Dominican Republic

1. General trends

In 2003 the economy of the Dominican Republic was affected by the banking crisis that broke out in the second quarter of the year, requiring a financial bail-out that cost the equivalent of 20% of GDP. This crisis resulted in a drop of 0.4% in productive activity and in severe macroeconomic imbalances, including an abrupt currency devaluation (74%), a considerable increase in inflation (which went as high as 42.7%), a large deficit (4%) in the non-financial public sector and a quasi-fiscal Central Bank deficit of 2.5% of GDP.

The bank frauds gave rise to a precipitous loss of certainty and confidence, resulting in increased dollarization and capital flight. Nonetheless, economic activity did not contract by as much as expected owing to the recovery of exports and tourism, and to the growth of family remittances from abroad. On the other hand, domestic demand fell sharply, so that the balance-of-payments current account moved from deficit to an unprecedented surplus. Even so, international reserves were severely depleted at year's end.

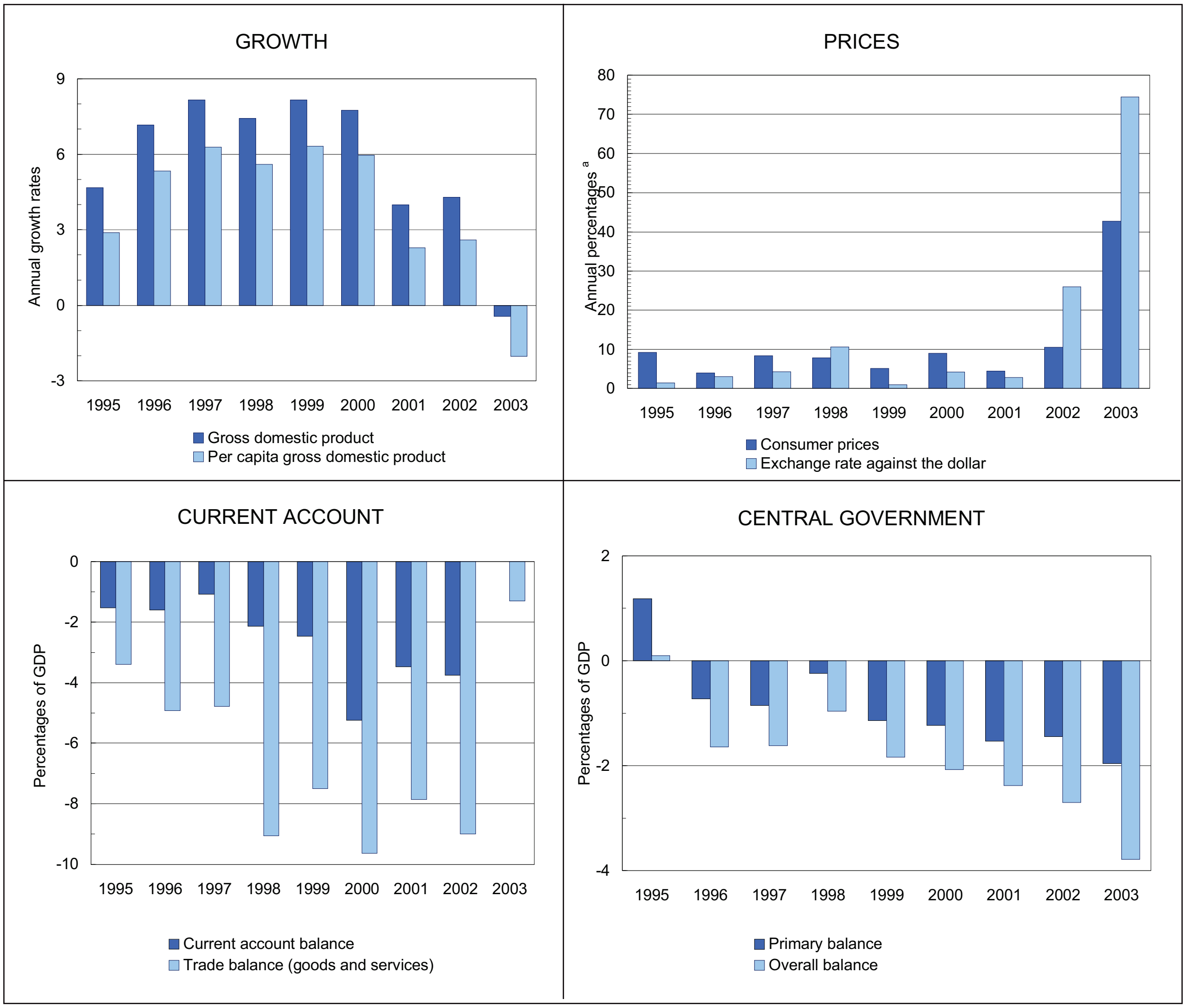
The authorities adopted strong stabilization measures and the deterioration of the banking system was halted by injecting funds into struggling banks. From August onward these measures were brought into the framework of a drawing rights agreement signed with the International Monetary Fund (IMF), which provided financial support, supported government policy and helped contain exchange-rate and financial volatility. The authorities did not meet the targets set, however, so the agreement was suspended in September. In February 2004 it was renewed, but in May it was broken off again. The February review of the agreement forecast a 1% decline in economic activity for 2004 owing to the large fall in domestic demand, even as external demand, and particularly tourism services, continued to grow. Inflation to December was expected to be 35%, a figure that was almost reached in the first half of the year alone, with a current-account surplus of 4.5% of GDP and a smaller deficit for the consolidated public sector of 3.8% of GDP.

