SOVEREIGN: Dominican Republic

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Ratings: Standard and poor's, BB-/Stable; and Moody's Ba3/Stable

Summary

The Banco Central de la Republic Dominica (BCRD) is projecting real economic growth in the Dominican Republic of 5.5% - 6.5% in 2018. The growth outlook is predicated on continued expansion in tourism, construction, exportation from the export zones, and the mining sector. We are forecasting growth of under 5% driven by higher levels of output in the aforementioned sectors. Higher GDP growth in the US buoyed by an increase in consumer spending will contribute to expansion in demand for tourism and goods from the free trade zones.

It is envisaged that the current account deficit will fall despite higher oil prices as increased flows are expected from tourism and remittance. Inflows into the capital account, primarily foreign direct investment from the service sector, are likely to offset the deficit leading to accumulation in reserves. Given developments in the external accounts, the outlook is for depreciation of the currency in line with the average over the last three years. This will help to keep exports competitive. The reserve position of the sovereign will allow the BCRD to defend the currency from wild swings in the event of shocks to the external accounts.

Having kept the policy rate stable over the last two quarters, upward rate adjustments are expected in keeping with anticipated rate increases by the US Federal Reserve (Fed) to help preserve the external account and to mitigate the risk of volatility in the currency market.

Risks to the domestic economy are fairly balanced at this time. A slowdown in economic expansion in the US and by extension the rest of the world could adversely impact growth in tourism and remittance. A continuous rise in oil prices and/or bad weather, especially hurricanes, could negatively affect the terms of trade and the current account, which could feed through into the foreign exchange market and cause volatility.

Economic Update

Growth

The world economy is expected to grow by around 3.3% in 2018 and 2.9% in 2019. The growth in the world economy is expected to be led by increased output in the USA and China. For Latin America and the Caribbean (LAC) growth is expected for all the countries with the exception of Venezuela; the forecast is for positive movement in GDP of 2.6% in 2018 and 2.9% in 2019. Growth in the Dominican Republic is expected at around 4.4% in 2018, one of the highest growth rates in LAC.

The outlook on growth for the sovereign is predicated on continued expansion in tourism and associated construction; exportation of goods from the free trade zones; and gold production. It is envisaged that strong growth in North America, in particular the US, and Europe will have a positive spill over effect on tourism in the Dominican Republic. Arrivals from all the major territories combined account for well over 80% of total stopover visitors.

Developments in infrastructure have had to keep pace with growth in arrivals. The volume and monetary value of planned and ongoing projects are elevated, as investment flows in the tourism industry are being buoyed by growth in the sector and an enabling business climate. Like tourism, export from the free trade zone should benefit from expansion in the US economy, which is the main trading partner for the DR. A modest increase in gold output and higher prices are expected to help drive real output growth in the mining sector. Government spending on infrastructure over the years has helped to buoy output. However as the authorities are planning to reign in the fiscal deficit, this will result in a reduction in capital spending, which is likely to reduce the growth momentum.

