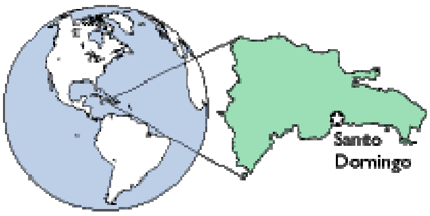
COUNTRY REVIEW

Dominican Republic



15 November 2010

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.
- High long-term growth of GDP per capita.
- Moderate debt ratios.

Weaknesses

- Chronically weak power sector.
- Volatile growth and dependency on tourism and access to US market.
- Weak external liquidity indicators overall (large current account deficit, low FDI coverage and relatively low FX reserves.)

Country Risk Assessment

Ratings	Dominican Republic Latest	Dominican Republic Previous	Median Grade C	Peers Jamaica	Peers Honduras	Peers Ghana
Systemic Political Risk:	**P2-**	**P2-**	**P3+**	**P1**	**P2+**	**P2+**
Systemic Economic Risk:	**E5**	**E5**	**E5**	**E5**	**E5**	**E5**
ME rating:	ME5	ME5	ME2	ME6	ME5	ME5
Structure	*3.3*	*5.9*	*5.9*	*5.7*	*5.0*	*6.0*
Policy	*4.3*	*4.8*	*5.2*	*6.0*	*4.6*	*6.0*
Solvency	*2.2*	*1.3*	*3.0*	*5.6*	*1.3*	*3.0*
External Liquidity	*6.0*	*6.0*	*4.3*	*4.3*	*4.8*	*2.3*
SBE rating:	SBE4	SBE4	SBE4	SBE3	SBE5	SBE4
COUNTRY GRADE:	**C**	**C**	**C**	**D**	**C**	**C**

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

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Santo Domingo
Population:	10.09 mn (2009)
GDP:	USD 46362 mn (2009)
Currency:	Peso (DOP)
Form of state:	Republic
Head of government:	President Leonel Fernandez
Next elections:	Presidential 2012

Major Industries (% of GDP at market prices, 2009)	
Agriculture& fishing	6.2%
Mining	0.1%
Manufacturing	24.4%
Construction & Utilities	7.8%
Services	61.3%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr) *	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	75	70

* World

Main Exports (% of total, 2009)	
Free Zone	69.3%
Cocoa & products	3.0%
Sugar & products	2.2%
Tobacco % products	0.2%

Main Imports (% of total, 2009)	
Consumption	53.6%
Raw materials & semi manufactures	30.4%
of which : Fuels	6.0%
Capital goods	16.0%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	40,918	44,449	46,362	51,289	55,156
Population (mn)	9.81	9.95	10.09	10.23	10.37
GDP per capita (USD)	4,171	4,467	4,595	5,014	5,319
Real GDP growth (% yr/yr)	8.5	5.3	3.5	7.0	4.5
Inflation (%, eop)	8.9	4.5	5.8	6.5	5.5
Fiscal balance (% of GDP)	-1.2	-4.7	-4.6	-4.0	-3.4
Current account balance (% of GDP)	-5.1	-10.2	-4.9	-7.1	-6.9
External debt/GDP (%)	26	24	25	25	27
External debt/Exports of goods & services (%)	67	68	83	87	94
Interest payments/Exports of goods & services (%)	3	4	4	4	4
Foreign exchange reserves (USD mn)	2,546	2,272	2,885	2,500	2,500
Import cover (months)	1.7	1.7	1.9	2.1	1.7
Exchange rate assumption, NTD:USD (av)	33.26	34.62	36.03	36.82	37.50
f: CRU central forecast					

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

Political Stability

A chequered history of "strong-man" rule—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—the Partido Revolucionario Dominica (PRD), the Partido Reformista Social Cristiano (PRSC) and the Partido de la Liberacion Dominic (PLD). Presidential elections in May 2004 resulted in a decisive victory for the PLD candidate and former president (1996-2000) Leonel Fernandez, over the incumbent, Hipolito Mejia, largely reflecting the fact that Fernandez' previous term was a period of strong economic growth and stability in sharp contrast to Mejia's, which ended in a deep financial and economic crisis.

President Fernandez 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. In legislative elections in May 2010 the ruling PLD increased its majority to two-thirds, which, along with a majority in the upper house, should ensure tight government control of the legislative agenda until 2012 at least when the next presidential elections are scheduled. The PRD will remain in control of the legislature, however, until 2016, as the new constitution approved in 2009 allows for a six-year term so that presidential and legislative elections will coincide from 2016 to give more continuity to government.

The new constitution permits presidents to serve an unlimited number of terms but not consecutively, so President Fernandez should stand down in 2012. Nonetheless, there has been speculation that he will try to seek support for a third term. Alternatively, he may choose to back a close supporter has hand-picked successor. The opposition remain divided, but if their candidate was to win in 2012, the legislative agenda could become much more difficult to achieve.

