INVESTMENT AND SOVEREIGN RESEARCH

***SOVEREIGN*: Dominican Republic**

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

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

Executive Summary

Moody's conducted a detailed credit assessment of the Dominican Republic, looked at four rating factors in isolation and comparatively with other Ba-rated sovereigns. The factors assessed were as follows: economic strength, institutional strength, fiscal strength and susceptibility to market risks.

Moody's is of the opinion that the sovereign's economic strength is "Moderate +." This designation reflects expected real GDP growth of 5%-5.5% over the next two years, and is driven by the country's reliance on tourism. The sovereign's institutional strength is "Low (-)" which highlights corruption challenges, and is in part made visible by the Odebrecht scandal that has engulfed several Latin America countries. Moody's rates the sovereign's fiscal strength as "Very low (+)" due to the high proportion of foreign-debt relative to the total debt and low debt affordability. With respect to susceptibility to event risk, Moody's deemed it to be "Low (+)". This view is predicated on declining balance of payment risks and containment of government liquidity risks.

The rating agency advised that the sovereign's credit ratings could increase if debt affordability indicators improve driven by higher revenues and/or lower debt levels. Conversely, a lack of action to cull the fiscal deficit and growing debt could prompt adverse ratings action over the next two years.

Introduction

Moody's Ratings agency conducted and in-depth credit analysis of the Dominican Republic's economy in late March. The ratings agency looked at four ratings factors in isolation and comparatively with countries in the Ba-rated sovereign risk category. The factors assessed were as follows: economic strength, institutional strength, fiscal strength and susceptibility to market risks. The ratings agency is of the view that the Ba3 stable credit ratings of the Dominican Republic is "supported by robust economic growth, contained external and government liquidity risks, and moderate fiscal deficits." The Dominican Republic was one of the fastest growing economies in Latin America in 2018. The competitiveness of the tourism industry is helping to drive the growth dynamics.

Debt to GDP is low but there are credit challenges arising from the high proportion of foreign debt relative to total debt and low debt affordability, as reflected in the high share of interest to government revenues at 18%. Revenue buoyancy is weak and revenue to GDP is low when compared to other regional sovereigns.

Moody's advised that the sovereign's credit ratings could increase if debt affordability indicators improve driven by higher revenues and/or lower debt levels. Conversely, a lack of action by the authority to cull the fiscal deficit and growing debt could prompt adverse ratings action over the next two years.

Economic Strength

Moody's is of the opinion that the sovereign's economic strength is "Moderate +." This designation reflects expected real GDP growth of 5%-5.5% over the next two years, and the country's reliant on tourism. Moody's noted that the score balances strong GDP growth and moderate economic development against the relatively small size of the economy (estimated at US$82 billion in 2018). Economic growth in expected to continue to outperform other regional countries in the coming years. On a purchasing power parity basis, the Dominican Republic's per capita GDP of US$16,994 in 2017 was above Ba-rated peers (US15,000) and double that of B-rated sovereigns (US$6,760). The ratings agency stated that strong economic growth and targeted spending contributed to reduction in unemployment and poverty. Unemployment fell to an estimated 5.8% in 2018 from 7.0% in 2013 while the incident of general poverty declined to 22.8% of the population in 2017 from 39.7% in 2012.

Regarding growth in 2018, Moody's noted that it was broad-based and driven by favourable external demand conditions which buoyed activities in free-zone exports and construction. The central bank also played role with the easing of monetary policy, which drove credit expansion by 11.3% in 2018. The service industry accounts for the lion share of the economy at just over 66% compared to 47% in 2000. Moody's noted that growth was not reliant wholly on tourism. The prevailing domestic macroeconomic conditions are expected to push growth above the potential growth rate of 5.6% despite climatic risk and tighter global financial conditions.

Key growth driver: Tourism

Moody's stated that opportunities in the tourism industry remain strong and that visitor arrivals have diversified when compared to say 2000 where 87% of guests where from the US. Arrivals from the US is down to 40% and there are increasingly more visitors from other destinations, including Latin American countries, and average spending is growing. Notwithstanding infrastructure and inconsistent electricity supplies, increasing infrastructure investments have positioned the Dominican Republic as a leading tourism destination in the Caribbean.

The Dominican Republic's tourism product is diverse; it caters to visitors who are on a budget as well as those who desire to partake in the high-end experience. The destination is served by several international air- and sea-ports. The administration has embarked on an ambitious plan to boost arrivals to 10 million visitors in 2020 up from 6.6 million in 2018 and 5.6 million in 2015.

