SOVEREIGN: Dominican Republic: September-15-2020

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Ratings: Standard and Poor's, BB-/negative; Fitch, BB-/negative; and Moody's Ba3/Stable

Summary

Preliminary data showed that the Dominican Republic's (DR) economy contracted by 8.5% over the period January-June 2020. For the period January-July arrivals at the airports declined by 62.7% relative to the similar period in 2019. In response, the fiscal authority and the central bank have implemented policies to help stimulate the economy. It is possible that further stimulus may be required to help improve growth and reduce unemployment. Due to the contraction in tourism and remittance flows the current account deficit has increased, so too has the depreciation momentum of the peso relative to the US dollar. Inflation has been muted since the start of the year, but jumped in July occasioned by elevated peso depreciation. With steep contraction in growth and the widening of the fiscal deficit, debt / GP is expected to rise over the medium term. A Fiscal remedy will be required in the medium to long run to prevent the debt from moving towards an unsustainable path.

Table 1: SWOT Analysis

Strength	**Weakness**
• Strong foundation in fiscal and monetary policies have paved the way for high economic growth, exchange rate stability and low inflation. • High GDP growth resulted in reduction in unemployment and lifted a large segmented of the society out of poverty.	• Underdeveloped electricity infrastructure causes frequent power outages, which is disruptive to smooth productive operations. • High dependency on tourism and the US economy leaves the local economy vulnerable to sluggish growth in the US.
Opportunities	**Threat**
• Service-oriented economy with a business friendly environment makes the sovereign an attractive destination for investments in the tourism and related sectors as well as manufacturing. • With the strong ties that exist with US, manufacturing outfits in the Dominican Republic are set to benefit from US corporations moving their supply chain close to home after COVID-19.	• Widening fiscal deficit and debt build up pose a challenge over the medium-term. This coupled with the slow pace of fiscal reform and high public sector charge, particularly in the electricity sector could lead to a high risk premium for government debt issuances. • Slower than anticipated improvements in the global economy pose downside risks to the pace of growth in the tourism and export sectors. The sovereign could face severe deterioration in its debt dynamics over the medium term.

The coronavirus (Covid-19) pandemic is negatively affecting the global economy. No economy is spared, especially those that are highly service oriented such as the tourism-dependent economies in the Caribbean. Preliminary data for June from the Banco Central de República Dominicana (BCRD) showed that the domestic economy contracted by 8.5% over the period January-June. This marks the first time in over a decade that the economy has contracted. In early March the government closed the borders due to the potential effect of the virus on the local population owing to several reported cases, most of which were imported at the time. With subsequent community spread the government issued a stay at home order to help curtail the disease from overwhelming the capacity of the health services and to preserve the general health of population. The net impact of these measures resulted in a fallout in tourism and commercial activities, as visitor arrivals and consumer spending fell precipitously.

Businesses have been adversely affected resulting in many scaling down operations and reducing their staff compliment. It is estimated that over 350,000 lost their jobs in the tourism and manufacturing sectors. The government recognized that the economic impact of Covid-19 would be severe, and even more so if nothing was done to help stimulate domestic consumption and maintain robust credit conditions. As a result, several measures were implemented to help soften the impact of declining economic activity on the public.