2. Economic policy

Highly restrictive fiscal and monetary measures continued in the first half of 2004 in a context of uncertainty, volatility and low confidence, compounded by the electoral turmoil surrounding the run-up to the May presidential election. The economic picture was complicated by the rise of world oil prices and expectations of rising international interest rates.

The new government that will take office in August 2004 faces enormous challenges: shoring up the agreement with IMF, restoring confidence, stabilizing

Figure 1
DOMINICAN REPUBLIC: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] December-December variation.

the exchange rate, reducing inflation and neutralizing the impact of a large volume of investment certificates issued at very high interest rates. It is also going to have to conduct a far-reaching fiscal reform to make the public finances sustainable and solve the chronic financial crisis of the electricity sector, which has a large generating deficit.

The drawing rights programme agreed with IMF in August 2003 and renewed in February 2004 established the framework for economic policy, the main aims being to safeguard the stability of the banking system, normalize the currency market and control inflation. In addition to economic performance targets, it included a set of measures to enhance prudential supervision and regulation, strengthen the public finances and monetary discipline and establish a flexible exchange-rate regime. The agreement meant that US$ 120 million of the US$ 600 million promised could be disbursed in 2003. Nonetheless, the pact has been in force only for brief periods, remaining basically suspended during the first half of 2004 because the goals and commitments agreed upon had not been met.

(a) Fiscal policy

The public-sector deficit rose considerably in 2003. The quasi-fiscal deficit reached 2.5% of GDP, owing to Central Bank intervention in the banking system, while the non-financial public-sector deficit rose to 4% of GDP. The strain in the public finances has carried over into 2004, with the quasi-fiscal deficit expected to rise by 3.9% of GDP. As a result, efforts to increase revenues and restrain spending in the rest of the public sector have intensified.

Despite the strong downward pressure on spending and the establishment of different temporary taxes in 2003, the central government recorded a deficit of 3.8% of GDP on an accrual basis, as against 2.7% in 2002, although in cash terms it had a surplus of 1% and 0.1%, respectively. The abrupt fall in domestic demand led to revenues falling in real terms, and as a percentage of GDP (from 16.8% to 15.8%). Direct and indirect tax revenue declined by 1.5% and 11.5%, respectively. This was partly due to the devaluation of the peso and large falls in imports subject to duty, even though revenue-raising measures included a surcharge of 10% on imports with an additional 2% from July, and an increase in foreign-exchange commission from 4.75% to 10%. In August 2003 a 5% tax was also levied on exports, while the fuel tax was indexed from October so that it no longer lagged inflation.