Table 1: Selected Macroeconomic Indicators

Indicator Name	2014	2015	2016	2017	2018 (e)	2019 (f)	2020 (f)	2021 (f)	2022 (f)
Real GDP growth, % y-o-y	7.6	7.0	6.6	4.6	4.4	4.6	4.5	4.6	4.2
GDP per capita, USD	6,281	6,475	6,730	6,978	7,236	7,545	7,915	8,362	8,826
Unemployment, % of labour force, eop	14.2	14.1	13.3	13.5	13.5	13.2	13.1	13.0	13.0
Inflation, % y-o-y, eop	1.6	2.3	1.7	4.2	4.0	4.3	4.5	4.6	4.5
Central bank policy rate, % eop	6.25	5.00	5.50	5.25	5.50	5.75	5.75	5.75	5.75
Exchnage rate: DOP/USD, eop	44.42	45.53	46.66	48.25	49.69	51.18	52.36	53.64	54.96
Total revenue, % of GDP	14.7	14.4	14.8	15.2	15.2	15.2	15.3	15.3	15.4
Fiscal balance, % of GDP	-2.8	0.1	-2.8	-2.2	-2.2	-2.1	-1.9	-1.7	-1.6
Current account balance, % of GDP	-3.3	-1.9	-1.4	-0.7	-1.2	-1.4	-1.1	-0.9	-0.7
Foreign reserves ex gold, USDbn	4.9	5.3	6.0	6.8	7.2	7.5	7.9	8.3	8.7
Import cover, months	3.4	3.7	4.2	4.6	4.6	4.6	4.6	4.6	4.6
Total government debt, % of GDP	36.4	35.4	37.3	37.1	37.0	36.7	36.4	35.9	35.2
Government domestic debt, % of GDP	11.8	11.9	13.1	12.7	12.7	12.6	12.4	12.3	12.1
Total debt service, % of GDP	4.9	7.7	5.4	-	-	-	-	-	-
Interest payments, % of GDP	1.3	1.6	1.8	-	-	-	-	-	-
Gold Mine Production, moz	1.13	1.04	1.22	1.25	1.12	1.14	1.16	1.20	1.24

Source: BMI and JMMBIR

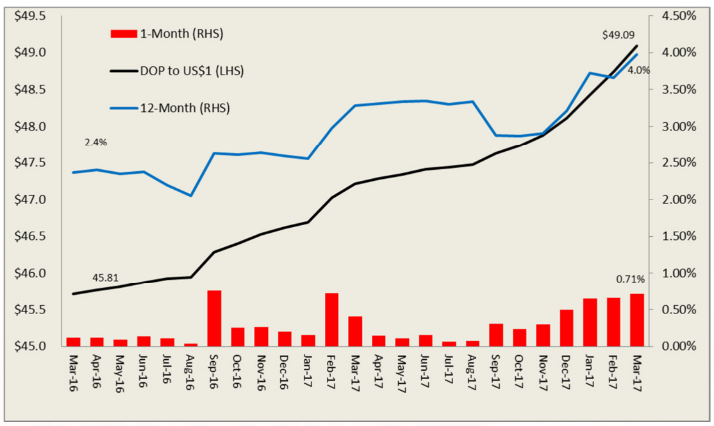
Fiscal Policy

In keeping with the thrust to reduce the fiscal deficit and stabilize the debt, the authorities are expected to reduce spending over the medium-term. As a result it is envisaged that the deficit as a proportion of GDP will fall incrementally over the forecast horizon. A deficit of 2.2% of GDP is projected in 2018, the same as the expected outturn in 2017. The sovereign's debt servicing ratio and debt-to-GDP are relatively low by LAC standards and is expected to fall marginally in line with real economic growth and a reduction in the fiscal deficit.

As we have outlined in previous publications, see for example Dominican Republic, Q4 2017, there is fiscal space to grow revenue if required as the revenue-to-GDP ratio is relatively low. In 2017 median revenue-to-GDP for the Caribbean territory as a whole is estimated at 26.7% compared to 15.2% for the Dominican Republic.

Current Account and Exchange Rate

Figure 1:



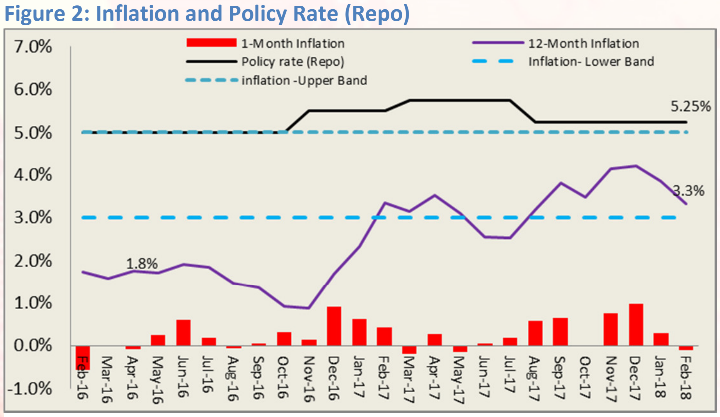
Source: BCRD and JMMBIR

A modest uptick is anticipated in the current account deficit (CAD) in 2018 due in part to upward pressures in energy prices. This however is not expected to be sustained over the medium term as the outlook is for increased remittance and tourism flows this should keep the CAD subdued. As noted overleaf, strong growth is anticipated in tourism and remittance flow which is congruent with improvements in the economic outlook for source countries.

