

# **DOMINICAN ECONOMIC PERFORMANCE JANUARY – DECEMBER 2004**

## **EXECUTIVE SUMMARY**

### **I. GROSS DOMESTIC PRODUCT**

The Gross Domestic Product (GDP), in real terms, grew by 2.0% in 2004, thus sending a clear message as to the recovery process that the Dominican economy had begun during the second half of the year. This is evident when comparing the 1.4% GDP growth corresponding to the first three quarters of the year to the increase for the last quarter, which was 3.3%. These results contrast dramatically with GDP performance for full year 2003, of -1.9%.

This performance has been the result of a number of factors, among them implementation of a strict monetary policy and the strengthening of fiscal position of the central government. These factors were determinants in the renewal of confidence in the Dominican economy among market participants. In turn, these have led to significant changes in the behavior of key macroeconomic variables, such as reductions in the rate of inflation, foreign exchange rate, and interest rates.

The sectors that most contributed to real GDP growth were Communications (18.3%), Agriculture and Livestock (3.5%), Mining (3.7%), Sugar production (6.7%), and Hotels, Bars, and Restaurants (4.6%). These sectors account for 35.3% of GDP.

In the case of Communications (18.3%), this sector continues to reflect the high growth rates that have been prevalent over the past few years. One important factor was a 25.8% increase in the mobile phone market.

Agriculture and Livestock as a whole rose by 3.5%, in contrast to a drop of -2.6% in 2003. Factors included an 8.7% increase in livestock production, 11.7% in forestry and fishing, and 16.6% in poultry production. However, agricultural activity fell by -3.8% due to unfavorable weather conditions, including Hurricane Jeanne, which was responsible for losses of around RD\$ 2 billion.

Another sector showing improvement at the end of 2004 was Manufacturing, having grown by 0.7%, in contrast to the -3.1% contraction in 2003. Recoveries were evident in all related sub-sectors: sugar production, due mainly to a 10.4% rise in raw sugar output, increased by 6.7%, compared to a drop of -1.3% in 2003. The remaining local manufacturing sector recorded a loss of -0.7%, still better than the -4.4% drop shown in 2003. Industrial Free Zone activity grew by 6.2%, higher than the 3.5% rate for 2003. This was mainly due to the installation of 40 new companies employing an additional workforce of 10,000. Local expenses also went up by 3.5%.

Despite adverse conditions affecting the Tourism sector in 2004, such as rising oil prices, the devaluation of the U.S. dollar vs. the Euro, and Hurricane Jeanne, the Dominican Republic maintains its position as the Caribbean's most visited destination, which resulted in the addition of 2,990 rooms in 2004, for a country total of 58,932 rooms. As noted above, total output for the Hotels, Bars, and Restaurants sector grew by 4.6% for the year in question.

The remaining sectors, though growing in amounts of little significance, reversed the prior year's trend. This is evident in the case of the Commerce and Transportation sectors, the latter growing by 0.2% in contrast to the drop of 8.2% for 2003.

The Commerce sector represents an important component of GDP, accounting for 11.2% of the total. What's more, its performance is reflective of the recovery process that the Dominican economy is undergoing. The Commerce sector grew by 0.1% for the year, an improvement when compared to the -13.7% contraction in 2003. Moreover, during the first three quarters of the year this sector fell by -2.7%, whereas in the final quarter the growth rate was a positive 9.1%. A series of factors impacted favorably on these results, such as a gradual reduction in prices, especially of imported goods, resulting from lower exchange rates, and also the seasonal pickup due to the holidays.

In keeping with the above, private consumption in real terms rose by 1.8% in 2004, a marked difference from the dramatic -12.4% falloff in 2003. In the fourth quarter of 2004 private consumption rose 7.8%, reflecting the turnaround in commercial activity. Similarly, imports of taxable goods, such as goods for consumption, raw materials, and machinery and equipment, registered a significant 26.7% increase in the last quarter.

Among the sectors having a negative impact on GDP, the most important are Electricity and Water (-19.6%), and Construction (-6.3%), the latter still being affected by the economic crisis, despite the fact that prices for construction materials are now considerably lower.

The per capita GDP expressed in U.S. dollars is estimated around US\$2,102.2, representing an increase of 10.2%. This is in contrast to a drop of -24.8% in 2003, when the figure was RD\$1,907.4. These results are mainly explained by the lower exchange rate, which together with lower inflation and interest rates translate into greater purchasing power for Dominican consumers.

## **II. INTERNAL PRICES**

The Consumer Price Index (CPI) for December, 2004 decreased by 1.49%, and the year ended with an overall inflation rate of 28.74%. This indicator's performance was better than the projected rate largely because of sustained reductions since June 2004 in the exchange rate, which fell by RD\$19.38. A deflationary process in the last four months of the year resulted in a cumulative negative rate for August-December of -2.39%, despite the taking effect in October of Law 288-04 on Tax Reform.