As for spending, this was cut severely in cash terms (from 16.8% of GDP in 2002 to 14.9% in 2003), but on an accrual basis it remained practically unchanged at 18.4% of GDP, the difference being accounted for by delays in the payment of interest and other capital expenditure. Current spending other than debt servicing was cut by 8.1% in real terms, while effective interest payments increased by 40.3%. Capital expenditure fell by 32.6%, excluding so-called expenditure in kind, although a number of infrastructure projects were carried through, including some connected with the pan-American games.

Because of the large increase in total interest payments due in 2004 (estimated at 6.2% of GDP), Congress passed new emergency measures in late 2003. The temporary taxes and surcharges adopted in 2003 were renewed, and the selective taxes on alcohol and tobacco consumption were raised by 30%. The electricity subsidy was also revised, with rates being increased for commercial users and higher-income households, although tariffs for small users remained unchanged.

During the first five months of 2004, although fiscal revenues were stronger than expected, growing by more than inflation, rising international oil prices and a weaker exchange rate than originally forecast caused spending to increase, as subsidy costs were higher. The intention is to hold social spending at about 7% of GDP, chiefly thanks to IDB loans, despite the strict adjustment planned for the current year. The banking crisis that broke out in the first quarter of 2003 as a result of fraud at a large bank and two smaller ones virtually doubled the public debt, including that of the Central Bank, which rose to 56.8% of GDP and placed the sustainability of the public finances in jeopardy. External debt rose to US$ 5.9 billion, US$ 1.36 billion more than in 2002, owing to the issue of US$ 600 million worth of sovereign bonds in January, disbursements by multilateral institutions and the external debt of the electricity companies acquired by the State. Lastly, the issuing of Central Bank investment certificates increased the domestic public debt from 4.7% to 18.9% of GDP in the same period, and interest payments on these rose to 4.6% of GDP from the previous 1.2%.

In March 2004, the authorities approached the Paris Club for a rescheduling of arrears and current-year payments totalling about US$ 200 million, but there is still a large financing gap. The government's debt servicing arrears and fragile financial position caused Dominican bond prices to collapse in the international market and the country's sovereign risk rating to be downgraded.

(b) Monetary policy

In 2004 the Central Bank continued with its efforts to reduce liquidity by imposing a 5% investment ratio on the banking system and by raising interest rates. The interest-bearing deposit rate reached 50% and the Lombarda lending rate reached 60%, while the rate at which investment certificates were sold averaged 59.4% in May.

In addition, the regulatory framework was strengthened as part of the agreements with IMF, the main measures being new regulations on the liquidation and winding-up of financial institutions, the contingent fund, the lender of last resort, capital adequacy and related-party credit.

The extraordinary support provided to troubled banks in 2003 resulted in a massive issue of investment certificates to contain the impact on liquidity. The value of outstanding certificates rose from 6.905 billion pesos in late 2002 to 60 billion pesos in 2003, and then to almost 81 billion pesos in April 2004. A high percentage of certificates had maturities of less than a month and interest rates on them rose from 28% in August to 31% in December, before reaching 60% at some auctions in June 2004, as a result of which the quasi-fiscal deficit of the Central Bank rose steeply.

