Rabobank

Country report

DOMINICAN REPUBLIC

Summary

After having outpaced most of its neighbors in recent years, economic growth in the Dominican Republic declined to 4.1% in 2011, down from 7.8% in the previous year. While increasing investments in the mining sector and rising tourist arrivals boosted output, necessary fiscal and monetary tightening put a brake on growth. Driven by rising exports and increased public spending ahead of the May 2012 presidential elections, economic growth will likely recover to about 5% this year. The presidential elections could bring an opposition candidate to power, but owing to a general consensus on economic policies across party-lines, no major policy changes are expected. While failures to meet several performance targets have strained relations with the IMF, a renewal of an expiring stand-by agreement is likely. This should boost the country's weak foreign reserves position, which is not expected improve despite a declining current account deficit on the back of surging mining exports.

Things to watch:

- Dependency on the Venezuela-sponsored PetroCaribe oil trading scheme
- Vulnerable external liquidity position and renewal of an IMF Standby-Agreement
- Access to capital markets if the euro area debt crisis were to worsen dramatically

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Dominican Republic

National facts	
Type of government	Democratic republic
Capital	Santo Domingo
Surface area (thousand sq km)	49
Population (millions)	9.6
Main languages	Spanish
Main religions	Roman Catholic
Head of State (president)	Leonel Fernández Reyna
Head of Government (president)	Leonel Fernández Reyna
Monetary unit	Dominican Peso (DOP)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	57	0.08
Nominal GDP at PPP	117	0.15
Export value of goods and services	13	0.06
IMF quotum (in mln SDR)	219	0.10
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.1	7.1
Agriculture (% of GDP)	7	7
Industry (% of GDP)	28	30
Services (% of GDP)	65	63
Standards of living	*USD*	*% world av.*
Nominal GDP per head	5842	54
Nominal GDP per head at PPP	11947	97
Real GDP per head	5042	62

Social and governance indicators	rank / total
Human Development Index (rank)	98 / 187
Ease of doing business (rank)	108 / 183
Economic freedom index (rank)	89 / 179
Corruption perceptions index (rank)	129 / 182
Press freedom index (rank)	97 / 178
Gini index (income distribution)	48
Population below $1.25 per day (PPP)	4.3%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	52	US	39
Haiti	18	Venezuela	6
Belgium	3	Mexico	6
UK	2	Colombia	5

Main export products (%)	
Free-trade zones	54
Cocoa & derivatives	3
Sugar & derivatives	3
Ferro nickel	4
Main import products (%)	
Fuels	24
Free-trade zones	14
Consumer goods	26
Raw materials	21
Openness of the economy	
Export value of G&S (% of GDP)	24
Import value of G&S (% of GDP)	36
Inward FDI (% of GDP)	3.2

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

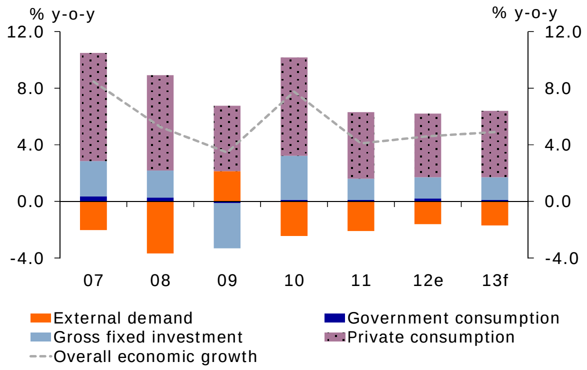
Economic structure and growth

The Dominican Republic is one of the larger Caribbean economies with a nominal GDP of USD 57bn in 2011 and a population of 9.6 million inhabitants. Located in the center of the Caribbean, it shares the island of Hispaniola with neighboring Haiti. Compared to its western neighbor, the Dominican Republic is fairly affluent, as nominal GDP per capita at PPP amounted to USD 11,947 (2011) versus USD 1,200 (2010) in Haiti. Yet, income is distributed highly unequally and human development is mediocre. Being richly endowed with natural resources, like ferro-nickel and gold, as well as vast beaches and various historic cities, the country has become a major recipient of foreign direct investment in recent years. Besides financing various mining projects, these inflows have turned the Dominican Republic into one of the main tourist destinations in the region, catering to more than 3.5 million tourists last year, predominantly from North America and Europe. Bearing witness to the importance of the tourism sector, two-third of national income is generated in the services sector, while industrial production, partly located in free-trade zones, and the exploitation of ferro-nickel and gold deposits accounted for 28% of GDP in 2011. Output of the agricultural sector, which amounted to about 7% of GDP, focuses on the production of cocoa and sugar.