Table 2: Selected Macroeconomic Indicators

Indicator	2015	2016	2017	2018	2019	2020 (e)	2021 (f)	2022 (f)	2023 (f)
Nominal GDP per capita, USD	6,922	7,281	7,609	8,051	8,282	7,449	7,539	8,024	8,528
Real GDP growth, % y-o-y	6.9	6.7	4.7	7.0	5.1	-5.3	2.2	4.9	4.8
Inflation, eop, % chg y-o-y	2.34	1.70	4.20	1.17	3.66	1.78	3.40	3.72	3.80
Pesos/USD, eop	45.55	46.71	48.30	50.28	52.96	61.15	64.06	65.66	66.98
Total revenue, % of GDP	16.6	13.9	14.0	14.2	14.4	13.1	13.5	13.6	13.6
Total expenditure, % of GDP	16.6	16.9	17.4	16.5	16.7	19.7	19.4	18.9	18.2
Current expenditure, % of GDP	14.5	15.2	15.6	15.0	15.2	18.4	18.0	17.6	17.0
Capital expenditure, % of GDP	2.1	1.7	1.8	1.5	1.5	1.4	1.3	1.3	1.2
Fiscal balance, % of GDP	3.0	-3.0	-3.3	-2.3	-2.3	-6.5	-5.8	-5.2	-4.6
Primary balance, % of GDP	5.3	-0.5	-0.8	0.3	0.4	-3.6	-3.0	-2.4	-2.1
Total government debt, % of GDP	34.3	35.8	37.3	37.9	38.4	52.7	53.9	56.6	59.1
Government domestic debt, % of GDP	11.5	12.5	13.5	14.0	13.9	18.9	19.3	20.3	21.2
Current account balance, pct of GDP	-1.8	-1.1	-0.2	-1.4	-1.4	-5.2	-3.8	-1.2	-0.7
Foreign reserves ex gold, USD	5,266	6,047	6,781	7,628	8,782	9,221	9,682	10,166	10,674
Import cover months	3.7	4.2	4.6	4.5	5.2	6.0	6.0	6.0	6.0
Reserve assets, pct of GDP	0.57	1.03	0.91	0.99	1.29	-	-	-	-

Sources: Fitch Connect, IMF and JMMBIR

Fiscal and Monetary Stimuli

Both the fiscal authority and BCRD took steps to help attenuate the impact of Covid-19 on the wider economy. This came in the form of, *inter alia,* a combination of grants from the government to households, and the BCRD reducing the policy rate as well as the reserve ratio for pesos and US dollar deposits. President Danilo Medina approved fiscal measures amounting to US$576 million or 0.75% of GDP. The giant portion of the resources were made available to the 'Stay at Home' programme and 'The Employee Solidarity Programme' (FASE). Over RD$17 billion was earmarked for the Stay at home programme which is a subsidy to the most vulnerable in the society and informal workers. This complemented the existing C*omer es Primer (*Eat first), which pays RD$5,000 or US$90 per month to beneficiaries and was extended to 1.5 million households, up from 0.8 million.

RD$15 billion was pumped into FASE of which 750,000 households are expected to benefit. These households are mainly comprised of the families of formal workers who were laid off. Monthly transfers of up to 70% of wages lost or a maximum of RD$8,500 will be given to each beneficiary. The BCRD reduced the policy rate by 100 basis points to 3.5%. In addition to the lowering of the policy rate a series of liquidity provision measures, both in US dollar and pesos, were adopted by the central bank to help financial institutions to continue to extend credit to households and businesses. Approximately RD$52 billion was made available under the programme. Coverage requirements for legal reserves in pesos were relaxed, which in the process freed up DR$22.0 billion or 2% of reserves. Of this amount $10 billion was made available to households and small business while the remaining portion, RD$12.3 billion, was made available to the productive sector at a relatively low interest rate. The tourism industry and export related sectors were the two main beneficiaries under this initiative.

Presidential Election and Political Risk

In the Midst of the covid-19 pandemic the Dominican Republic pressed ahead with presidential elections. The electorate gave the nod to Luis Abinader from the Partido Revolutionario Moderno (PRM) to become president. This is a seismic shift in the political landscape in the Dominican Republic, as previously the Partido de la Liberación Dominicana (PLD) had a firm grip on state power for over a decade and a half. Mr. Abinader faces what appears to be an insurmountable challenge of steering the economy towards growth in the face of strong economic headwinds. His first task at hand is to reassure the investing public that he will follow through on his campaign promise of being business-centric, and secondly to address the corruption scandals that have dogged the previous administration and fuelled discontent among civil society.

