

COUNTRY REVIEW

Dominican Republic



18 August 2009

ANALYST: David Atkinson

EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Functioning democracy with a track record during the past decade of non-violent handovers of power to the opposition via elections, even in 2004 in the depth of an economic crisis
- High long-term growth of GDP per capita.
- IMF monitoring programme
- Moderate debt ratios
- Flexible exchange rate regime
- FDI covers 80-90% of expected 2009-10 current account deficits

Weaknesses

- Chronically weak power sector
- Volatile growth and dependency on tourism and access to US market
- Widening fiscal deficit and rising public debt ratios
- Relatively weak external liquidity indicators overall
- Appreciation of real exchange rate in past two years eroded competitiveness gains of heavy depreciation during financial crisis

Key Risks

- Recession
- Sharp depreciation of exchange rate

Country Risk Assessment

Ratings	Dominican Republic		Median Grade C	Jamaica	Peers Turkey	Sri Lanka
	Latest	Previous				
Systemic Political Risk:	P2-	P2-	P3+	P2-	P3-	P3-
Systemic Economic Risk:	E6	E6	E5	E6	E5	E5
ME rating:	ME5	ME5	ME5	ME6	ME5	ME5
<i>Structure</i>	5.9	5.9	5.9	5.7	3.3	5.0
<i>Policy</i>	4.8	4.8	5.2	5.8	4.6	6.0
<i>Solvency</i>	1.3	1.0	2.8	5.8	4.8	3.5
<i>External Liquidity</i>	6.0	6.0	4.3	6.0	6.0	5.8
SBE rating:	SBE4	SBE4	SBE4	SBE4	SBE3	SBE3
COUNTRY GRADE:						

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Santo Domingo
Population:	9.81 mn (2007)
GDP:	USD 40918 mn (2007)
Currency:	Peso (DOP)
Form of state:	Republic
Head of government:	President Leonel Fernandez
Next elections:	Legislative 2010, Presidential 2012

Major Industries (% of GDP at market prices, 2008)

Agriculture	8.1%
Mining	0.5%
Manufacturing	25.5%
Utilities & construction	6.8%
Services	59.1%

Global Assumptions

	2008	2009
Real GDP grth (% yr/yr) *	0.7	-3.0
Inflation (% , av) *	3.4	1.0
Dated Brent (USD/b)	98	50
* Major economies		

Main Exports (% of total, 2008)

Free Zone	65.4%
Ferro-nickel	7.1%
Sugar	1.7%
Cocoa	1.5%
Tobacco	0.2%

Main Imports (% of total, 2008)

Consumer goods	50.5%
Raw materials & intermediate goods	33.7%
<i>of which</i> : fuel & lubricants	9.1%
Capital goods	15.8%

Lead Export Markets (% of total exports, 2007)

US	66.4%
Belgium	3.7%
Finland	3.2%
UK	2.6%

Lead Import Markets (% of total imports, 2007)

US	46.0%
Venezuela	8.1%
Mexico	5.9%
Colombia	4.7%

Basic indicators

Selected economic indicators	2005	2006	2007	2008f	2009f
Nominal GDP (USD mn)	29,243	35,201	40,918	44,449	43,792
Population (mn)	9.53	9.67	9.81	9.95	10.09
GDP per capita (USD)	3,069	3,640	4,171	4,467	4,340
Real GDP growth (% yr/yr)	9.3	10.7	8.5	5.3	0.0
Inflation (% , eop)	7.4	5.0	8.9	4.5	4.8
Fiscal balance (% of GDP)	-1.3	0.1	0.6	-3.5	-2.5
Current account balance (% of GDP)	-1.6	-3.7	-5.1	-10.0	-4.0
External debt/GDP (%)	27	25	23	23	24
External debt/Exports of goods & services (%)	60	61	60	67	80
Interest payments/Exports of goods & services (%)	2	2	2	3	4
Foreign exchange reserves (USD mn)	1,843	2,116	2,546	2,272	2,000
Import cover (months)	0.8	1.6	1.7	1.7	2.0
Exchange rate assumption, DOP:USD (av)	34.88	33.80	33.34	35.46	36.00
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

A chequered history of “strong-man” rule—for thirty years under the Trujillo dictatorship and then under President Balaguer—ended in 1996 when Balaguer was forced to leave office early after allegations of electoral fraud. Since then four elections have seen relatively smooth handovers of power to opposition leaders, as more representative government has become entrenched. Three parties have dominated the political system since the end of dictatorship in 1966—the Partido Revolucionario Dominicano (PRD), the Partido Reformista Social Cristiano (PRSC) and the Partido de la Liberación Dominicana (PLD). Presidential elections in May 2004 resulted in a decisive victory for the PLD candidate and former president (1996-2000) Leonel Fernández, over the incumbent, Hipólito Mejía, largely reflecting the fact that Fernández’ previous term was a period of strong economic growth and stability in sharp contrast to Mejía’s, which ended in a deep financial and economic crisis.

President Fernández easily won a second consecutive term in elections held in May 2008, taking 53% of the vote in the first round, enough to avoid a second round run-off. The PLD also won an overall majority in congressional elections in May 2006. The next elections are due in May 2010, which may put additional pressure on the fiscal accounts, and are likely to prove difficult for the PRD as the economy is in recession, though the PRD is internally divided.

Policymaking operated within the framework of an IMF programme under the previous Fernández administration with the original 28 month stand-by agreed in February 2005 extended by eight months to January 2008. The formal IMF programme replaced during 2008 by an IMF monitoring agreement, which does not involve formal quantified targets or financing. Priorities for the government are to rein in the fiscal deficit and return to a position of primary surpluses sufficient to stabilise public debt ratios. In the medium-term long-standing problems in the power sector remain a critical challenge.