The Dominican Republic's exports are dominated by products manufactured in the country's various free trade zones (zonas francas), which accounted for 54% of total exports in 2010. Industrial production in the zonas francas focuses largely on textiles, garments, pharmaceuticals and medical appliances. Textile exports will likely gain in importance in the near future as various

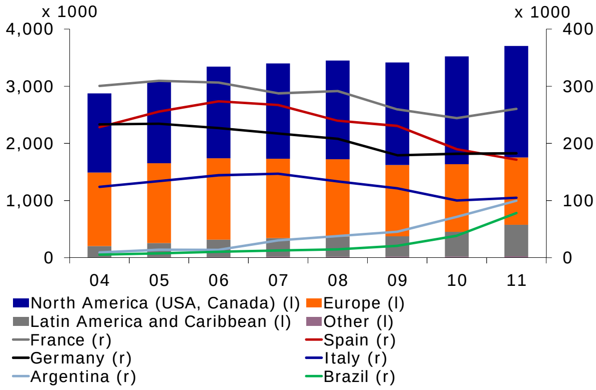
clothing brands are shifting their production from Asia to Central America and the Caribbean in order to benefit from the proximity to the US market and preferential access under the Dominican Republic-Central American Free Trade Agreement.
Mining exports, largely ferro-nickel, accounted for about 4% of total exports in 2010, but due to the opening of several large gold mines, their share is expected to increase considerably this year. Traditional agricultural exports like cocoa and sugar each account for about 3% of total exports. With respective shares of about 25%, consumer products and fuel dominate the Dominican Republic's imports. The marked dependence on fuel imports is largely due to the country's deficient and highly oil-dependent energy sector, the Achilles heel of the local economy that haunts the country with recurrent long-lasting black-outs and exposes the balance of payments to changes in global oil prices.
Most exports are destined for the US market, while exports to earthquake-torn neighboring Haiti accounted for about 20% in 2010, since the Dominican Republic benefits from ongoing reconstruction efforts. The country's banking sector is highly concentrated, as three banks hold about 60% of total assets. Foreign bank operations in the Dominican Republic are quite limited. Throughout 2011, solvency and liquidity ratios have remained at adequate levels, with the solvency ratio standing at 16.4% and the liquidity ratio coming in at 23% in November 2011. Non-performing loans stood at about 3% in early 2011. Regulatory reforms, which have been initiated after the 2003 financial crisis continued throughout 2011, focusing in particular on the prevention of systemic risks.

Chart 1: Economic growth



Source: EIU

Chart 2: Tourist arrivals by plane



Source: Central Bank of the Dominican Republic

After having outperformed most of its regional peers in 2010, economic growth cooled down markedly last year, as fiscal and monetary stimulus have been gradually withdrawn in line with the conditions of an IMF stand-by agreement. As real annual credit growth declined from 15.8% to 6% in 2011, private consumption and investment growth fell accordingly, reducing overall economic growth from 7.8% in 2010 to 4.1% last year. In line with falling domestic and foreign demand, industrial growth slowed down in 2011, with the notable exception of goods being produced in the zonas francas. The resumption of ferro-nickel exploitation and rising tourist arrivals also supported growth last year. While tourist arrivals from Europe continued to fall, rising bookings from the US and Canada, and Latin America in particular, have so far shielded the Dominican Republic's tourist sector from the economic problems in the euro area. Even though tourist arrivals will likely stabilize this year on the back of lower economic growth in the Western hemisphere and a possible recession in the euro area, strongly rising mining exports should propel economic growth to a level of about 4.5%. Risks to the outlook, however, are tilted to the downside, given the ongoing weakness of the US recovery and the possibility of strongly increasing oil prices amid rising tensions in the Middle East, which would hit the heavily oil-dependent Dominican Republic hard. An escalation of the sovereign debt crisis in the euro area could lead to, both, a considerable decline in tourist arrivals from Europe depressing current account earnings, and external financing problems in case of rising turbulences on international financial markets and a concurrent widespread flight to safety. Due to its considerable external financing requirement and low reserves levels, the Dominican Republic is particularly exposed to the latter.