Policymaking has been generally market-friendly under President Fernandez. For most of the president's terms of office policy has been formulated within the framework of an IMF programme. A new 28-month stand-by was agreed in November 2009, as the economy needed bolstering against the global recession. There has been some slippage on the IMF programme, but the second and third reviews were concluded at the end of October and the fourth review is under way. Structural reforms are likely to remain slow, but overall IMF financing is seen as necessary and so the programme can be expected to remain in place.

Internationally, relations with the US and the IFIs are good. The Dominican Republic (DR) has signed and ratified the DR-Central American Free Trade Agreement with the US. DR has also entered into arrangements with President Chavez to receive subsidised Venezuelan oil imports under PetroCaribe and Venezuela is looking to invest in an oil refinery in DR, but President Fernandez 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 Fernandez administration on assuming office in 2004 acted swiftly to restore confidence within the framework of an IMF programme and a market friendly debt restructuring and real GDP increased by an annual average 8.5% in 2005-08.

Growth fell to 5.3% in 2008 and to 3.5% in 2009 as the global recession hit investment, tourism, remittances and free-zone activity (though this was a relatively good performance in a regional context). In H1 2010 real GDP increased by 7.5% yr/yr as local manufacturing and construction recovered and tourism related services began to pick up after declining in 2009. Free-zone manufacturing output, however, continued to fall. On the demand side, consumption growth accelerated and investment rebounded. Import growth exceeded exports. We expect full year 2010 growth of around 7%, easing to 4.5% in 2011.

The IMF programme (which includes IMF and other multilateral financing of the budget) allowed a fiscal stimulus in 2009 and the central government deficit widened to 3.2% of GDP. In 2010 the re-cast budget deficit is targeted at 2.3% of GDP and the 2011 budget, already presented to congress, envisages a further reduction to 1.6% of GDP, as the authorities look to withdraw the stimulus in line with the recovery. However, there could be some slippage in both years and we expect outturns of 2.6% and 2% respectively. There remains a tendency towards arrears, notably in the energy sector, though the most recent IMF mission noted that arrears had been cleared. The central bank quasi-fiscal deficit remains at 1.4% of GDP, which will take the overall deficit to around 4% of GDP in 2010. General government debt rose sharply in 2008-09, but at 28% of GDP remains relatively low and should consolidate around this level in 2010-11. Overall public debt is higher at 36% of GDP and, though still moderate, underlines the need to reduce the fiscal deficit.

As food and oil prices fell sharply and domestic demand fell away inflation declined sharply for most of 2009 reaching a low of -0.3% yr/yr in October, but has rebounded since then (base effects and food and energy prices) and was 6.2% in October 2010. We expect inflation of 6.5% yr/yr at end 2010 and 5.5% at end-2011, as gradual monetary and fiscal tightening feeds through, though the risks are on the upside. Interest rates were lowered in 2009 and the first part of 2010, but with the economy growing, inflation pressures picking up and interest rates negative in real terms, monetary policy tightening has begun (overnight rates have been raised by 100bps from a 4% low in September) and can be expected to continue for some time. The exchange rate has been relatively stable in this period and the real effective rate is not overvalued.

The IMF noted that "it has been reassuring to find out that in the middle of a global credit crunch, Dominican banks remain liquid, solvent and profitable" at the time of the stand-by request towards the end of 2009 and have not made negative comments in statements since then. Private sector credit growth is expanding very strongly in 2010, which may need to moderate, though this comes after a period of contraction.

The external current account narrowed to 4.9% of GDP in 2009 from 10.2% of GDP in 2008, as the fall in imports (demand and lower commodity prices) outweighed the fall in goods exports, earnings from tourism and remittances. Exports of domestic goods have increased in 2010 but Free-zone exports continue to decline. Workers remittances have also begun to recover. Nonetheless, increased imports will take the current account deficit back to around 7% of GDP in 2010 and 2011. At these levels FDI will probably cover less than 50% of the deficit. FX reserves cover less than two months of imports and only 70% of estimated short and medium-term external debt due in 2011. Moreover, FX reserves are only around 35% of the combined total of the projected current account deficit plus principal repayments due in 2011 and estimated ST debt outstanding.

The external debt-GDP ratio is moderate at around 25% in 2010 and the external debt-exports of goods and services ratio is moderate also at 87%. Interest payments as a proportion of exports of goods and services ratio are also a moderate 4%.

Overall, external liquidity indicators remain relatively weak, though debt ratios are moderate and policies are framed within the context of an IMF stand-by agreement which also provides budgetary support. Growth has recovered strongly in 2010 but will ease to a more sustainable pace in 2011.

Structural Business Environment

The Structural Business Environment is adequate**,** but below average (129 out of 210 countries assessed). Based on data and definitions from the World Bank's 2011 Doing Business Survey, of nine areas surveyed two—Starting a Business and Registering a Business—were weaker areas, ranking below average but and one—Closing a Business—was very weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality, Rule of Law and Control of Corruption below average for the Caribbean region, with Regulatory Quality above average and Rule of Law and Control of Corruption below average for the lower middle income group of countries. Transparency International's Corruption Perception Index, 2010, assigns Dominican Republic a score of 3.0—on a scale of 1 (bad) to 10 (good)—and a ranking of 101= out of 179 (the same as Zambia among others). As a broad measure of the pro-business environment The Heritage Foundation 2010 Index of Economic Freedom ranks Dominican Republic 86 out of 179.

