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INVESTOR UPDATE

OCTOBER, 2018

ARUBA UPDATE-
Assessment of Aruba's Economy and Bond Recommendation

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SUMMARY

Aruba is in a precarious economic position. On the one hand fiscal consolidation has led to reduction in the fiscal deficit while on the other hand the debt overhang has severely constrained government spending. We are forecasting growth of 2% per annum over the medium term, but the outlook hinges on the re-opening of the petroleum refinery in 2019. Citgo, the majority owner in the partnership, is facing financial challenges arising from issues with its parent company. Delay in the start time of the refinery will negatively affect GDP growth and government revenues. With the sovereign finances already constrained by austerity measures, the government will find it exceedingly difficult to generate additional revenues and/or cut expenditure further to meet the fiscal targets. Under the scenario of lower than envisaged growth, debt servicing will become increasingly challenging. Economic challenges facing Venezuela have spilled over into Aruba resulting in lower tourism and domestic exports. The external accounts are vulnerable, as the economy is not sufficiently diversified to weather external shocks and reserves are relatively low. **Given our outlook on Aruba's macro-fiscal profile and political environment as well as the risks facing the country, we are revising our recommendation on the sovereign bonds to UNDERWEIGHT.**

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SWOT ANALYSIS OF ARUBA

STRENGTHS

- Improved growth outlook over the medium term buoyed by tourism and crude oil refinery.
- Strong political and legal institutions highly influenced by the Dutch government.
- High per capita GDP and growing employment opportunities
- Currency peg with the US dollar limits currency risk of the external debt and minimises the pass through effect of external price rise.

WEAKNESSES

- Narrow industrial base - heavily dependent on imports of industrial goods and consumables.
- Undiversified economy that is reliant on tourism which leaves sovereign susceptible to external shocks, in particular economic downturn in the US.
- The sovereign lacks complete autonomy over its affairs and therefore certain political decisions have to be given the assent of the government in the Netherlands.

OPPORTUNITY

- Refurbishing of the oil refinery by Citgo will help to diversify the economic output.
- Lower debt burden over the long term will help to free up fiscal space and allow the government to improve the country's infrastructure.

THREAT

- Economic challenges in Venezuela pose downside risk to tourism and economic growth.
- Fiscal austerity has the potential to cause social unrest as the government cut public sector jobs and rein in entitlement benefits.

Ratings: S&P, BBB+/negative; and Fitch, BBB-/negative

Default: Never

MACROECONOMIC OUTLOOK

The growth outlook for Aruba over the medium term is positive with growth expected from two main areas: tourism and refined petroleum products. Over the medium term it is envisaged that real output will expand upward of 2% per annum. However, downside risk to growth is increasing due to long standing and emerging challenges. Like most other tourist-dependent destinations across the Caribbean, the domestic tourism product has benefited and is expected to continue to benefit from strong economic growth and robust job market conditions in the United States of America (USA) from which 60% of the more than 1.1 million visitors are expected. On the downside, Aruba's economy is susceptible to Venezuela's ongoing economic challenges which are transmitted through three means: tourism, exports and the refurbishing of the oil refinery by Citgo. Tourism flows from Venezuela continue to fall and indications are that in 2017 total visitor arrival from Venezuela declined by more than 100,000 or 53% when compared to 2016. This had a negative impact on overall arrivals despite growth in other markets.

Central to Aruba's growth outlook is the restart of the sole oil refinery which is slated to recommence operations in 2019. Recommencement of operations was originally scheduled to start in mid-2018 but has been pushed back due to a number of issues, including financial challenges with majority owner, Citgo. Citgo is owned by Petroleos de Venezuela (PDVSA), the Venezuelan state-owned and operated oil company. Arising from sanctions imposed by the USA and poor economic management, foreign direct investment flows to Venezuela have dried up. The sanctions and low oil prices have negatively affected PDVSA's revenue flows while the decline in investments severely constrain the corporate's ability to explore new oil acreage, or to undertake needed capital expenditure to at a minimum maintain stable oil output. In a nutshell PDVSA is beset with serious financial challenges which is a major risk to Citgo completing the Aruba refinery project within the stipulated time frame. Later than expected completion and/or abandonment of the project would adversely affect Aruba's near- to medium-term economic growth and put pressure on the fiscal trajectory.

FISCAL OPERATION AND DEBT TRAJECTORY

The government of Aruba reached a deal with the Dutch government to monitor the sovereign's fiscal operation. In 2015 a decision was reached by the Aruban authorities to reduce the fiscal deficit and debt so as to improve the sovereign's fiscal profile. Arising from global recession in 2008 which devastated Aruba's tourism-dependent economy, the government engaged in counter-cyclical fiscal policy to stabilize growth. For the period 2008-2014, the economy grew marginally while the debt level doubled and the fiscal balance moved from a surplus of 1% of GDP to a deficit of 8% of GDP. The coalition government led by Evelyn Wever-Croese's People's Electoral Movement (MEP) who won 9 of the 21 seats in the uni-cameral legislative house in September 2017 is expected to allow continuity of the economic monitoring agreement reached with the Dutch.

