INVESTMENT AND SOVEREIGN RESEARCH

SOVEREIGN: Dominican Republic – Q2 2021

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Ratings: Standard and Poor's, BB-/negative and Fitch, BB-/negative

Summary

Table 1: SWOT Analysis

Strength

- 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 has lifted large segments of the society out of poverty.
- The sovereign's attractiveness to tourism mecca and business friendly environment will help drive the post-COVID recovery

Weakness

- Underdeveloped electricity infrastructure causes frequent power outages & is disruptive to smooth productive operations.
- High dependency on tourism and the US economy leaves the local economy exposed to sluggish growth in the US.
- Exposure to recurring damages from natural disasters is an impediment to long term growth.

Opportunities

- Service-oriented economy with a business friendly environment makes the sovereign an attractive destination for investments in the tourism and related sector 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.
- Higher gold prices could help to bolster growth in the mining sector and assist the recovery effort.

Threat

- Widening fiscal deficit and debt build up pose a challenge over the medium-term. This coupled the slow pace of fiscal reform and high public sector charge, particular in the electricity sector could result in a higher risk premium for government debt issuances.
- Slower than anticipated improvements in the global economy, especially the in the US, pose downside risk 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.

Key Highlights

- **The Economy is expected to expand by 4.8% driven by exports of goods and services, including tourism, and mining.**
- **COVID-19 social programmes are expected to carry over into 2021, keeping spending elevated.**
- **The fiscal deficit will remain wide in 2021, but is expected to contract thereafter.**
- **Debt level is expected to breach 60%.**

Table 2: Selected Macroeconomic Indicators

Indicator	2016	2017	2018	2019	2020	2021	2022	2023
Nominal GDP per capita, USD	7,280.9	7,609.4	8,050.6	8,282.1	7,268.2	7,573.0	7,855.9	8,235.5
Real GDP, % chg y-o-y	6.7	4.7	7.0	5.1	-6.7	4.8	4.7	4.4
Inflation, eop, % chg y-o-y	1.7	4.2	1.2	3.7	5.6	5.0	3.8	3.9
Central bank policy rate, %	5.50	5.25	5.50	4.50	3.00	3.00	3.50	3.75
Lending rate, %, eop	15.1	14.8	15.1	14.1	12.4	12.2	12.3	12.3
LCU/USD, eop	46.7	48.3	50.3	53.0	58.3	61.3	62.9	64.3
Total revenue, % of GDP	13.9	14.0	14.2	14.4	14.2	14.6	15.1	15.4
Total expenditure, % of GDP	16.9	17.4	16.5	16.7	22.5	21.6	21.1	20.6
Budget balance, % of GDP	-3.0	-3.3	-2.3	-2.3	-8.0	-7.0	-6.1	-5.2
Primary balance, % of GDP	-0.5	-0.8	0.3	0.4	-4.7	-4.1	-3.1	-2.3
Current account balance, pct of GDP	-1.1	-0.2	-1.5	-1.3	-2.0	-2.1	-2.4	-2.0
Current account balance, % chg y-o-y	-36.3	-83.7	894.0	-10.1	29.7	14.2	18.6	-10.9
Capital and financial account, % of GDP	-3.2	-2.7	-3.6	-3.5	-4.3	-	-	-
Foreign reserves ex gold, pct of GDP	8.1	8.6	9.1	10.2	14.1	14.0	13.8	13.7
Foreign reserves ex gold, USD	6,047	6,781	7,628	8,782	10,752	11,311	11,876	12,470
Total government debt, % of GDP	35.8	37.3	37.9	40.1	53.9	57.5	60.2	62.6
Government domestic debt, % of GDP	12.5	13.5	14.0	15.2	19.8	21.1	22.0	23.0
Unemployment, % of labour force, eop	11.9	10.0	10.4	10.4	14.7	13.1	9.8	9.8