It should be noted that, in the first seven months of the year, most food products making up the goods and services basket of Dominicans experienced price increases of up to 190%, while in the August-December period their prices registered significant negative rates.

### **III. EXTERNAL SECTOR**

#### **3.1 Current Account**

The Balance of Payments Current Account ended the year with a surplus equal to 7.5% of GDP, or US\$1.4 billion. This is largely attributable to a reduction in the commercial goods deficit, due to an increase of US\$279.1 million in national exports that partially offset the rise in imports. In fact, during the last quarter of 2004, imports rose by 21.2%, in line with greater overall economic growth. Imports of oil and oil products increased by US\$251.3 million, due primarily to higher overseas oil prices.

The balance of services registered a surplus of (US\$78.5 million, an increase of 3.5%). The largest share, tourism, went up by US\$52.6 million, despite the unfavorable effects of the hurricane season in the third quarter.

Net current transfers are estimated at US\$2.50 billion, representing an increase of 6.9% or US\$161.8 million. Family remittances from Dominicans living overseas increased by 6.8%. This caption represents around 88.0% of net income from this type of transfer. On the other hand, the revenue balance reflected a reduction in the deficit of 4.4%, provoked largely by a decrease in direct investment revenue equal to US\$146.2 million.

#### **3.2 Capital Account**

The Capital and Financial Account ended the year with a negative balanced of US\$709.1 million, due to a reduction in portfolio investment with respect to the prior year, when the second Sovereign Bond float took place in the amount of US\$600.0 million. Also, overseas deposits increased, especially during the first quarter of 2004. According our own estimates, using Bank for International Settlements (BIS) figures, deposits in foreign banks corresponding to Dominicans were US\$248.2 million lower than the outflows in 2003, in the wake of the banking crisis.

#### **3.3 Foreign Exchange Market**

The average exchange rate for purchases of U.S. dollars by foreign exchange intermediaries, after scaling unprecedented levels not only in magnitude but also with regard to variability indicators during the first half of the year, ended 2004 with an average value of RD\$29.16::US\$1.00. This represents a decrease of 38.2% compared to the average rate in January of that year. This progressive recovery, in value as well as stability, of the currency contributed in turn to normalizing exchange spreads, which were narrower on average at the end of the period in question than in 2003.

During 2004, multi-service banks and authorized exchange agents purchased US\$8.79 billion, for an increase of 28.6%. This reflects a greater availability of funds in the current account, as well as higher demand on the part of private agents.

The positive performance reflected by the exchange rates during the period, which was even more evident in the third quarter, was the result of several factors, among them the application of a rigorous monetary policy through the placement of Central Bank certificates.

Gross international reserves closed at US\$824.8 million as of Dec. 31, 2004, and net reserves closed at US\$602.2 million. Net reserves excluding financial intermediaries' legal reserves and central government's deposits in U.S. dollars for foreign debt payments were US\$201 million, in contrast to the negative balance of US\$95.4 million at the end of 2003.

It should be pointed out that, purchases of foreign currency to expand Central Bank reserves were carried out without affecting the stability of the exchange market.

### **3.4 Foreign Public Debt**

Between Jan. 1 and Dec. 31, 2004 the government made debt service payments equal to US\$892.5 million. From this amount, approximately 50% was disbursed between August and December of that year. For 2004, US\$543.5 million was paid in principal and US\$349.0 million in interest.

Payments made with regard to the country's bilateral debt made it possible for the Dominican Republic to comply with its principal Paris Club commitments. As of December 31, 2004, the country became current insofar as its obligations are concerned, as had been agreed to in the Minutes signed in April 2004 between the Dominican Republic and Paris Club members.

## **IV. CENTRAL GOVERNMENT FINANCIAL PERFORMANCE**

Central Government fiscal operations, on an accrual basis<sup>1</sup>, ended the year with a deficit of RD\$23.2 billion, or 3.0% of GDP. It is important to note that, for the final quarter, the IMF had estimated a NFPS deficit of some RD\$4.62 billion, while the actual deficit figure was RD\$2.14 billion. The Central Government operational deficit was financed mainly with external funding. Foreign disbursements equaled RD\$30.91 billion, 59.1% of which correspond to bilateral loans for projects.

Central Government Internal Financing rose by RD\$7.37 billion. This is mainly explained by an increase in net banking sector credit to the Central Government, consistent with the IMF agreements.

On October 1, 2004 a series of new Tax reform measures went into effect, in which new taxes were applied and previous ones modified. Among these are an increase in the VAT (ITBIS) from 12% to 16%, a tax on financial transactions, changes to the Tax Rate on Physical Persons, a 10% tax on telecom services and an increase of the Luxury Housing Tax.