Institutional strength

Moody's is of the opinion that the sovereign's institutional strength is "Low (-)" which reflects corruption challenges, and is in part highlighted by the Odebrecht scandal that has engulfed several Latin America countries. The score also reflects the Dominican Republic's low ratings among other countries in the region in the World Governance Indicator.

The inflation targeting framework implemented by the central bank in 2012 has strengthened policy credibility, but this is offset by 'stop-and-go" fiscal policy. Moody's assessment of the sovereign's overall intuitional strength reflects policy credibility anchored by institutional support. The central bank has been successful in containing inflation within the targeted band of 3% - 5%. Low oil prices in 2015 and 2016 and again in 2018 contributed to low levels of inflation. Price rise in 2017 reflects increases in oil prices and pent-up demand following hurricanes in the second half of the year.

There are improvements in the Dominican Republic's institutions as reflected in the strengthening of banking supervision, expansion in the domestic capital market and increased transparency in financial statistics.

Fiscal Strength

Moody's rate the sovereign's fiscal strength as "Very Low (+)" due to the high proportion of foreign-debt relative to total debt as well as the low debt affordability. The ratings agency noted that even though the sovereign's debt to GDP ratio at 40% is low and moderate by global standard, debt affordability is unfavourable relative to peers with interest payments accounting for 18% of government revenues in 2018. This more than double that of rating peers.

The government has maintained a relatively stable fiscal programme with the deficit 2.3% of GDP over the last four years. With the deficit increasing to 6.6% of GDP in 2012 the authority embarked on spending cuts and revenue measures to reduce it. The revenue measures which include increased taxes and improved administration generated revenues amounting to 0.5% of GDP of the last four years.

Moody's stated that despite strong economic growth fiscal consolidation is limited. The fiscal deficit is in part due to the low tax base. With revenues to GDP of 15% the Dominican Republic has one of the lowest tax base in Latin America and the Caribbean where the median revenue to GDP is 22%. The low revenue intake mirrors the sovereign's high interest payment-to-revenue ratio.

The correlation between government revenues and GDP is weak due to tax exemptions and loopholes as well as the large informal sector. The sectors that are the main drivers of economic growth – Tourism, Construction and Free zone exports – are given favourable tax treatments. Economic growth at 7% of GDP in 2018 was 2% higher than programmed while revenue growth was only 0.9% above budget.

The fiscal deficit declined to 2.4% in 2018 compared to 3.5% in 2017 while revenue administrative measures pushed revenues-to-GDP to 15% in 2018 relative to 14.7% in 2017. Capital spending in 2018 fell 0.4% largely due to the winding down of spending on the coal-powered fuel plant under construction at Punta Catalina. One off hurricane-related spending of 0.335 of GDP in 2017 was also not expended in 2018.

Notwithstanding ongoing fiscal containment government debt is growing and is expected to increase to 40.4% of GDP in 2019 from 39.6% in 2018. Moody's is not as optimistic as the government with respect to the measures being implemented to boost revenue and curtail expenditure growth. The ratings agency is anticipating pressures on the fiscal account in the form of higher interest payments due to increase in the debt stock, a less benign global environment and higher than programmed subsidies due to increasing oil prices. Accordingly fiscal deficits just below 3% is envisage over the next two years.

Improved financial conditions in the energy in sector to reduce drag on the fiscal accounts

Moody's noted that inefficiencies and technical and commercial losses have plagued the state owned electric company for years. Its operation has put pressure on the fiscal accounts because of the high levels of subsidies given to the entity by the government, in part to fund 'social electricity' as a high proportion of the population does not pay for the utility. Construction of the coal-fuel power plant at Punta Catalina will change the fuel mix of the energy being supplied to the grid and add 740 MW in new capacity, just about 30% of total demand. This and other projects which are expected to come on stream by 2020 are likely to reduce fuel costs on the fiscal accounts and in the process cut government subsidies to the electricity company by $400-$500million per year (0.5%-0.6% of GDP).

Susceptibility to event risk

Moody's deemed the Dominican Republic's susceptibility to event risk as "Low (+)". This view is predicated on declining balance of payment risks and containment of government liquidity risks. With presidential election constitutionally due in 2020, the ratings agency is not expecting any shift in policies but does anticipate accelerated spending ahead of the election. The front runners in the election are the incumbent president Danilo Medina, who will seek Congressional amendment to the Constitution in order to run for a third term, and former president Leonel Fernandez, both of whom are form the same party. A shift in the political administration will not fundamentally alter current policy direction.