Sources: Fitch Connect, IMF and JMMBIR

Growth Outlook and Fiscal Developments

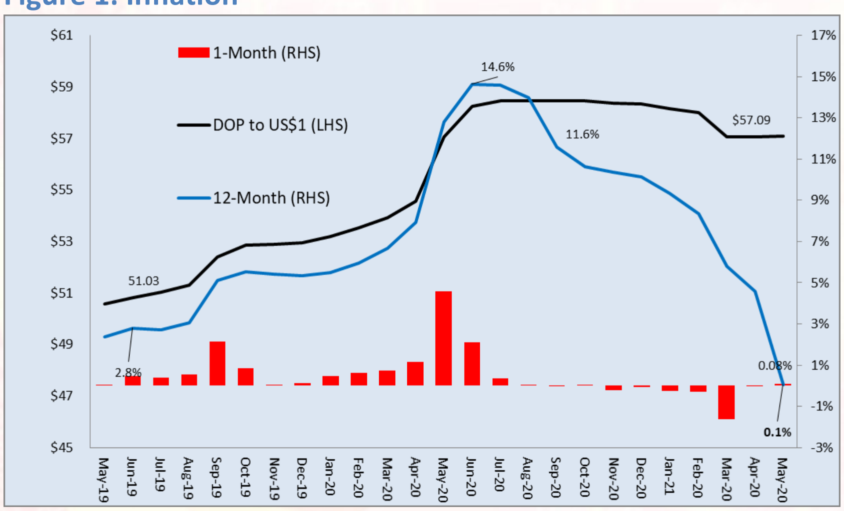
Following a tepid performance in 2020, the Dominican Republic's economy will return to growth in 2021. We estimate that the economy will expand by 4.8% during the period, driven by Construction, Tourism, Free Zone, and Commerce activities. The revival in domestic and external consumption will help to stimulate growth in these areas. The high price of gold could also lead to robust performance in the mining sector. During the first four months of the year, high-frequency data pointed to a significant improvement in economic activities, particularly in March and April. We expect this momentum to continue throughout the year, culminating with improvements in the domestic public health outlook and the international environment.

Higher output will redound favourable to public finance, as we expect revenue to grow from tax buoyancy. In 2020 revenues declined by 3.7%, while expenditure expanded by over 31%. This resulted in a fiscal deficit of 8% compared to a deficit of 2.3% in 2019. Debt to GDP jumped to 53.9% in 2020 compared to 40% in 2020. We do not expect the deficit to close over the medium term despite Mr Abinader campaigning to tighten the fiscal purse. The pandemic has forced his government to continue with many of the spending policies he inherited from the Danilo Medina Administration to support local businesses and households. Although growth is expected to rebound, we do not expect the overall economic activity level to return to pre-pandemic level until after 2023, while unemployment is expected to remain elevated. Although we expect spending and tax reform at some point in the future, we do not foresee that happening over the medium term. Mr Abinader and his coalition government will not want to risk political capital in carrying out budgetary reforms too soon.

We contemplate a gradual adjustment in the deficit to around 5.2% of GDP by 2023, driven by modest expenditure cuts in expenditure and improvements in revenues. We expect the debt ratio to increase due to a combination of the fiscal deficit and depreciation of the pesos. Over 60% of government debt is denominated in foreign currency.

The Foreign Exchange and the Current Account

Figure 1: Inflation



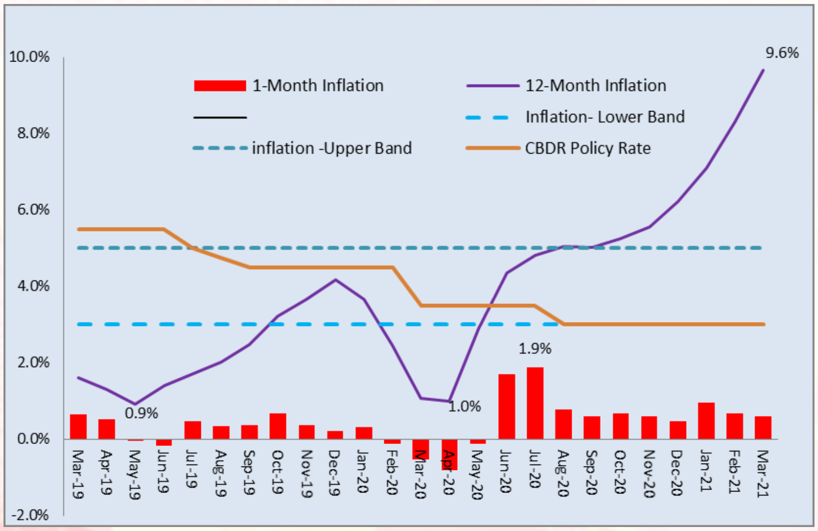
Sources: Central Bank of the Dominican Republic and JMMBIR