Political and social situation

This year's political developments in the Dominican Republic will be dominated by the May 16th presidential elections. The country is currently governed by President Leonel Fernández Reyna of the centrist Partido Liberación Dominicana (PLD) that won the 2010 legislative elections in a landslide, providing the president with an absolute majority in both chambers of parliament. Since constitutional barriers prevent Mr Fernández from running again, the PLD has chosen Mr Danilo Medina as its candidate. Together with his running mate, current first lady Margarita Cedeño de Fernández, he will face Mr Hipólito Mejía of the center-left Partido Revolucionario Dominicana (PRD). Owing to the closeness of recent polls, we expect a second round. Consequently, rallying support from a coalition of 14 minor parties will be crucial for any of the candidates to win. So far, these parties have supported incumbent president Fernández's PLD, but have not expressed their preferences yet. Irrespective of which candidate prevails, economic policy continuity should be ensured, as programmatic differences between the parties are negligible. Still, given PLD domination of Congress at least until the concurrent legislative and presidential elections in 2016, progress on reforms under a PRD president could be delayed.

The governing PLD's struggle to remain in power in spite of the Dominican Republic's strong growth performance during the global economic crisis illustrates the party's deficiency in addressing various social issues. Owing to still rampant corruption and clientilism, a highly-skewed income distribution and a seriously underperforming educational system, only few average citizens could share in the economic success of the country so far, while high inflation, especially for essential foodstuff and energy, put considerable pressure on people's disposable income. Unsurprisingly, rising inflation ranks high among voters' concerns, as does the deteriorating security situation. In recent years, violent crime has been on an upward trend, as the Dominican Republic's geographical location in the center of the Caribbean, its weak corruption-ridden public institutions and its porous border with neighboring Haiti, contribute to the country's attractiveness for drug-transit operations. While drug-related criminal activity has not reached levels seen in various Central American countries, like El Salvador, Guatemala or Honduras, the doubling of the homicide rate from 12.5 murders per 100,000 inhabitants in 2001 to 24.9 in 2010 bears witness to the increasing urgency of the problem. Responding to concerns brought forward by the Catholic Church, civil society groups and the business sector, a commission comprising the country's attorney-general, as well as the heads of the police, army and secret service has proposed various measures to improve law enforcement. It remains to be seen, however, to which extent these proposals can be realized, given widespread corruption among the police and limited funding, as the government has to seriously start reining in recent budget deficits under an IMF standby-agreement.

While drug-related violence leaves most of the population and businesses unaffected, frequent power shortages and blackouts continue to haunt the general public, sparking, at times violent, protests.

The Dominican Republic's external relations will be dominated by its close links to the United States, but owing to increased dependence on sponsored oil deliveries under the PetroCaribe oil trading scheme, good relations with Venezuela have gained in importance. Dominican foreign policy will consequently be forced to find some middle course that keeps the country out of US-Venezuelan tensions. Meanwhile, the historical animosity with neighboring Haiti continues to recede, as the Dominican Republic assists in the post-earthquake relief efforts. Still, remaining racist attitudes among Dominicans and fears of increased illegal immigration on the back of sluggish progress in Haitian reconstruction constitute stumbling blocks on the road to reconciliation, as do unresolved citizenship issues and domestically undisputed deportations of illegal Haitian immigrants.

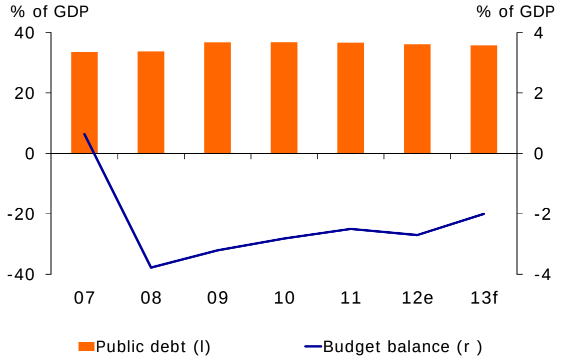
Economic policy

The Dominican Republic's economic policies mainly focus on increasing the nation's attractiveness for foreign direct investment through favourable tax treatment and investments into infrastructure, as well as preferential market access for Dominican exports through the conclusion of various free-trade agreements. Benefitting from its majority in both chambers of parliament, the incumbent government did not face major obstacles in implementing its pro-business agenda. Furthermore, no major changes to economic policy are expected should the opposition win the presidency. Policy implementation could be delayed though. Fiscal operational space, however, will be limited, as the government faces the daunting task to rein in budget deficits and tame stubbornly high inflation rates without choking economic growth amid a worsened external environment.

