at reducing the debt level in the medium term to at least 70%. For this to be achieved a structural surplus of 1.5% of GDP is needed. The IMF indicated that a number of measures still have to be taken before even this less ambitious target can be attained.

A further decrease is desirable in the long term. Recent research by the IMF shows that in the Caribbean a public debt that exceeds 35% of GDP can become a threat for growth, while a debt over 60% can lead to shrinkage. These outcomes confirm earlier studies from the IMF that a sustainable debt level for small island economies is somewhere around 35 to 40% of GDP. For Aruba, which has a relatively high per capita income in the region, my presumption would be that a debt level at the higher end of that range, i.e. 40% of GDP, would be a sustainable level.

Graph 7



Present plans of the government of Aruba are for closing the budget by the year 2018 and then aim for a budget surplus of 0.5% of GDP. If Aruba manages to achieve this it will still take until 2034 before debt will be back to the level of 2008, i.e. 40%. Even a debt level of 70% of GDP will not be reached before 2025.

So it does not take long to increase your debt, but it definitely takes a long time before debt is reduced again. During this period, there is no fiscal space to adapt to new shocks which, as we all know, may occur sooner or later. That is why it is so important to get government finance in order at a determined and rapid pace, so that trust is restored that government means business.

This explains the advice which the Cft recently has given to take measures without any hesitation. A solidarity fee in indirect taxation would help in the short run. In the longer run a series of measures are being contemplated by the government which will help contain government expenditures in a structural manner. It is important that these measures indeed are implemented.

The Cft has also advised to establish independent supervision on government finances. This is the final topic I would like to dwell on.

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To start off it may be helpful to explain the workings of the Committee for financial supervision in the countries and public entities of the former Netherlands Antilles, i.e. Curaçao, Sint Maarten, Bonaire, Statia and Saba. Here the Cft has been involved for a period of more than five years, with a formal legal backing since 10-10-10.

What does financial supervision involve? In essence it means following the budget process from preparation to execution and final accountability. In doing so, the Cft is neither an auditor nor an accountant. These parties, like the internal accountant and the audit chamber (Rekenkamer), are of course closely involved, but they do so from their own responsibility which is auditing the annual accounts. So, the accountant and the Rekenkamer come into play at the end of the budget process.

The Cft also is not a substitute to the Advisory Council (Raad van Advies) whose main task is to advice on the draft budget and the other drafts of relevant legislation. So, the Raad van Advies comes into play at the beginning of the budget process.

The Cft, on the contrary, follows the whole budgetary process from the beginning stages of preparation, following execution till the accounting stages when the year has ended. It is important to follow the execution of the budget during the year. If you want to be in control, you not only want to know how much you have spent at the end of the year. At the end of the year, you cannot steer anymore and neither can you correct. Therefore, parliament should be informed a number a times during the year if the budget execution is still on track.

During all the different steps the Cft provides advice to all stakeholders concerned; the ministers, the members of parliament and eventually the Council of Ministers of the Kingdom or, as is the case with the Dutch Caribbean, the minister of BZK in the Netherlands. It sees to it that the process is done in an orderly and timely manner, in accordance with the country's own rules.

There is the possibility to escalate to the higher level if the rules are not followed. Not that that is a desirable step, but sometimes a necessary threat. Internal institutions, like the audit chamber or the Raad van Advies, do not have such possibilities of follow-up.

What is it that the Cft looks after? The most important test the Cft carries out is to check whether the budgetary norms set by the countries themselves are met. Often people forget that the financial supervision on the countries Curaçao and Sint Maarten is based upon legislation and norms set by the countries themselves. The norms are not invented by the Cft, but they are norms that are agreed upon by Curaçao, Sint Maarten and the Netherlands and which are enshrined in domestic legislation.

The same principle applies to the balanced budget rule that Aruba has established itself. The Aruban government has taken the decision to balance the budget in a couple of years and reach a surplus in 2018. The Netherlands and Aruba have talked about this decision and consequently the Cft was asked by the government of Aruba to check whether the draft budget was sufficient to realize this goal.

It is important to realize that the question how Aruba wishes to realize this goal, is an entirely different matter. Aruba can for instance choose to cut back on the number of public servants or to raise taxes. This is something the government decides itself in an autonomous manner.

The Cft does not interfere in questions of policy choices because these are political questions which should be decided upon by elected officials and not by the supervisor. The supervisor's role is to stress over and over again that governing means that decisions *have* to be made if the government wants to meet its own targets, not *what* decisions have to be made.

The Cft looks after the entire public sector, so we not only pay attention to the budgets of the different ministers, but also to the SVB and the AZV. Public corporations can cause risks for the budget of the government and therefore they need to be taken into account as well. Public private partnerships are another example of expenditures outside of the government budget but with risks for the budget. Restoring budgetary balance by bringing expenditures outside of the budget but keeping the risks, can hardly be a solution for fiscal problems.

Lastly, the Cft looks into financial management. If the quality of financial management is not sufficiently guaranteed, it is not possible to judge how realistic the budget is and it is even hard to say how much the government spends. In Aruba this is very relevant. For example, the audit chamber has not been able to comment on the budget because financial management is insufficient to check the accounts.

I always refer to the Cft as a ruthless truth teller and a trusted advisor. We explain the situation as it is, not the way we would like it to be. We provide transparency and often that is enough. It is never pleasant when an outsider tells you how things are and what needs to change. Still, the fact that we are outsiders, that we are independent and transparent in what we do, is exactly what a budget process needs.