The Dominican Republic pesos traded at an exchange RD$57.09 to US$1 at the end of May 2020, a depreciation of 0.1% relative to May 2020. Over the last three years, the 12-months depreciation rate averaged approximately 3.0%. However, volatility increase in the foreign currency market in H1:2020, occasioned by a sharp contraction in tourism flows during the period, which led to a steep decline in foreign exchange flows. This came against the background of relaxation of monetary policy in mid-2019 that led to increased demand for domestic and foreign goods and services. There was a high demand overhang for US currency going into 2020. With falling tourism flows and relatively high imports, the pace of depreciation of the pesos sped up in Q2:20, resulting in a loss of value of 7.8% during the period. At end-June 2020, the 12-month depreciation rate of the pesos was 14.6% relative to 2.8% for the same period in 2019.

A surge in remittance flows and lower imports elicited by the economic contraction and falling oil prices helped shape activities in the currency market in H2:20 into Q1:21. As a result, the pesos gained 2% in value over the nine months, pushing down the 12-month depreciation rate to 5.8%. Leading into A2:21, volatility in the foreign currency market has died down. We expect the pace of depreciation to remain relatively subdued as tourism flows normalise and remittance flows remain elevated. We envisage a current account deficit (CAD) of 2.6% of GDP and believe that high remittance and investment flows will fill the gap, resulting in an increase in external reserves. Notwithstanding this view, persistently high energy cost could reintroduce higher volatility in the currency market and push the depreciation rate above our expectation.

However, we are concerned about increased commodity prices, most notably crude oil price, as this could lead to erosion in the gains made in the foreign exchange market. At the start of the year, the consensus forecast was US$65 for West Texas Intermediary crude oil. Crude is currently trading around the US$70 per barrel mark, 49% higher than at the start of the year. With a drawdown on inventory and a boom in economic activities globally, there is a possibility that the price could move even higher. Under this scenario, the currency account deficit could increase, leading to an acute shortage of foreign exchange and an increase in the pace of depreciation of the pesos.

Inflation and the Policy Rate



Sources: Central Bank of the Dominican Republic and JMMBIR

Elevated depreciation of the pesos in Q2:20, damage caused to local crops by two weather systems that push up farm produced prices and rise in international commodity prices helped push inflation outside the forecast range of 3% -5%. In May, the 12-month depreciation rate was 9.7%. Core inflation, inflation due mainly to monetary condition, is just above 5%. We expect inflation to trend towards the mid-point of the forecast range by the end of the year leading into Q1:22 as the effect of the external shocks on the economy wane.

As is the case with our concern in the foreign exchange market, the continuous rise in commodity/oil prices could cause inflation to remain above the forecast range much longer than envisaged. This is even more likely to happen in an environment where the central bank's policy remains accommodative and the pace of economic growth move in line with or above expectation. We assign a moderate probability to inflation remaining above the forecast range leading into Q1:21.

The Central Bank of the Dominican Republic (CBDR) reduced its policy rate by 100 basis points to 3.50% in March 2020. In August, the Bank shaved off another 50 basis points, pushing the policy rate down to 3.00%. It has held steady since, and we do not expect any change in the policy rate in 2021. The rate cut accompanies a series of liquidity measures amounting to RD$240 billion (approximately 5% of GDP) to help preserve credit conditions in an economy weakened by the COVID-19 pandemic. We believe that one of the major goals of the BCDR, at least in 2021, is to return the economy to its normal growth path and raise the employment level. Inflationary pressure is in its cross-hair, but as external dynamics are driving it, the Bank is not likely to act too soon to tighten credit. If this were to occur, the economy's transition toward its potential growth path would take longer than expected.

Outlook

We are bullish on the growth outlook for the Dominican Republic in the coming quarters. Strong tailwinds from global growth, especially in the US, will help propel mining, tourism, and manufacturing activities. Despite this optimistic view, the headwind from COVID-19 has not yet abated. Although the virus appears to be mutating, we expect the infection rate to fade significantly by the end of Q3:21. Overall, we are not expecting any deviation in some of the more salient macroeconomic variables to warrant any immediate concern. As noted, elevated fiscal deficits combined with the depreciation of the pesos will cause debt levels to rise despite expected improvements in real GDP growth. We expect the government to continue to provide benefits to help attenuate the impact of COVID-19 on households and businesses in the near term. However, we do not expect this to carry over into 2022. We expect that the administration will yield to its election promise to coral government spending and improve public administration efficiency.

Sources: Bloomberg, Fitch Connect, Oppenheimer and World Bank