Until its expiry in March 2012, fiscal policy is subject to the conditions of a 28-month USD 1.7bn IMF stand-by agreement, which had guided government policies in reforming the deficient energy sector and reducing fiscal and monetary stimulus amid strong economic growth. In an attempt to meet its target with the IMF to increase tax revenues to 15% of GDP by 2012 from about 13.5% last year, the government introduced various tax measures, including a new 1% tax on commercial bank assets and the closure of property tax law loopholes. On the expenditure side, the government committed itself to a 12% cut of non-social spending and, following an 11% hike in 2010, an increase in electricity tariffs by 8% last year in order to reduce government transfers to the ailing electricity sector. However, in spite of these measures, the government repeatedly missed various fiscal performance targets under the IMF standby-agreement, as rising oil prices and insufficient electricity tariff increases made additional transfers necessary. Consequently, only a minor reduction of the budget deficit could be achieved last year, as the deficit declined from 2.8% of GDP in 2010 to 2.5%. This year's budget deficit is expected to rise to 2.7% of GDP, since increased government expenditures ahead of the May presidential elections are highly likely. While continuous IMF involvement would assist the government in politically defending its consolidation course, it remains to be seen whether the current IMF standby-agreement will be renewed this year, given rising frictions over electricity tariff hikes ahead of the presidential elections. However, recent comments by the IMF suggest that an extension of the current standby-agreement beyond the presidential elections could be possible. This would enable the government to postpone politically painful tariff hikes and improve its compliance with the IMF's conditions.

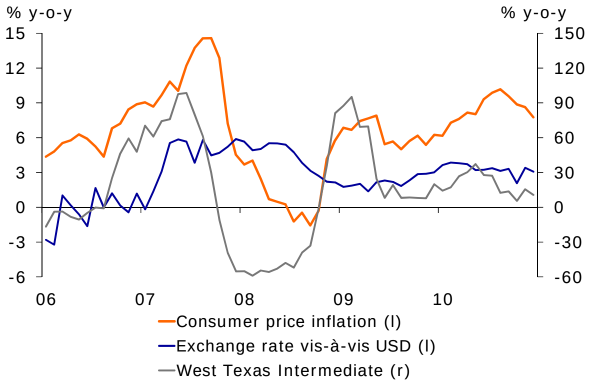
The government's reluctance to implement agreed tariff increases prior to the elections illustrates that the ailing electricity sector continues to haunt the Dominican Republic's economic and fiscal policies, even though most structural IMF targets for the overhaul of the sector have been met. Insufficient coverage of input costs by electricity tariffs, the source of continuous fiscal transfers, will likely persist in the coming years as the government has not yet implemented an automatic adjustment of electricity tariffs to oil price increases. Unless this change has been realized, government finances will remain exposed to variations in global oil prices. Notwithstanding, various steps have been taken so far to broaden the energy mix and shield the country from oil price fluctuations. As far as the former is concerned, the use of renewable energies has been promoted through the compulsory blending of gasoline and ethanol, which can be distilled from domestically produced cane sugar, and the opening of wind power plants. Regarding the latter, the Dominican Republic has joined the Venezuela-led PetroCaribe oil trading scheme to benefit from subsidized oil prices and co-operates with the state-owned oil company Petróleos de Venezuela S.A. (PdVSA) in tripling its refining capacity.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation



Source: EcoWin, OANDA

Since relatively high economic growth compensated for recent budget deficits, the public debt ratio has stabilized at 37% of GDP since 2009. Provided budgetary consolidation continues and absent major increases in oil prices, the Dominican Republic's public debt ratio is expected to decline to 36% of GDP this year. Even though the overall debt level remains moderate, a considerable share of government debt is external, reflecting recent successes in attracting foreign investors, and exposes the government to exchange-rate risk. Since about 15% of public debt (2011 figures) has been accumulated under the Venezuelan PetroCaribe oil trading scheme, additional risks could evolve if a different Venezuelan government were to change the currently extremely lenient and unorthodox repayment conditions[1].