An important aspect of our work in the neighboring countries is that if the budget adheres to the norms agreed upon, countries may borrow through the offices of the Dutch government. Consequently, the interest rate is the same as the Dutch government pays on the international capital markets. This rule for example made it possible for Curaëao to borrow for the building of its new hospital at an effective interest rate of only 1.25%. This is another advantage of being part of the Kingdom.

When the Cft was asked by the government of Aruba to give its advice it took as a starting point of the analysis the norms which Aruba had set itself, i.e. the balanced budget rule established by the government. We check if the norms are met, but only after the internal process in the countries is ready. The Council of Ministers checks if the balanced budget rule is met, parliament checks the proposals of the Council of Ministers and uses the advice of the Raad van Advies. Parliament has its own responsibility. The Governor checks if the laws, including the budget law, is in conformity with the norms and the Kingdom laws. All these internal control procedures will have to have taken place before the Cft comes in action. And if all parties have done their work properly, the Cft will be in and out again and will have an easy job.

In practice governments often ask the Cft's advice before presenting the draft budget to parliament. This enables not only the government to make well informed decisions, but also helps parliament in fulfilling its controlling and legislative functions.

Let us finally take a look at the norms agreed upon for Curaçao and Sint Maarten, which are different from the balanced budget rule of Aruba.

The most important norm is that the current account of the budget needs to be in balance. This rule implies that current expenditures, i.e. government consumption, has to be paid for by current income, i.e. taxation. It is not allowed to borrow for recurring expenditures like salaries.

The idea of a balanced current account is called the golden rule of public finance. There is an appealing logic to this rule, that is why economists call it a golden rule. If you borrow money for recurring expenditures, your debt will increase every year. There is no limit anymore. You may compare it with a household. Families borrow for investments like a house. That makes sense, because a house will be in the family for a long time and owning a house saves money because you don't have to pay rent. These savings can be used for the interest and for paying back the loan. However, if a family has to borrow for its daily groceries, than a serious financial situation looms. Every day it makes these expenses and every day it has to borrow money. There are no savings so there is no possibility to pay the interest or pay back the loan. Eventually it has to borrow for the interest expenses as well.

There is another logic I should mention as well though. Some economists and politicians consider it good policy to spend more in economically difficult times, like the last couple of years. The other side of the same coin, however, is that in economically better times the debts have to be paid back. Government should have a surplus in good times so it can pay back the debts it made in the bad years. So, in good times government should cut back in its expenses. If, however, in the bad times government has spent more on current expenditures, it is very difficult to reverse that even if the economy grows again. In most cases it will imply cutting back on salaries or laying off public servants.

More expenditures in economically hard times can be wise, but mainly if they are investment expenditures. In Aruba the current deficit is mainly caused by rising current expenditures, like personal and interest payments. These expenditures don't earn themselves back. On the contrary, they tend to grow every year because of the automatic growth of such expenditures through indexation and automatic promotions.

The norms for Curaçao and Sint Maarten, that are agreed upon in the Kingdom law, make it possible to borrow only for investments and not for consumption. Interest payments are limited to a maximum of 5% of total revenues of the government. If the economy grows at a normal rate and the interest rate is not exceptional either, this implies a debt level in the order of 40% of GDP.

Whether these norms could be helpful for Aruba is a question not for me to be answered. It should be answered in the political setting.

Let me conclude my presentation by making some observations about our values, the way we work and the elements in our work we cherish.

Our values are professionalism, independency and transparency. The secretariat of the Cft is made up of people that know their way in public finance: they have a lot of experience as economists, accountants or as lawyers. Political opinions don't play a role in their professional job; they look at the figures and this is what only counts for them. The same goes for the members of the Cft itself. They are appointed by the Kingdom government on the proposal of the individual countries because of their experience. We have made up a profile that summarizes what we expect from the members.

The Cft is independent. The members play their role without instructions from any of the governments and advise solely on the basis of their expertise and experience. Conflicting interests are prohibited and all functions of members are made public.

The budget of a country is in essence about the way the government spends taxpayers' money. The constitution therefore rightly regulates when the budget should be sent to parliament and when and how debates should take place and how the budget eventually becomes a law. Parliament decides how the money is being spent and how much taxes will be collected. It is the fundament of a democracy that taxpayers' money is spent in a prudent and transparent manner and that parliament is in control.

The Cft tries to stimulate this transparency. We are transparent about our work and our advice. We tell what the situation is and we leave it to governments to act on that information. We follow our own policy towards the media and we have our own website.

The countries we work for are autonomous democracies with a parliament that decides on the budget. What advices are given by us and how these advices are taken into account by government should be clear.

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To round off; first of all, whatever school of thought government adheres too, this is the time to cut back on expenditures and bring the debt back to a structural healthy level.

Second, restoring trust and creating fiscal space for investments that Aruba needs so much, should be the main agenda for government.

Third, financial supervision is a means to restore trust. Supervision is meant to help governments in achieving the goals they set for themselves and to give confidence to the population .

Discussions on supervision and Cft yes or no only distract from the challenges at hand. I would call upon parties concerned to move to these challenges for the benefit of people of Aruba. I have visited Aruba ever since I was a student, now more than 40 years ago. I share the pride which Aruba has in having built up on its own a strong and vibrant country. Aruba has been able to reinvent itself a number of times during its history. This time may be such another time of reinvention in a changed global environment.