Dominican Republic update

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Rabobank

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Introduction

The Dominican Republic enjoyed strong economic growth until 2003. Growth turned negative in 2003 with reduced tourism, the collapse of BanInter and limited growth in the US economy (the source of about 80% of export revenues), but recovered in 2004-06. The country's financial situation stabilised with the help of strict fiscal targets agreed with the IMF in a standby loan. Although the economy continues to grow at a respectable rate (GDP increased at an average annual rate of 10% during 2005-2006 and is forecast to average 5-6% in 2007-08), high unemployment (16%) and inflation (8% in 2006) remain important challenges. The Domican Republic suffers from marked income inequality. On the upside, the country's development prospects improved with the ratification of the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA). The latter came into force in March 2007.

Banking sector

During the severe 2003-2004 crisis most of the banking system's borrowers were affected by low economic activity and the volatility of the foreign exchange rate. As the Dominican Republic's banking sector has benefited from steady economic growth and a more stable macroeconomic and operating environment since then, the system has been able to digest the crisis and maintain a very proactive position toward recovering problem loans and improving its credit risk tools and controls.

Past-due loans decreased almost 5% during 2006, to represent 4.5% of total loans (2005: 5.9%). Part of this improvement has been thanks to rapid loan growth (+24%). This rise is not matched accordingly by the increase in loan loss reserves, which is a regional phenomenon.

Unlike its neighbours, the Dominican Republic has not seen a significant inflow of foreign investment into the financial sector, partly as a result of the high concentration of the market in a limited number of players including a large public sector bank. The leading banks are not for sale, while the smaller banks are not advantageous for potential buyers. Further progress is also needed to strengthen the Central Bank's supervision of the banking sector.

Fiscal side

The Fernández administration has implemented corrective measures on the fiscal side, which have been effective in reducing the fiscal deficit. It should be noted that the economic upturn has also played its part. The fiscal adjustment has relied heavily on tax measures, while expenditure adjustment has lagged. In particular, the loss-making electricity sector continues to be a drain on public finances. The cost of bailing out three domestic banks, borne by the Central Bank, has also slowed the pace of fiscal consolidation in 2006. Looking forward, capital spending is budgeted to rise, reflecting the construction of the Metro in the capital. A further increase in spending is envisaged for 2008, related to the mid-year presidential election. All in all, a fiscal the primary balance is expected to post a surplus of approximately 1% of GDP in 2007-08. With quasi-fiscal losses at the Central Bank projected at 2.5% of GDP, the combined public sector to post a deficit of just over 2% of GDP in 2007 (compared to 6.6% in 2004).

Public debt ratios now stand at levels roughly similar to those observed in the pre-crisis period (43% of GDP in 2006, and are expected to remain broadly stable in 2007-08). Government debt was reduced as a result of a rescheduling of external debt by commercial banks and the Paris Club. It is important to note that around three-quarters of the government's debt is denominated in foreign currency, which still leaves it vulnerable to exchange rate fluctuations.

External position

The Dominican Republic's balance of payments is characterised by high trade deficits (nearly 13% of GDP in 2006), on the back of large fluctuations in nickel prices. The country has relied on tourism income, transfer remittances and foreign direct investment to finance the trade imbalance. Overall, the deficit on the current account balance declined from 7.5% of GDP in 2004 to just over 2% in 2006. This favourable balance of payments performance, together with reduced debt service outflows (as a result of the debt restructuring) and a reversal of capital flight, has underpinned the steady recovery of foreign exchange reserves. However, reserves are still relatively low at 2 months of import cover and are forecast to remain at this level in 2007-08.

After declining slightly in 2007, the current account deficit should move back to around 2% of GDP in 2008. External amortisations will increase in 2007 as restructured bonds begin to amortise. This in turn could put downward pressure on the Dominican Republic's liquidity ratio. In 2007-08, the liquidity ratio is forecast to hover around 100%.

Political developments

Following the May 2006 congressional and local elections, the ruling Partido de la Liberacion Dominicana (PLD) has a majority in both houses of Congress. Recently, incumbent President Leonel Fernandez overwhelmingly won the PLD's primaries. As Mr. Fernandez's rival, Danilo Medina, denounced a 'victory of the state machinery', internal rifts within the PLD cannot be ruled out. Moreover, governability would suffer further.

The country's presidential elections are scheduled for May 2008. Mr. Fernandez's main opponent in the election will be Miguel Vargas Maldonado from the Dominican Revolution Party (PRD), the former public works minister of ex-president Mejia (2000-2004). Although Mr. Fernandez remains popular three years into his term, issues of crime, power supplies and the cost of living may be instrumental to the PRD campaign. However, it remains to be seen whether Mr. Maldonado can heal the party's divisions, after the previous PRD government's disastrous record in office.