Short term political risk is relatively high as Mr. Abinader is a political neophyte who will have to make bold decisions pertaining to his country's healthcare system and the economy in the early days of his presidency. These are not easy decisions as he grapples with the decision of imposing further restrictive measures to curtail the spread of Covid-19, or further open up the economy within limits, a process which commenced in July. He will also need to articulate clearly his foreign policy and align his country with a state or group of states that best serves the DR's interest. .

In late August there were 94,241 reported coronavirus cases in the Dominican Republic. This represents a prevalence rate of 869 infections per 100,000 of population, which is the highest in the Caribbean. So far the disease has claimed the life of 1,681 persons in the DR and 66,776 have recovered. As the country gradually reopens its borders the political administration will have to weigh the trade-off between a spike in the number of persons infected with the disease and lowering the unemployment rate. The unemployment rate is estimated at just over 12%, which is almost 3 percentage points higher than at the start of the year. Faced with an increase in unemployment and social pressure to ease the economic hardship on the populace, especially the poor, Mr Abinader may be forced to increase fiscal stimulus, or risk social tension. This however could potentially be very costly in the medium- to long run as the country's fiscal metric is slowly deteriorating ***(See Table 2).***

Mr Abinader will have to show signs that he is prepared to act on his promise to help cauterise corruption and corrupt practises by public officials. A number of high profile corruption cases are currently before the courts involving politicians and public officials who are connected to the Brazilian company, Odebrecht, bribery scandal. The pervasiveness of corruption in public office and the Odebrecht scandal gave rise to a visible and vocal grassroots anti-corruption group in 2017 known as March Verde. The failure of the former President Danilo Medina to tackle corruption fuelled this group's fervour, which in our estimation played in the favour of Mr. Abinader being elected. In his pre-election declaration he advised that he would appoint an attorney general that is not politically aligned and that he will increase transparency in public procurement. Failure to deliver on these promises could reignite the flames of March Verde, leading to social and political unrest.

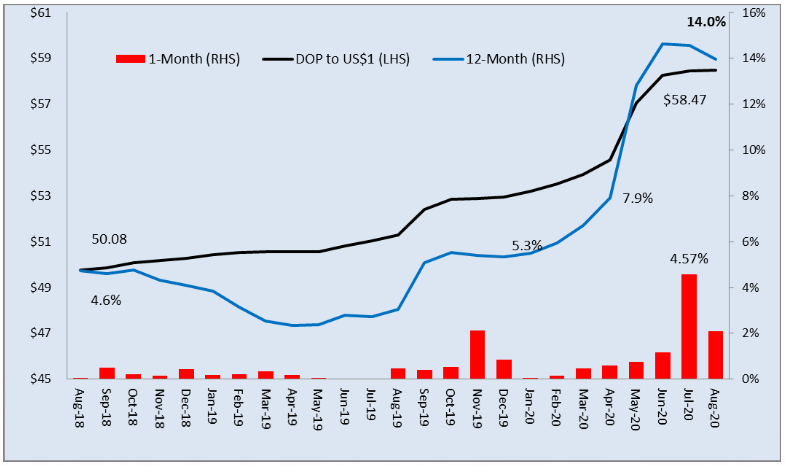
The fiscal Accounts: Fiscal Deficit and the Debt

At the end of 2020, revenue as a percentage of GDP is expected to fall to 13.1%, down from 14.4% in the previous year. Marginal growth in revenue is however envisaged in 2021 predicated on improvements in overall economic activity. The fiscal deficit is expected to widen to 6.5% at the end of the period occasioned by a combination of a fall in revenue and increased spending to help cushion the effect of Covid-19. The evolution of the fiscal accounts as outlined follows the baseline assumption where the government refrains from further fiscal stimulus and the global economy slowly returns to normal in 2021/22. **Under said scenarios, debt to GDP is expected to increase from 38.4% in 2019 to 52.7% in 2020 and trend towards the 60% mark thereafter.**

With the headwinds facing the global economy and the fallout in employment, President Abinader may be forced to implement additional fiscal stimulus to help shore up his government in the event of a deeper than anticipated fallout in domestic growth. Under this scenario the fiscal deficit and debt to GDP would rise at a faster pace. Debt to GDP would remain elevated over the medium term, which could result in ratings action being taken against the sovereign if corrective measures are not implemented to place the fiscal accounts, including the debt, on a more sustainable path.