Table 1
DOMINICAN REPUBLIC: MAIN ECONOMIC INDICATORS

	1995	1996	1997	1998	1999	2000	2001	2002	2003 [a]
	Annual growth rates [b]								
Gross domestic product	4.7	7.2	8.2	7.4	8.1	7.8	4.0	4.3	-0.4
Per capita gross domestic product	2.9	5.3	6.3	5.6	6.3	6.0	2.3	2.6	-2.0
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	5.2	9.2	3.3	1.1	8.8	5.6	8.1	2.5	-2.9
Mining	9.4	2.4	3.1	-15.9	-1.5	13.3	-15.6	-2.7	8.7
Manufacturing	1.3	3.1	7.5	5.7	6.0	7.5	-1.3	4.0	-2.7
Electricity, gas and water	-4.1	10.3	10.1	13.8	8.1	7.0	18.4	7.8	-8.5
Construction	5.8	13.4	17.1	19.6	17.7	5.6	0.5	3.2	-8.5
Wholesale and retail commerce, restaurants and hotels	9.4	10.1	12.4	9.4	8.6	10.7	-0.1	3.6	1.2
Transport, storage and communications	10.3	10.0	11.7	13.5	11.1	15.0	16.4	9.7	5.5
Financial institutions, insurance, real estate and business services	1.2	2.1	2.8	3.0	3.2	2.8	2.5	2.6	-2.0
Community, social and personal services	1.9	5.1	3.8	4.6	3.7	4.3	6.2	3.9	4.1
Gross domestic product, by type of expenditure									
Consumption	1.7	8.9	7.3	8.6	3.7	8.4	4.4	7.5	-7.0
General government	-0.5	10.7	1.2	6.5	3.6	-1.0	14.9	8.8	9.1
Private	2.0	8.7	8.2	8.9	3.8	9.6	3.2	7.3	-9.1
Gross domestic investment	3.7	9.2	18.3	26.2	13.5	6.8	2.0	2.5	-12.4
Exports (goods and services)	7.4	4.8	9.0	6.8	6.6	6.4	-7.2	-3.4	8.2
Imports (goods and services)	3.0	8.4	12.8	18.3	4.0	6.9	-6.2	1.3	-11.7
	Percentages of GDP								
Investment and saving [c]									
Gross domestic investment	19.5	19.0	19.8	23.4	24.2	24.0	23.1	23.2	17.2
National saving	18.3	17.7	18.7	21.3	21.7	18.7	19.7	19.4	21.8
External saving	1.2	1.2	1.1	2.1	2.5	5.2	3.5	3.7	-4.5
	Millions of dollars								
Balance of payments									
Current account balance	-183	-213	-163	-338	-429	-1 027	-741	-798	867
Merchandise trade balance	-1 391	-1 674	-1 995	-2 617	-2 904	-3 742	-3 503	-3 673	-2 444
Exports, f.o.b.	3 780	4 053	4 614	4 981	5 137	5 737	5 276	5 165	5 439
Imports, f.o.b.	5 170	5 727	6 609	7 597	8 041	9 479	8 779	8 838	7 883
Services trade balance	985	1 019	1 275	1 182	1 602	1 854	1 826	1 757	2 219
Income balance	-769	-725	-795	-890	-975	-1 041	-1 092	-1 152	-1 244
Net current transfers	992	1 168	1 352	1 987	1 848	1 902	2 028	2 269	2 336
Capital and financial balance [d]	329	173	254	350	581	978	1 256	243	-1 320
Net foreign direct investment	414	97	421	700	1 338	953	1 079	917	310
Financial capital [e]	-85	76	-167	-350	-757	25	177	-674	-1 630
Overall balance	146	-40	91	11	151	-48	515	-555	-453
Variation in reserve assets [f]	-131	15	-40	-98	-194	70	-519	527	352
Other financing [g]	-15	25	-51	87	42	-22	4	28	101
Other external-sector indicators									
Terms of trade for goods (index: 1997=100)	98.0	95.8	100.0	101.1	101.9	100.0	101.5	100.9	100.0
Net resource transfer (% of GDP)	-3.8	-4.0	-3.9	-2.9	-2.0	-0.4	0.8	-4.1	-14.2
Total gross external debt (millions of dollars)	3 999	3 807	3 572	3 546	3 661	3 682	4 177	4 538	5 899
Total gross external debt (% of GDP)	33.5	28.6	23.7	22.4	21.1	18.8	19.6	21.3	34.1
Net profits and interest (% of exports) [h]	-14.1	-12.3	-11.9	-12.7	-13.4	-13.1	-14.8	-17.6	-17.9