In line with the current IMF standby-agreement, a fully-fledged inflation targeting regime has been adopted by the Central Bank of the Dominican Republic in early 2012. It replaces a multitude of, at times, contradicting policy objectives. Under the new regime, gradually declining inflation targets, including a ±1% tolerance band, have been set to meet a 4% inflation target from 2015 onwards. Since the new regime forces the central bank to focus on one policy objective only, it has to allow greater exchange rate volatility while trying to anchor long-term inflation expectations. Given the island nation's heavy dependence on imported oil, this could prove difficult, however, as the managed float of the exchange rate helped buffer supply-side induced inflation shocks. In spite of this effect and continuous monetary tightening, headline inflation reached a level of 8.6% in 2011 on the back of rising global commodity prices and the concurrent depreciation of the peso versus the US dollar. Given strongly declining domestic credit growth, inflation is expected to cool down to about 5% this year, but upside risks remain, as rising tensions in the Middle East could lead to spiking oil prices.

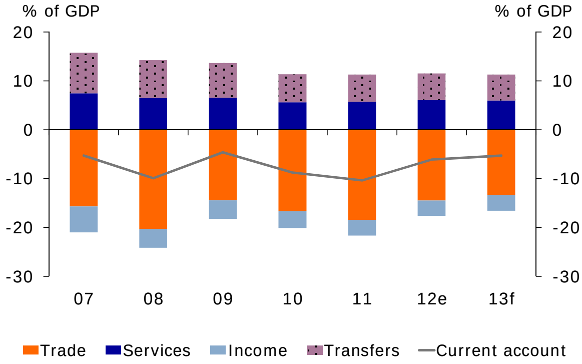
Balance of Payments

After having deteriorated to 10.4% of GDP last year on the back of strongly increasing oil prices, the current account deficit is expected to decline to about 6% this year, as mining exports will strongly increase. The underlying trade balance deficit is expected to improve from 18.4% of GDP

[1] The current repayment conditions allow for non-pecuniary repayments in goods, like beans or chicken.

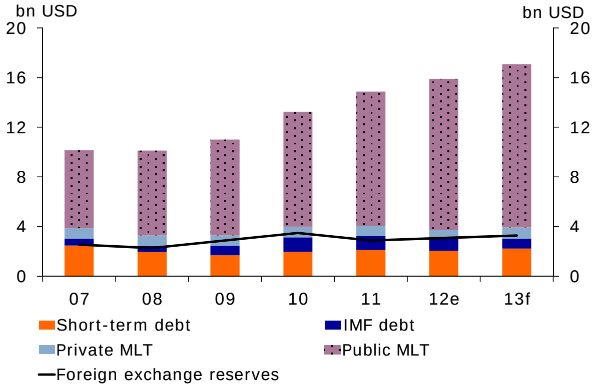
in 2011 to 14.5% this year, which will explain most of the improvement of the current account deficit. The structural services surplus is expected to slightly increase to about 6% of GDP, as rising tourist arrivals from the Americas compensate for fewer arrivals from the euro area. Reflecting the improved economic outlook for the US, remittances inflows are expected to rise, but ongoing weakness of the US and Spanish labor market put a brake on major increases. Strongly rising oil prices on the back of increasing tensions in the Middle East form a major risk to the outlook, however, and could invalidate the improvement of the trade balance.
Since net foreign direct investment flows are expected to cover about 50% of this year's current account deficit, while net portfolio inflows remain negligible, access to sufficient debt financing to cover the remaining deficit remains crucial for the Dominican Republic. Therefore, a renewal of the IMF standby-agreement is imperative, as it not only provides funding at concessional terms, but also improves investor confidence.

Chart 5: Current account



Source: EIU

Chart 6: External debt



Source: EIU

External position

The Dominican Republic's foreign debt structure looks relatively favourable, as total foreign debt amounted to a moderate 26% of GDP last year and about 50% is owed to official creditors under oftentimes lenient repayment conditions, as most of the external debt is public. Recent progress in developing a domestic debt market should open up an alternative financing source for the government, which should assist in servicing the external debt position. About 14% of the 2011 foreign debt load was short-term debt. As foreign debt growth is expected to be outpaced by economic growth in the coming years, foreign debt in terms of GDP will likely stabilize at around 25% of GDP.
Despite rising foreign exchange earnings from surging mining exports, the liquidity position remains quite weak in 2012. Foreign exchange reserves are expected to cover only 1.8 months of imports and 87% of debt service costs, which even compares poorly to other Caribbean nations. Likewise, the liquidity ratio of 91 is quite weak. While last year's success in tapping international capital markets helped mitigate the vulnerable liquidity position, continuous multilateral support will most likely be needed throughout the coming years. Being aware of the risk that a major deterioration of the sovereign debt crisis in the euro area could lead to turmoil on financial markets, which could impede market access for countries like the Dominican Republic, the government will likely try to renew the current IMF standby-agreement. This should ensure sufficient external liquidity in the coming years. Given the deteriorated external environment, we stress the need for continuous multilateral support and note the extreme external vulnerability of the Dominican Republic in the absence of this assistance.