To address these concerns fiscal reform is needed which will require political will and savvy to get done. This is not an easy task as one of the biggest challenges facing the Dominican Republic is the weak correlation between revenue and GDP growth. This is due mainly to the large tax breaks that are given to corporates operating in the high growth sectors such as tourism and the free zones. A low tax rate was among the value propositions that attracted these investments in the first place. Therefore a 180-degree shift by the government in its policy would not sit well with the business community, or imbue trust in future policies. Grandfathering of the existing policies in these industries and/or imposition of additional taxation on businesses and individuals in the short run may be required to arrest the situation. Over the medium to long run, comprehensive tax reform is necessary, especially if the government is going to play any meaningful role in advancing the welfare of the poor and working class.

Figure 1: Exchange Rate: Pesos/USD



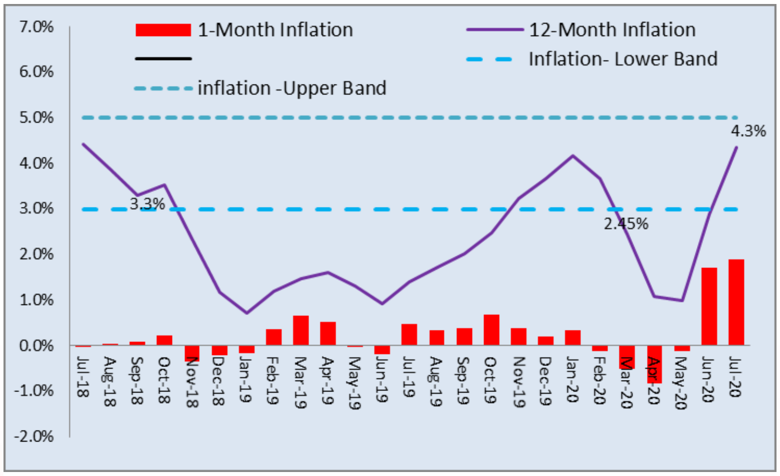
<u>Current Account, Reserve and the Exchange Rate</u>

Despite a reduction in imports, the current account (CAD) is expected to widen to 5.2% of GDP at the end of 2020 due primarily to fallouts from tourism and a reduction in remittance flows. There was a 62.7% reduction in inbound passenger arrivals for the period January-July 2020 when compared to the same period in 2019. In light of expected improvements in the global economy beyond 2020, it is envisaged that the CAD will gradually fall over the medium term. Notwithstanding this view, downside risk in the short run is relatively high, as slower global recovery and a spike in the coronavirus spread could result in inflows from tourism and remittance remaining depressed over a much longer period. Under this condition the CAD would contract at a less gradual pace and remain relatively high over the forecast horizon.

The foreign currency market has been negatively affected by the fallout in the CAD, as conditions in the market tightened substantially after March. The market was facing some challenges prior due to the easing of monetary policy in the latter half of 2019, which resulted in increased end-user demand for foreign currency to purchase imports. At the end of March 2020 the peso depreciated by 6.7% year over year (y/y) compared to 2.5% in March 2019. **The pace of depreciation accelerated in subsequent months and by the end of August the peso was trading at DR$58.47 to US$1, which represents a depreciation of 14% y/y.** Relative to March, the domestic currency lost 8.4% of its value in August. Conditions in the foreign exchange market are likely to remain tight, at least until there are improved inflows. This is however not expected to occur until late 2021.