Table 1 (concluded)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 [a]
	Average annual rates								
Employment									
Labour force participation rate [i]	51.9	52.6	54.1	52.6	53.5	55.2	54.3	55.1	54.3
Unemployment rate [j]	15.8	16.5	15.9	14.3	13.8	13.9	15.4	16.1	16.6
	Annual percentages								
Prices									
Variation in consumer prices (December-December)	9.2	4.0	8.4	7.8	5.1	9.0	4.4	10.5	42.7
Variation in nominal exchange rate (December-December)	1.4	3.0	4.2	10.6	1.0	4.2	2.8	25.9	74.4
Variation in average real wage	0.5	0.6	1.4	4.3	4.9	-0.1	5.5	-0.5	-9.6
Nominal deposit rate [k]	...	...	13.3	16.2	15.4	18.6	16.1	16.4	20.6
Nominal lending rate [l]	...	...	19.0	22.9	22.2	23.6	20.0	21.3	27.8
	Percentages of GDP								
Central government (accrual basis)									
Current income	15.2	14.2	15.9	15.9	15.6	15.8	16.3	16.5	15.7
Current expenditure	8.3	8.8	11.5	11.7	12.2	11.8	11.8	12.0	11.6
Current balance	6.9	5.3	4.4	4.2	3.4	4.0	4.5	4.5	4.1
Net capital expenditure	6.5	6.8	5.7	4.7	5.2	3.8	5.8	6.3	6.8
Primary balance	1.2	-0.7	-0.8	-0.2	-1.1	-1.2	-1.5	-1.4	-2.0
Overall balance	0.1	-1.6	-1.6	-1.0	-1.8	-2.1	-2.4	-2.7	-3.8
Public debt	...	...	...	...	...	...	...	...	...
Domestic	...	...	...	...	...	...	...	...	...
External	33.5	28.6	23.7	22.3	20.9	18.7	19.3	21.0	33.3
Interest payments (% of current income)	7.1	6.5	4.8	4.5	4.5	5.3	5.2	7.6	11.6
Money and credit [m]									
Domestic credit [n]	22.8	25.3	25.4	28.2	31.0	33.2	35.4	38.6	40.8
To the public sector	0.2	1.5	1.3	1.0	1.7	2.0	1.8	2.2	2.6
To the private sector	22.6	23.7	24.2	27.1	29.3	31.2	33.5	36.4	38.2
Money stock and local-currency deposits (M2)	23.5	24.8	25.0	26.7	28.7	29.3	31.6	34.5	38.9

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures. [b] Based on figures in local currency at constant 1978 pesos. [c] Based on figures in local currency at current prices. [d] Includes errors and omissions. [e] Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. [f] A minus sign (-) denotes an increase in reserves. [g] Includes the use of IMF credit and loans and exceptional financing. [h] Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. [i] Economically active population as a percentage of the working-age population. [j] Unemployed population as a percentage of the economically active population, nationwide total. [k] 90-day certificates of deposit. [l] Referential average rate. [m] The monetary figures are annual averages. [n] Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.

Restrictive policies were adopted against a background of large-scale capital outflows, currency depreciation and high inflation. The legal reserve was raised from 17% to 20% for local-currency deposits, from 12% to 20% for foreign currency and from 10% to 15% for non-bank institutions. Limits were also placed on private credit.

Notwithstanding, the money supply rose by almost 8% in real terms, while cash held by the public increased by 13.7% and the broader monetary aggregates (M2 and M3) expanded by about 20% in real terms (it must be noted that in 2003 the assets and liabilities concealed by the fraudulent banks were included in the accounting, which introduced distortions into the monetary aggregates). Owing to the increasing uncertainty, dollarization accelerated so that the proportion of dollarized financial assets and liabilities in the multiple banking system rose to 35% and 36.4% of the respective totals. This tendency continued in 2004.