The Odebrecht scandal in 2017 resulted in widespread protests and calls for the government to take action against corrupt political and public officials who received US$92 million in bribes from the engineering and construction firm to secure favourable government contract. Political fallout from the protests were minimal, but the president political capital was eroded which in the process limited him pressing ahead with structural reforms.

Moody's see the government's liquidity risk as "Low (+)" despite the high proportion of foreign denominated debt relative to total debt and low debt affordability indicator. The proportion of debt falling due in 5 years fell to 32% in 2018 compared to 41% in 2013. Average time to maturity increased to 9.2 years in 2018 compared to 5.2 years in 2013. The government has initiated programmes to broaden the appeal of the domestic capital market and the share of fixed rate debt in the government portfolio increased to 87.3% in 2018, up from 74% in 2013.

Repayment of the PetroCaribe debt reduced the debt by 3% in 2015 but debt levels have subsequently risen due to higher debt issuances. There is strong demand for government bonds in the international capital market (ICM) and financial flexibility is improving. Access to the ICM has prompted a shift from bilateral to market debt. Bilateral debt accounted for 9.7% of external debt in 2018 compared to 38.3% in 2014. Demand for government debt remains strong among local financial institutions and the domestic capital market is deepening.

Moody's is concern about the increasing level of foreign debt at 70% relative to the overall debt portfolio. A significant portion of debt issued locally are foreign denominated due in part to relatively high local rates.

Moody believes that banking risk is "Very low (+)". Domestic banks account for 75% of the banking system assets in an industry that is highly concentrated. The Dominican's Republic Financial depth is low when compared to other Latin American countries. The banks continue to report strong earnings against historically weak efficiency, as lending spreads are well above regional average. Financial flexibility is supported by a stable deposit base and adequate liquidity buffer. High growth in loans however poses downside risks particularly as exposures in cyclical sectors are high. Non-performing loans at 1.5% of gross loans as at end-December 2018 is low but could rise if GDP growth slows. However, loan loss reserves ratio at 180% help to mitigate this risk.

Moody's see the sovereign's external vulnerability risk as "Low (+)" due to subdued oil prices, increase remittance flows and accumulation of reserves. The current account deficit (CAD) has fallen from 9.5% of GDP in 2014 on the heels of elevated oil prices to 1.4% of GDP in 2018. This coupled with increasing remittance flows (8% of GDP) and tourism earnings pushed reserves in 2018 to US$7.7 billion, or 4.4 months of imports.

The ratings agency expects the tailwind from growth in the US to subside which is likely to have ripple effects on the domestic economy. The US is the sovereign's main source country for tourism and remittance, and destination for exports from the free zones. The foreign reserves is expected to grow modestly but the CAD is likely to widen to 2%-3% of GDP over the next two years.

Opinion

The Dominican Republic remains one of the fastest growing economies in Latin America and the Caribbean with growth averaging upward of 5% over the last decade. The growth path has been buoyed by tourism, construction, mining and exports from the free zones. Tourism accounts for over 17% of total output. The US is one of the sovereign's main trading partners and accounts for around 40% of visitor throughput and a large share of its exports. Given the dependency of the Dominican Republic on the US economy, sharp slowdown in US growth could negatively affect domestic output. The US yield curve is inverted which suggests the possibility of a slowdown in the US economy in coming months. At the same time however the Federal Reserve is likely to stay further rate rise in 2019, which bode well for stabilizing growth in the US and allowing the central bank in the Dominican Republic to remain neutral in its monetary policy stance.

The sovereign is beset with many challenges, particular on the fiscal side. For example the correlation between economic growth and government revenues is weak due to the large tax break given to high growth sectors, such as tourism and the free zones. As a consequence the pace of government revenue increase has not kept pace with economic growth. Arising from moderate fiscal deficits over the years, debt levels are rising and debt service cost to government revenues is relatively elevated when compared to peers. Structural changes are slow in coming, but with the pending construction of a coal-fuelled electricity plant at Punta Cana the fiscal accounts could benefit; government subsidy to the electricity sector is expected to fall by around 0.5%-0.6% of GDP over the next several years.

Sources:

Bloomberg
The International Monetary Fund
Moody's Investor Service

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

UNDERWEIGHT—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET
SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.
HOLD/MARKETWEIGHT—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

VERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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