Internationally, relations with the US and the IFIs are good. The Dominican Republic has signed and ratified the DR-Central American Free Trade Agreement with the US. DR has also entered into arrangements with President Chávez to receive subsidised Venezuelan oil imports under PetroCaribe and Venezuela is looking to invest in an oil refinery in DR, but President Fernández can be expected to continue to tread a careful path between the US and Venezuela.

Economic Stability

The economy is heavily dependent on Free Trade Zone (FTZ) earnings (particularly textiles and electrical goods), tourism and workers remittances from overseas. Chronic electricity sector problems remain a constraint on growth and, as a net oil importer DR is vulnerable to high oil prices.

A sharp slowdown in 2001-02 descended into full-blown crisis in 2003, as a major bank fraud led to the failure of two smaller banks, capital flight, a collapse of the exchange rate and unsustainable public debt payments. The Fernández administration on assuming office in 2004, however, acted swiftly to restore confidence within the framework of an IMF programme and a market friendly debt restructuring and growth recovered strongly. Real GDP increased by an annual average 8.5% in 2005-08. However, growth fell to 5.3% in 2008, as the global recession hit investment, tourism, remittances and free-zone activity, particularly in Q4, a pattern that continued in H1 2009, exacerbated by a fall in public consumption as spending was reined-back, with growth falling to 1.4% yr/yr. On the output side free-zone activity was down almost 20%, construction 19% and tourism related services also contracted. For calendar 2009 we expect zero growth with around 2% in 2010.

The central government fiscal deficit returned to deficit in 2008 equivalent to 3.5% of GDP (0.8% surplus 2007) as revenues fell as a proportion of GDP while expenditure increased, including increased subsidies on food and energy to cushion the impact of the global downturn). Faced with a more difficult financing environment and the need to bring down interest rates, the government has introduced measures to curb spending and in the 2009 budget targeted a central government primary surplus of 0.5% of GDP, against a primary deficit recorded of 2.3% in 2008. Based on H1 data this objective will be hard to achieve owing to the sharp fall in revenues, but nonetheless, the overall central government deficit should narrow in 2009 to 2-3% of GDP. However, pressures on government finances have led to a build-up of arrears to suppliers, notably in the energy sector. The central bank quasi-deficit has continued to narrow dropping to 1.3% of GDP in 2008.

The return of central government deficits and the issue of bonds to cover the re-capitalisation of the central bank boosted the public debt ratio from an estimated 29% of GDP to 35% in 2008 and the ratio will rise further in 2009. The ratio is not excessively high but is heading in the wrong direction and

stabilisation of the ratio will require further substantive spending cuts.

Monetary policy operates via quantitative monetary targets. Inflation accelerated rapidly through 2007 and much of 2008 under pressure from food and energy prices and strong credit growth, prompting monetary tightening. However, after peaking at 14.6% yr/yr in September 2008, inflation slowed to 0.3% yr/yr in July 2009, as food and oil prices fell sharply and domestic demand fell away. As the sharp fall partly reflects base effects in the index, the yr/yr rate will pick up through the rest of 2009 but should remain below 5% through 2010. Monetary tightening was reversed from the end of 2008 and interest rates have been reduced sharply since then. The exchange rate has been relatively stable in this period and the real effective rate is not strongly overvalued.

In the IMF's first monitoring review it was noted that "the domestic financial system has weathered the immediate effects of the international financial crisis. Banks exposure to foreign credit lines has been very limited since the 2003-04 crisis and prudential indicators point to liquidity and capital buffers that will allow banks to withstand moderate stress."

The external current account widened to an unsustainably large 10% of GDP in 2008. The deficit narrowed sharply in H1 2009 (by almost 65%) as the fall in imports (demand and lower commodity prices) outweighed the fall in goods exports, earnings from tourism and remittances. The deficit for calendar 2009 is likely to narrow to around 4% of GDP and should remain under 5% in 2010. At these levels FDI, though down on 2008, should cover 80-90% of the deficit. FX reserves, however, cover only around two months of imports and only 85% of short and medium-term external debt due in 2009. Moreover, FX reserves are less than 50% of the combined total of the current account deficit plus principal repayments due in 2009 and ST debt outstanding.

The external debt-GDP ratio was 24% in 2008 and the external debt-exports of goods and services was also low at 60%, though this ratio will increase to and interest payments-exports of goods and services ratios are also relatively low at 67%, though it will rise to around 80% in 2009 as a result of lower export earnings. Interest payments as a proportion of exports of goods and services remain modest at 4%.

Overall, sharply weaker GDP in 2009, after very strong growth in recent years, can be expected to increase corporate stress. Fiscal policy also needs further adjustment and domestic supplier', arrears have built-up in some sectors. External liquidity indicators are relatively weak, though debt ratios remain modest and the exchange rate is managed flexibly, which should help contain the downside risk.

Structural Business Environment

The Structural Business Environment is adequate, but below average in our assessment overall (130 out of 210 rated).

Based on data and definitions from the World Bank's 2008 Doing Business Survey, of ten areas surveyed Employing Workers, Registering Property and Protecting Investors were weaker areas, ranking below average, while Closing a Business was particularly weak and well below average. The World Bank Institute's Governance Research Indicator puts regulatory quality below and control of corruption and the rule of law well below average for the Caribbean region, but regulatory quality was above average, the rule of law about average and control of corruption just below average against the lower middle income group of countries. Transparency International's Corruption Perception Index, 2008, assigns Dominican Republic a score of 3.0—on a scale of 1 (bad) to 10 (good)—and a ranking of 102= out of 180. As a broad measure of the pro-business environment The Heritage Foundation 2008 Index of Economic Freedom ranks Dominican Republic 88 out of 179.

David Atkinson

London: +44 (0)20 7860 2807

Charts