Developments in the current account coupled with strong capital flows directed through investments into various sectors in the economy are likely to result in an increase in foreign currency reserves. This bodes well for activities in the foreign currency market where relatively stable supplies are expected and should therefore help to stymie any movement of the pesos relative to the US dollar. In the event of shocks to the external accounts, the authorities will have the wherewithal and resolve to intervene in the foreign currency market to help minimise volatility.

Inflation and interest Rates

Figure 2: Inflation and Policy Rate (Repo)



Source: BCRD and JMMBIR

For most of 2017 inflation hovered at the lower end of the central bank's policy band of 3% - 5%. As a result of this and overall developments in the domestic and international economy, the BCRD reduced the policy rate (Repo) by 50 basis points to 5.25% in July-2017. Rates have held steady subsequently and the expansionary monetary policy has been hailed as a boon to an increase in economic activities emanating from higher household and business spending due in part to credit growth.

While inflation remains within the target band, higher oil prices could put upward pressure on general prices. It is our view that there is a relatively low probability of an accelerated rise in oil prices over the medium-term. However, should this event become a reality the effect could linger over multiple periods in light of recent geo-political tensions and developments in the oil sector, such as reduce output from Venezuela.

The consensus forecast is that the Federal Reserve (Fed) will increase interest rates three times in 2018 with the possibility of a fourth, depending on the evolution of the economy, in particular price expectation. The Fed raised rates by 25 basis points in March citing in part a more robust domestic economy, having raised the outlook on growth to 2.7%, up from 2.4%. As a precursor to the Fed rate hike, the Federal government reduced the tax rate for US corporates from 35% to 21%. The combination of interest rate hikes and lower tax rates is likely to lead to flight to quality, as funds move from Emerging Market economies into the US.

Given our outlook in regards to movements in domestic inflation and serial increases in US interest rates, the BCRD is likely to adjust the policy rate to help preserve the external accounts and keep inflation within its forecast band. We however do not expect a one-on-one mapping between domestic and US rate increases. As such, the BCRD is likely to increase rates with a lag in order to balance its outlook on the evolution of the external account with its growth objective.

Outlook

The Dominican Republic's economy continues to perform favourably due to strong policy implementation and linkages with the US. Like many Caribbean and Latin American economies that are dependent on oil, an increase in oil prices poses upside risk to inflation. Lower tax rates in the US and an increase in Fed rates could result in funds flowing out of EM economies resulting in increased funding rates in these jurisdictions, as central banks implement policies to curtail capital flight. The consensus forecast is pointing towards three rate hikes by the Fed in 2018, the first of which took place in March. If the Fed presses ahead with raising rates, we are of the opinion that the BCRD will match them, perhaps with some time lag, to preserve the DR's external accounts and maintain the current growth path. The probability is weighted towards an increase in the Bank's policy rate in 2018.

As we have highlighted previously, we are not anticipating any major deviation in the trajectory of the domestic currency. Depreciation pressures are likely to remain subdued in keeping with the evolution in the balance of payment accounts. We continue to maintain a positive outlook on the sovereign and its macro-fiscal framework. Notwithstanding this view, risks to the domestic economy are fairly balanced at this time. A slowdown in economic expansion in the US and by extension the rest of the world could adversely impact growth in tourism and remittance. A sustained increase in oil prices and/or bad weather, especially hurricanes, could negatively affect terms of trade and the current account, which could feed through into the foreign exchange market leading to currency volatility.

Source:

Bloomberg, Jeffries, Oppenheimer

APPENDIX

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