Interest Rate and Inflation

Figure 2: Inflation



Sources: BCRD and JMMBIR

As noted overleaf the BCRD reduced the policy rate to 3.50% in March to help guide the economy towards a higher growth path. There is further room for the Bank to cut rates and these factors are likely to influence this decision in the coming months. The first has to do with how the economy is likely to evolve over the next few quarters. Further reduction in GDP growth could prompt the BCRD to cut rates in order to help stimulate loans growth, domestic consumption and overall economic activities in the future.

Second, at this point in time the BRCR need not concern itself with capital flight, as developed countries central banks are expected to keep their policy rates low in order to help move their economies out of recession. Of particular interest to the BCRD is the policy action of the US Federal Reserve (Fed) in coming months. Of note, the Fed has cut its policy rate to 0% to 0.25% in March and signalled in late August its intention of keeping rates relatively low even if inflation pressure increases. This view reflects the weak state of the US economy and the high rate of unemployment, two variables that the Fed is concerned about. Within this context, an opportunity presents itself where the BCRD can further adjust rates downwards without the pressure of capital outflow.

Third, headline inflation is relatively subdued in the Dominican Republic and is expected within or possibly below the BCRD's forecast range of 3%-5% over the next eight quarters. In the months leading up to July, headline inflation was running below 2.5%. However in July the inflation rate jumped to 4.4%, mainly due to the pass-through effect of the depreciation of the peso on domestic prices. Our view however is that weak domestic demand and subdued international prices are likely to help keep inflation within range despite some pressure from depreciation of the peso in coming months. If inflation remains low it will give the BCRD additional ammunition to cut the policy rate further. However, having said that, there is the risk that inflation could rise at a much faster than anticipated pace due to the pass-through effect of accelerated depreciation in the peso on domestic prices. Accordingly, the BCRD has to be measured in its action as it risks injuring its credibility should inflation move beyond its forecast range.

Outlook

Real GDP in the Dominican Republic is expected to contract by 5.3% in 2020 with modest recovery in 2021. It is however possible that the economy could contract even steeper with recovery occurring over a much longer period. The path that the economy will take over the next couple of quarters is heavily dependent on how the global economy evolves. The global economy is expected to contract by 4.9% in 2020 with gradual recovery in 2021. However, downside risks are elevated and conditions could remain depressed in 2021 or even longer. An upward shift in the growth trajectory is heavily contingent on a vaccine or an effective treatment for Covid-19 that would help to reduce the incidence of morbidity and death. This would allow for the easing of restrictions in many countries and a much quicker return to normality. If this were to occur it would act as a catalyst for employment and demand for leisure activities, which would resound favourably for tourism-dependent economies in the Caribbean, including the Dominican Republic. Recovery in the global economy, especially if swift, would prove beneficial to the sovereign's industries and external flows, including remittances and foreign direct investments.

The foreign exchange market is expected to remain tight in light of a precipitous decline in inflows from tourism, remittance and foreign direct investments. Although end-user demand has declined, this is not sufficient to maintain stability in the market. As a result the pace of depreciation of the peso is expected to remain elevated at least until H2:20 where improvements in inflows are expected to help stabilize market conditions. In the absence of such shifts in inflows, the relatively high pace of depreciation may well continue into 2022.

The inflation path is likely to track within the BCRD's forecast range. However, there is the possibility that it could move higher. This view is highly contingent on whether or not the central bank is willing to risk its reputation. On the one hand the economy is expected to remain depressed and fiscal stimulus alone will not be sufficient to push growth on a higher path, especially if global markets remain depressed. Thus, the BCRD may be required to help steer the economy to a higher growth path. However, if the bank lowers the policy rate to help achieve this objective it risks the possibility of inflation moving beyond the upper band of its forecast range due to domestic price pressure from the pass-through effect of the elevated depreciation of the peso. It is nonetheless likely that the Bank may relax its inflation policy stance in the wake of the overwhelming economic challenges facing the Dominican Republic. It is therefore likely that the policy rate will be adjusted downwards to help steer the economy towards a higher growth path.

Sources:

Bloomberg
Fitch Connect
Jeffries
Oppenheimer

APPENDIX

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