In keeping with measures adopted to improve fiscal operation, revenues are expected to increase on average 5% per annum. The revenue forecast includes anticipated flows from the refinery, the crises-levy implemented in mid-2018, and self-assessed corporate income tax. Tax receipt from income and profits grew by 10% in 2015 and this trend is expected to continue over the medium-term contingent on positive real GDP growth.

On the spending side, the government is expected to implement expenditure cuts to help achieve the overarching objective of a sustainable fiscal path for Aruba. It however is going to be difficult to overhaul certain entitlement benefits, as there is staunch opposition from powerful forces in the population. Notwithstanding, the fiscal deficit is expected to narrow over the medium term. Given the combination of revenue increase, expenditure cuts and economic expansion, overall debt to GDP is expected to stabilize at around 86% of GDP, of which the domestic component is expected at 41% of GDP.

RATINGS ACTION

Aruba is rated BBB+/negative and BBB-/negative by Standard and Poor's (S&P) and Fitch, respectively. On June 25, 2018 S&P revised the outlook on Aruba from stable to negative, but maintained the sovereign's BBB+ credit ratings. Prior to S&P's credit action, on April 18, 2018 Fitch revised the outlook on the sovereign from positive to negative but maintained the BBB- ratings.

S&P advised that its ratings reflect the benefit of Aruba's strong link with the Netherlands, its prosperous economy and moderate debt level. However, the Ratings Agency stated that the risk of worsening government debt burden in the next two years is high due to fiscal slippage. The Ratings Agency advised further that there is a one-in-three chance of Aruba being downgraded within the next two years due to the risk of rising government debt. S&P noted that the steady rise in debt burden and interest costs pose a threat to Aruba's public finance. Despite the change in the political administration in September 2017, the Ratings Agency believes that there is enough consensus on key economic and fiscal policies across the political parties to foster sustained policy continuity.

S&P stated that the new political administration faces a daunting task of fiscal consolidation to stabilize and contain the debt. It also faces the task of promoting sustainable economic growth, complicated by the problem-riddled oil refinery, which has exacted a high economic cost on Aruba. The Ratings Agency noted that financial challenges facing Citgo have hindered progress to upgrade the refinery.

S&P is expecting the low current account deficit to be offset by capital inflows resulting in a relative increase in international reserves. The Ratings Agency advised that Aruba's long standing currency peg with the US dollar anchors inflation, but constrains monetary flexibility.

POLITICAL RISK

The MEP-led coalition government has continued with the fiscal consolidation measures adopted by the previous administration, which demonstrates the strength of policy continuity across political administrations. The new administration has taken the austerity policy a bit further by implementing a 'crisis levy'; which took effect on July 1 and includes: increase in the sales tax from 2% to 6%; a salary cap for executives of state owned entities; and a tax on gasoline. These measures are welcome in light of the depth of Aruba's debt burden, but they could have negative repercussions as, coupled with spending cuts, households are being impacted negatively and there is a risk that people could take to the streets to voice their opposition if austerity continues over multiple periods.

The instability in Venezuela poses downside risks to the sovereign's economic stability. Earlier in the year the Madura administration banned all travel with the ABC Islands, accusing them of illegal smuggling activities. The ban was lifted in April, but tension between the two nations persists.

ANALYST'S RECOMMENDATION

The macroeconomic fundamentals in Aruba are slowly evolving. There are some improvements, particularly on the fiscal side, but the debt burden is elevated and debt servicing cost is rising. While our forecast for growth is relatively upbeat, it is contingent on the re-opening of the oil refinery in 2019. The completion of work to upgrade the refinery is tilted towards the downside given financial and operational challenges with PDVSA, the parent company of the majority owner of the refinery, Citgo. If the plant does not come on stream in 2019, it will cut the growth forecast by at least one-half. This has implications for fiscal operations on the revenue side, which means that in the absence of deeper expenditure cuts the fiscal deficit could widen and debt levels increase. If this persists over multiple periods it could put further pressure on the sovereign's ability to service the debt, as servicing cost which is at 10% of GDP keeps rising.

Notwithstanding this narrative, the fiscal consolidation effort and policy continuity of the new government are noteworthy and will help to steer the country towards fiscal sustainability if it is not derailed. However, there are limits within which additional fiscal efforts can yield the desired result to correct the deviation from the intended fiscal path in the event of shocks, especially against the background of low GDP growth and high external vulnerability.

Having assessed Aruba's macro-fiscal and political environment as well as the risks that could affect the country, we are revising our recommendation on the sovereign bonds to UNDERWEIGHT.

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation DEFINITIONS/ RECOMMENDATIONS.

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