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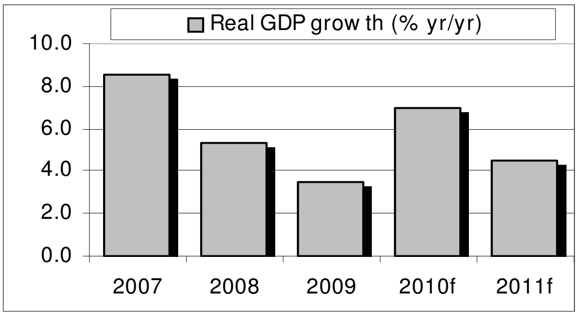
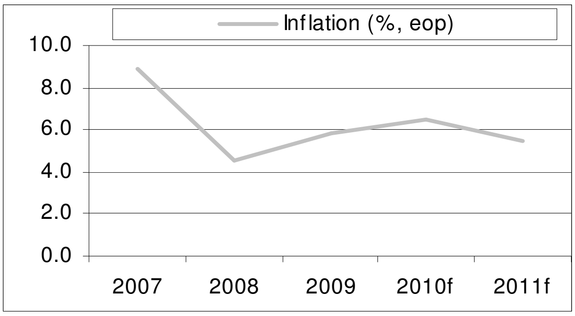
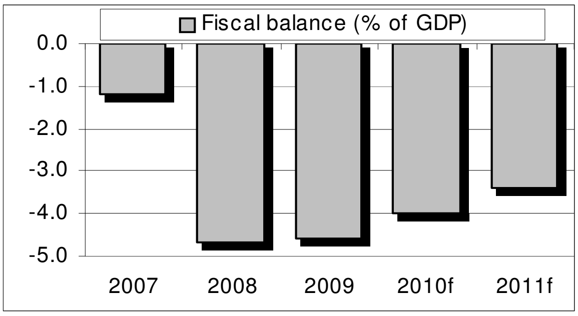
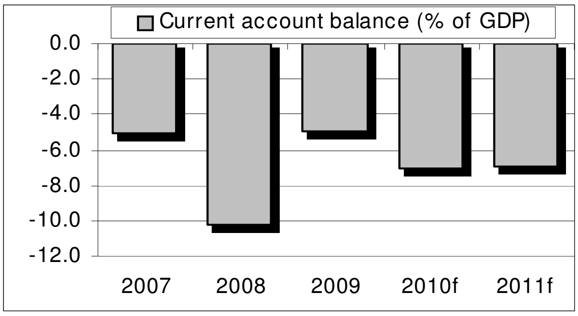
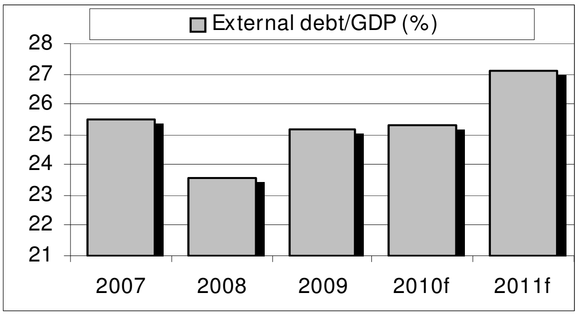
Charts


Real GDP grow th (% yr/yr)
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f

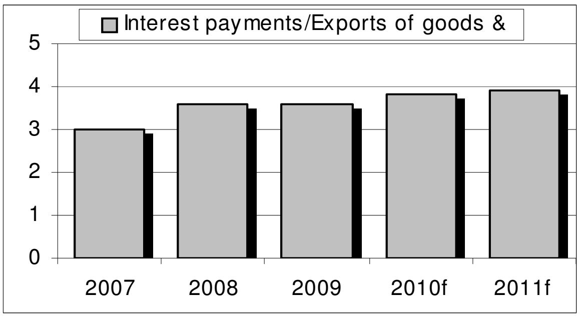

Inflation (%, eop)
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f

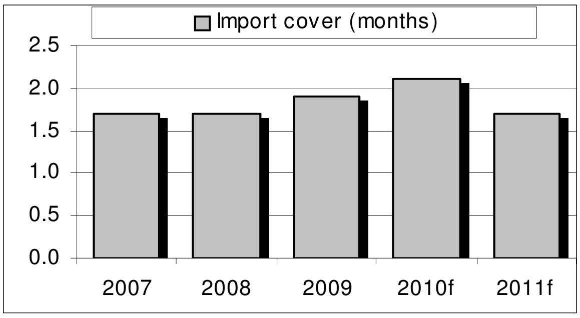

Fiscal balance (% of GDP)
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
28
27
26
25
24
23
22
21
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
100
80
60
40
20
0
2007
2008
2009
2010f
2011f


Interest payments/Exports of goods &
5
4
3
2
1
0
2007
2008
2009
2010f
2011f


Import cover (months)
2.5
2.0
1.5
1.0
0.5
0.0
2007
2008
2009
2010f
2011f