Total Central Government revenues for the year increased to RD\$126.25 billion, representing a nominal increase of 57.4% over the prior year. Total tax collections increased by 56.9% in nominal terms. Similarly, the tax burden increased by 0.2% of GDP, from 14.9% to 15.1%, as a result of the Tax Reform measures.

Total spending for the central government in 2004 grew to RD\$140.85 billion, or 42.7% over the prior year. Capital spending as a share of the total fell by 9.8 percentage points, from

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<sup>1</sup> The calculation is made based on net internal and external financing operations of the government; that is, using the "below the line" and accrual basis method of approximation.

36.6% to 26.8%. Thus, current expenses accounted for 73.2%, due primarily to an increase in Central Government current transfers to the public as well as the private sector.

## **V. MONETARY POLICY**

Central bank monetary policy was conditioned by increases in monetary aggregates in 2003 and part of 2004, resulting from the bank bailouts. The monetary authorities emphasized the use of open market operations, through the placing of investment certificates by auction and direct placings, in order to partially neutralize the increase in liquidity. The contraction of liquidity had the effect of containing the inflationary and devaluation expectations of market agent, which led to lower interest rates and longer maturities for Central Bank monetary instruments.

This strict monetary policy, combined with higher confidence, helped reduce uncertainty about the future of the economy, especially during the latter part of the year. In effect, for the August-December 2004 period, the exchange rate maintained its downward trend, reflecting an appreciation of 33.7%. Meanwhile, the inflation rate closed at 28.74%, substantially below the projected level of 45%, in the Monetary Program by mid-2004.

At month-end December, 2004, monetary issuance stood at RD\$78.55 billion, or 1.3% higher than the same prior-year period. This performance was achieved despite the improvement in NIR excluding dollar deposit legal reserves, rising from a negative balance of US\$95.4 million in 2003 to a positive balance of US\$201 million in 2004.

The M1 money supply grew by RD\$5.22 billion during the year, or 7.0%, affected by year-end seasonal variances. In annual terms, from the perspective of its components, money in circulation grew by 9.7% while deposits from individuals increased 5.2%, affected by decreases in the latter part of the year. Additionally, broad money supply (M2) was influenced by M1 and the valuation effect of the exchange rate on dollar deposits denominated in local currency. For these reasons, M2 grew by RD\$22.61 billion compared to December 2003.

In 2004, Central Bank securities in circulation amounted to RD\$110.81 billion, or 84.7% higher than the level of RD\$60.01 billion as of December 2003.

## **VI. FINANCIAL SECTOR**

The Aggregate Financial Sector as of Dec. 31, 2004 had assets amounting to RD\$387.76 billion, liabilities of RD\$326.39 billion, and paid-in capital of RD\$17.64 billion. This represents growth of 11.8%, 10.0%, and 14.8%, respectively. As of that date, multi-service banks reported assets of RD\$296.71 billion, liabilities of RD\$259.97 billion, and paid-in capital of 23.53 billion, increases of 8.6%, 6.7%, and 13.7%, respectively, compared to 2003.

Asset performance is due essentially to securities investments made by the intermediaries through Central bank Investment Certificates, and to a lesser extent, the local currency loan portfolio, which grew 61.3% and 9.4%, respectively. The foreign currency loan portfolio shrank by 33.8%. The total gross portfolio at year-end 2004 posted a drop of 2.1%. On the liability side, local currency deposits and securities in circulation increased by 15.6%. The

intermediation coefficient maintains its downward trend, having reached 59.1% compared to 69.8% in December 2003.

Financial and extraordinary income for the banking sector in investments and services led to an average capital profitability figure of 49.2% for year-end 2004. This in turn resulted in higher levels of capitalization for the sector.

Meanwhile, a continuing strategy to strengthen the regulatory framework was maintained, through the approval of the Statutes of Application of the Monetary and Financial Law, as had been agreed between the Monetary Authorities and the IMF. This will allow more transparency in operations and greater soundness for the financial intermediation agencies.

As of year-end 2004, the banking sector had a legal reserve surplus equal to RD\$841.3 million. Over and above this, the multi-service banks have excess liquidity in the amount of RD\$32.54 billion. This is mainly due to the investments that they maintain with the Central Bank, equal to RD\$31.10 billion.

### **6.1 Financial Sector Interest Rates**

As of December, 2004, the asset rate for multi-service banks averaged 30.88% and the liability rate 21.27%. These results are similar to those for the remaining financial intermediation agencies.

Having established a measure of foreign exchange and price stability, real interest rates for multi-service banks as of December were 2.14% for assets and -7.47% for liabilities; in December 2003, these had reached negative rates of 12.93% and 22.91%, respectively.

The Remunerated Short Term Deposit window and the Lombard window have gone from interest rates of 50.0% and 60.0% annually at the beginning of the year, to 7.0% and 45.0% annually at the close of December, 2004.