A PLD victory would provide policy continuity, under guidance of the IMF (the standby arrangement expires at the end of January 2008).

Internationally, the Dominican Republic's relations with the US will remain very close, also helping the government in its dealing with the IMF. Bilateral ties were boosted on the back of the free trade agreement DR-CAFTA, which came into force in the first quarter of 2007. Although relations with Haiti have improved somewhat, illegal immigration from Haiti to the Dominican Republic will keep tensions between the two alive. The Fernandez government will seek close relations with other Latin American countries, the EU and several Middle Eastern nations in order to boost trade and investment, as well as energy provision. Maintaining close ties with both the US and Venezuela could prove to be a challenge.

Conclusion

The Dominican Republic continues to enjoy strong economic growth. Stable remittances and tourism revenue fully cover the country's high trade deficits. External debt ratios are fairly low compared to its peers. The weakest links include the fragile external liquidity position, underpinned by low foreign exchange reserves, as well as the weak financial sytem. On the fiscal side, the loss-making electricity sector continues to be a drain on public finances.

Things to watch:

- Fiscal developments
- External position
- Presidential election (May 2008)

Economic growth (% volume change)	2005	2006	2007	2008
- gross domestic expenditures	9	11	6	5
- private consumption	15	10	6	5
- public sector consumption	5	8	6	5
- gross fixed investments	10	20	9	7
- exports of goods and services	6	3	4	4
- imports of goods and services	14	5	6	6

Policy indicators (levels in %)	2005	2006	2007	2008
- public sector balance (in % GDP)	-1	-1	-1	-1
- unemployment	18	16	15	15
- short term lending rate	24	19	19	19
- inflation (CPI)	4	8	5	6

Current account of the BoP (in mil. USD)	2005	2006	2007	2008
- exports of goods	6145	6440	6865	6580
- imports of goods	9875	11190	11775	12270
- trade balance	-3730	-4750	-4910	-5690
- balance on the current account	-505	-780	-650	-930

Foreign debt and reserves (in mil. USD)	2005	2006	2007	2008
- total foreign debt	7855	8580	9245	9615
- debt service	2320	2775	3000	3185
- total arrears (interest and principal)	30	0	0	0
- foreign exchange reserves	1845	2115	2265	2415

Financing (mil. USD) *	2005	2006	2007	2008
a) Total financing needs	2380	3035	3075	3490
- balance on the current account	-505	-780	-650	-930
- amortisation of long term debt	-725	-1105	-1125	-1190
- amortisation of short term debt plus all arrears	-1150	-1150	-1300	-1370
b) Financing sources	3425	3305	3225	3640
- inward direct foreign investments	1025	1185	1225	1300
- inward portfolio flows	-15	0	0	0
- long term loans	1200	1640	1540	1665
- refinancing of short term debt	1150	1150	1300	1370
- net other sources of finance	65	-670	-840	-695
c) Change in foreign exchange reserves	1045	270	150	150

*A "minus" sign indicates an outflow

Dominican Republic

Date: June 2007 Indicators (%)	Average 2002 2006	Estimate 2007	Forecast 2008
Economic structure			
- Real economic growth	5	6	5
- Fixed Investments / GDP	16	17	17
Economic policies			
- Government budget / GDP	-2	-1	-1
- Inflation	23	5	6
Balance of Payments			
- Balance Current Account in % GDP	-1	-2	-2
- Exports of goods in % GDP	23	17	15
- Exports / Imports (gs&i)	81	75	72
Foreign debt			
- Debt service ratio (gsi&t)	21	19	20
- Interest service ratio (gsi&t)	3	4	4
- Gross external debt / export (gs&i)	61	59	60
Liquidity position			
- Liquidity ratio (gs&t)	93	102	100
- FX-Res/ imports of goods (mnths)	2	2	2
- Debt service / FX-reserves (%)	429	132	132

Structural data	2006
- surface (in 1000 km2)	49
- population (m)	9
- gross domestic product (USD bn)	38
- GDP/capita (USD)	4181
- GNI/capita (purchasing power equivalent in USD of 2004)	6860
- GDP by sector	
- agriculture	11%
- industry	29%
- services	59%
- exchange rate (Dominican peso per USD)	33,4
- unemployment in %	16
- IMF-quotum (in m SDR)	219
- in % of total IMF-quota	0,10%

Structure foreign trade	2002	2005
- Major export markets (%)		
US	86	79
South Korea	0	2
Netherlands	1	2
- Major import markets (%)		
US	51	45
Venezuela	9	15
Colombia	2	5
- Major export products (%)	2002	2006
Ferro nickel	84	70
Sugar & derivatives	3	11
Cocoa & derivatives	2	2
- Major import products (%)		
Consumer goods	15	25
Capital goods	29	22
Raw materials	24	23

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