As an annual average, bank deposit rates rose by almost four points from their 2002 level to reach 20.5% in 2003, while lending rates increased by almost five points to 31.4%. In real terms, however, both rates were negative, so the authorities agreed on measures to raise them in 2004.

Table 2
DOMINICAN REPUBLIC: MAIN QUARTERLY INDICATORS

	2002				2003 [a]				2004 [a]	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year) [b]	5.8	7.8	2.8	1.5	1.6	-3.2	-1.2	0.9	-0.2	...
Merchandise exports, f.o.b. (millions of dollars)	1 270	1 309	1 350	1 255	1 351	1 431	1 414	1 243	...	...
Merchandise imports, c.i.f. (millions of dollars)	2 079	2 185	2 242	2 293	1 971	1 964	2 070	1 879	...	...
International reserves (millions of dollars)	884	876	578	468	561	437	251	253	424	453
Consumer prices (12-month percentage variation)	3.9	4.0	5.4	10.5	18.7	26.1	33.1	42.7	62.3	60.3
Average nominal exchange rate (pesos per dollar)	17.6	17.9	18.4	20.6	23.2	25.5	32.0	37.2	46.9	46.2
Nominal interest rates (annualized percentages)										
Deposit rate [c]	13.3	15.6	17.6	19.1	20.0	20.4	21.4	20.6	20.2	23.0
Lending rate [d]	17.6	19.3	22.8	25.6	26.8	26.7	29.5	28.3	29.1	31.1
Interbank interest rate	12.3	13.1	15.6	17.1	19.7	23.0	26.8	27.4	45.8	51.6
Sovereign bond spread (basis points)	342.2	404.6	0.0	537.6	526.4	836.5	847.3	1 572.1	1 968.4	2 566.8
Domestic credit [e] (variation from same quarter of preceding year)	21.5	23.4	16.9	18.7	17.2	39.9	42.4	30.9	37.5	26.5 [f]
Non-performing loans as a percentage of total loans (%) [g]	2.7	3.1	6.2	5.9	6.2	...				

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures. [b] Based on figures in local currency at constant 1978 prices. [c] Average of reference rates. [d] 90-day loans, multiple banks. [e] Refers to credit extended to the public and private sectors by commercial banks and other financial and banking institutions. [f] Data up to April. [g] Refers to total credit extended by the consolidated financial system.

(c) Exchange-rate policy

As uncertainty increased, currency volatility and depreciation intensified considerably in the first quarter of 2004. Nonetheless, the exchange rate tended to stabilize in the second quarter owing to the improving external financial position and renewal of the agreement with IMF in February.

In 2003, owing to the pressure placed on the currency market by capital outflows, the peso depreciated abruptly against the dollar, with an average annual devaluation of over 34% in real terms. Towards year's end the authorities adopted a flexible currency regime, subject to occasional interventions by the Central Bank to avoid excessive fluctuations. In addition, they unified the market by transferring payments for oil imports, a process which was completed in the early months of 2004 with the inclusion of official foreign debt payments. In February 2004, the Monetary Committee of the Central Bank approved currency market regulations that lay down rules, policies and procedures for currency transactions.

(d) Trade policy

In November 2003, the Dominican Republic commenced negotiations with the United States on a Free Trade Agreement (FTA), and these concluded in March 2004. The documents are expected to be put to the respective congresses for approval in the second half of the year. The FTA with the United States is expected to bring the greatest benefits to the export processing zones that generate 80% of the country's exports, and this is important given the huge competition faced by this sector in the United States market.

3. The main variables

The pick-up in external demand (8.2%) after two years of decline and the steady growth of family remittances were not enough to cushion the sharp contraction of private consumption (-9.1%) and the fall in investment (-12.6%) resulting from credit restrictions, higher interest rates, devaluation and the climate of uncertainty. Although productive activity recovered in the fourth quarter of 2003, in the first quarter of 2004 it was virtually stagnant (-0.2%).