Dominican Republic

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	8.5	5.3	3.5	7.8	4.1	4.6	4.9
Consumer prices (average % change pa)	6.1	10.6	1.4	6.3	8.6	5.3	5.2
Current account balance (% of GDP)	-5.3	-9.9	-4.6	-8.8	-10.4	-6.1	-5.3
Total foreign exchange reserves (mln USD)	2546	2272	2885	3476	2876	3080	3280
Economic growth							
GDP (% real change pa)	8.5	5.3	3.5	7.8	4.1	4.6	4.9
Gross fixed investment (% real change pa)	12.5	9.2	-14.8	17.6	7.6	7.5	8.0
Private consumption (real % change pa)	8.9	7.8	5.2	7.7	5.2	5.0	5.2
Government consumption (% real change pa)	10.0	7.7	-3.4	3.3	2.0	7.7	4.0
Exports of G&S (% real change pa)	3.2	-4.0	-7.4	11.6	8.5	13.5	8.8
Imports of G&S (% real change pa)	6.8	4.7	-9.8	14.4	11.0	12.9	9.5
Economic policy							
Budget balance (% of GDP)	0.6	-3.8	-3.2	-2.8	-2.5	-2.7	-2.0
Public debt (% of GDP)	34	34	37	37	37	36	36
Money market interest rate (%)	8.2	12.2	8.1	6.3	7.5	7.8	8.1
M2 growth (% change pa)	18	8	15	13	7	16	17
Consumer prices (average % change pa)	6.1	10.6	1.4	6.3	8.6	5.3	5.2
Exchange rate LCU to USD (average)	33.3	34.6	36.0	36.9	38.2	39.1	40.2
Recorded unemployment (%)	15.6	14.1	14.9	13.3	13.3	12.6	12.0
Balance of payments (mln USD)							
Current account balance	-2166	-4519	-2159	-4566	-5916	-3770	-3500
Trade balance	-6437	-9245	-6741	-8701	-10508	-8920	-8810
Export value of goods	7160	6748	5519	6598	7778	9140	10610
Import value of goods	13597	15993	12260	15299	18286	18060	19420
Services balance	3053	2962	3046	2936	3264	3740	3930
Income balance	-2183	-1748	-1769	-1788	-1832	-1940	-2130
Transfer balance	3401	3513	3305	2987	3160	3350	3510
Net direct investment flows	1667	2870	2067	1626	1800	2000	2200
Net portfolio investment flows	538	-251	-324	-50	100	200	200
Net debt flows	1517	18	586	2383	1622	1040	1190
Other capital flows (negative is flight)	-1116	1607	447	1204	1794	730	110
Change in international reserves	435	-274	618	597	-600	200	200
External position (mln USD)							
Total foreign debt	10144	10121	10860	13241	14863	15900	17090
Short-term debt	2476	1938	1679	1964	2112	2040	2220
Total debt service due, incl. short-term debt	2851	3914	3272	2915	3326	3520	3700
Total foreign exchange reserves	2546	2272	2885	3476	2876	3080	3280
International investment position	-10046	-13764	-16327	n.a.	n.a.	n.a.	n.a.
Total assets	11144	10307	10664	n.a.	n.a.	n.a.	n.a.
Total liabilities	21190	24071	26991	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-15.7	-20.3	-14.5	-16.7	-18.4	-14.5	-13.4
Current account balance (% of GDP)	-5.3	-9.9	-4.6	-8.8	-10.4	-6.1	-5.3
Inward FDI (% of GDP)	4.1	6.3	4.4	3.1	3.2	3.2	3.3
Foreign debt (% of GDP)	25	22	23	25	26	26	26
Foreign debt (% of XGSIT)	62	62	75	86	86	82	80
International investment position (% of GDP)	-24.5	-30.2	-35.0	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	17	24	23	19	19	18	17
Interest service ratio incl. arrears (% of XGSIT)	2.6	3.4	3.5	3.2	3.3	3.2	3.2
FX-reserves import cover (months)	2.0	1.5	2.4	2.4	1.7	1.8	1.8
FX-reserves debt service cover (%)	89	58	88	119	86	87	88
Liquidity ratio	97	81	95	88	82	91	93

Source: EIU