(a) Economic activity

Goods production contracted considerably (-4.1%), while service activity grew slightly. Construction contracted by 8.5% and agriculture by 2.9% as crop production fell, in part because of the severe damage caused by heavy flooding at year's end. Manufacturing output fell by 2.7% owing to the downturn in the sugar sector, although activity increased in the export processing zones (3.4%) and there was an upturn in the finance, insurance and services sector (2%). The electricity, gas and water sector shrank by 8.5%, against the background of a chronic electricity generation shortfall. Higher international prices for nickel-iron revived mining, which grew by 8.7%, while government services and telecommunications, storage and communications also progressed, although at a much slower rate than in the past. Commerce slumped by 12.4%, although hotels, bars and restaurants grew by 29.6%.

(b) Prices, wages and employment

In 2003, owing to the devaluation of the peso and higher oil prices, the country experienced its highest inflation (42.7% from December to December) in over a decade. The sharpest increase were seen in transport (66.7%), while increases in the food and health-care industries were 51.1% and 30.8%, respectively. Price adjustments for wearing apparel and footwear, furniture and accessories, and education lagged much further behind.

In the first five months of 2004, consumer prices rose (28.5%) as the currency depreciated. The highest price rises were for food, beverages and tobacco, and for transport.

This high inflation meant that real wages fell sharply, despite nominal increases. Thus, wages fell by 17% in large enterprises, 12% in medium-sized and small ones and 9.1% in export processing zones. The authorities expect to raise the wages of public-sector employees in the second half of 2004.

The decline in economic activity caused the employment rate to fall from 46.2% to 45.2%. Since the global participation rate also fell (from 55.1% to 54.3%), the impact on unemployment was moderate. The open unemployment rate rose from 5.9% to 6.5%, while the broader unemployment rate increased to 17%.

(c) The external sector

In 2003 the country ran an unprecedented balance-of-payments current-account surplus of 5.1% of GDP (for the present year, the authorities believe the surplus could be 4.5% of GDP). The collapse in domestic demand led to a fall in imports and thus an improvement in the trade balance, while a growing influx of tourists yielded a larger surplus in the services balance. Furthermore, family remittances continued to grow (5.1%). Sovereign bond issues totalling US$ 600 million on international markets, together with disbursements by external financial organizations, were not enough to prevent a drop in international reserves for the second year running. In fact, the figure at year's end was US$ 124 million, one of the lowest levels of recent times. The first quarter of 2004 saw a slight recovery.

After two years of decline, goods exports recovered by 5.3%. Exports of local products rose by 22.8%, largely owing to sales of nickel-iron (52.8%), whose international price increased, although sales of coffee and cacao also improved, as did those of various non-traditional products (15.5%). Shipments from export processing zones, accounting for 80% of the total, grew by a mere 1.9% to US$ 4.399 billion. Exports of wearing apparel and footwear (about half of the sector) declined by 1.5%, while the remaining categories grew by 6.2%, the best performers being electronics (16%) and pharmaceuticals (4%).

The downturn in consumer and investment spending caused imports to decline by 10.8%, the largest falls being experienced by consumer goods (-18.5%) and capital goods (-27.5%). Meanwhile, purchases of inputs fell by 8.6%, while the oil bill rose by 10% owing to higher international prices.

The traditional surplus in services widened as tourism revived (23%) owing to recovery in the international economy and the large devaluation of the peso against the dollar, and of the latter against the euro. In 2003, the number of non-resident travellers reached 3.3 million, 470,000 more than the previous year, generating revenue of US$ 3.1 billion. Foreign direct investment fell to US$ 310 million, 66% below the previous year's level and the lowest for six years.

During the early months of 2004, total exports grew only very modestly since, while exports of locally made goods rose by 30%, those of the export processing zones fell by 2.6% in the January-May period. Meanwhile, the number of tourists rose by 7.9% to May, with 108,000 more visitors coming into the country than in the same period the previous year.