REPORT ON THE DOMINICAN ECONOMY
January-December 2005
EXECUTIVE SUMMARY

Gross Domestic Product

The Gross Domestic Product (GDP) measured in real terms, grew by 9.3% during the January-December 2005 period, which is a consolidation of the recovery process begun in the second half of 2004. This performance was highlighted by the increase in GDP of 10.4% in the third quarter and of 14.6% in the fourth quarter. As a result, the Dominican Republic is one of the fastest growing economies in Latin America, together with Cuba (11.5%), Venezuela (9.0%), and Argentina (8.6%).

This renewed activity in the national product has been driven by the strengthening of macroeconomic stability, manifested in factors such as the relative stability of the exchange rate, the reduction in inflation, and the resulting renewal of confidence on the part of economic agents.

All economic activities that form part of GDP registered positive performance with the exception of Mining (-1.7%). Among the most active were Communications (26.8%), Commerce (19.9%), and Transportation (10.2%), Hospitality Industry (Hotels, Bars, and Restaurants (7.4%), Agriculture & Livestock (7.3%). It is also worth noting the reversal that occurred in several sectors, which, after a falloff in 2004, grew during 2005. Among these are Construction (6.2%), Electricity and Water (4.6%), and Finance (3.9%).

Another factor that has contributed to the economic recovery has been the gradual and sustained reduction in interest rates. During 2005, the average asset rate in the commercial banking sector dropped by 10.7 percentage points. This set the scene for an increase in total sector portfolio net disbursements of RD$ 18,964.9 million compared to December, 2004. Of this amount, RD$ 11,268.4 million (59.4%) was disbursed in fourth quarter 2005.

During full year 2005, total supply of goods and services in real terms rose by 10.7% compared to the same prior year period. This is a consequence of the extraordinary growth in GDP (9.3%) and National Imports of Goods and Services (14.2%) in real terms. On the total demand side, growth in internal demand was notable (13.0%), thus reversing the drop of 1.9% registered in the prior year. This was determined primarily by an increase in consumption (14.3%), and the recovery in gross domestic investment (9.6%), after a contraction of 7.0% in 2004.

On the consumption side, the growth of private consumption (17.0%) was decisive, driven by greater purchasing power resulting from the public and private sector salary increases, as well as local currency appreciation, control over inflation, and spending on the part of Dominicans residing in the country on their visits abroad (13.7%). It is important to note that imports of goods valued in dollars grew by 47.7%. On the other

hand, public consumption in real terms fell by 2.6% due to a reduction in General Government spending.

Gross domestic investment rose due to considerable levels of recovery in each of its components. The substantial increase in machinery and equipment, from a negative 11.4% in 2004 to a positive 27.6% in 2005, is due primarily to higher imports of capital goods for transportation and industry, together with an 18.5% rise in foreign direct investment during the period in question. Similarly, the recovery of the construction sector had an important positive effect.

Prices

Inflation in 2005 was equal to 7.44%, which is well bellow the rate for 2004, of 28.74%. On average, the inflation rate was 4.19%, compared to the 51.46% registered during the same prior year period. It is important to point out that, in accordance with the framework of the IMF agreement, 2005 ended with a single-digit inflation rate, which is derived from the enforcement of prudent monetary policy in coordination with fiscal policy, thus permitting the reestablishment of internal price stability.

During the first quarter of the period in question, cumulative inflation was only 0.82%, whereas the increases in oil prices in the third quarter drove the inflation rate for that period to 5.27%, thus having a significant impact on the yearly rate.

Indeed, international oil prices rose to record levels in September, affecting domestic fuel prices and transportation services, which due to their relative weight in the goods and services basket, strongly influenced the final result. Accordingly, if the impact of the above is excluded from the inflation calculation for the year, the CPI would have risen only 2.72%. This indicates that the influence of these adjustments accounted for 4.72 percentage points. Thus it is evident that the increase in internal prices, although less than forecast, was not a response to either monetary factors or other factors of domestic origin.

External Sector

According to preliminary figures, the country's balance of payments ended the year with a positive balance of US $670.1 million, which allowed the Central Bank to accumulate a level of net reserves far higher than the IMF Stand-By Agreement target, while maintaining exchange rate and price stability.

The balance of payments **current account** went from a surplus of 6.1% of GDP in 2004 to a deficit of 0.5% of GDP in 2005. This variance is primarily due to an increase in the trade goods deficit, given the 9.3% growth in the economy during the year, which led to higher demand for imports and a higher oil bill.

The **trade balance**, which includes national goods transactions and industrial free zones, increased its deficit by US$ 1,529.3 million (78.3%) in 2005. This was due, among other

factors, to the above mentioned renewal of economic activity. In fact, total goods imports grew by 21.9% over 2004, driven by national import performance, which rose 34.2% or US$ 1,838.5 million. This trend, evident beginning in fourth quarter 2004, was sustained during full year 2005, based on the reactivation of internal demand resulting from economic agents' greater confidence in economic policies.

The **balance of services** registered a surplus of US$ 2,494.9 million in 2005, equal to 8.6% of GDP. This is significantly higher than the 2004 levels, in nominal terms and as a percentage of GDP. Among the principal causes for this performance is an increase in tourist services (travel) and communications.

Financial and capital account. The 2005 period was marked by a return of capital flows to the economy as confidence in economic policies was renewed. This was reflected in this account's positive balance of US$ 752.8 million, representing an increase of US$ 503.6 million over 2004. This was equal to 2.6% of GDP, which allowed not only coverage of the deficit in the balance of payments current account, but also the accumulation of foreign assets.

Foreign public debt. As of year-end 2005, total foreign public debt equaled US$ 6,755.7 million, which represents an increase of 5.9% over the prior year. During 2005, the public sector received disbursements of US$ 940.7 million, or 6.7% higher than the previous year. These disbursements were in compliance with the Central Government's efforts to maintain externally financed expenses in line with the parameters established in the IMF Stand-By Agreement signed early this year.

Foreign public debt service payments were met promptly and equaled US$ 871.7 million, which was only 2.3% lower than the figure for same period 2004, despite renegotiation efforts by the Government before the Paris Club, the London Club, and sovereign bondholders. With the former, all maturities corresponding to pre-cut-off date loans to be restructured, with the London Club, current maturities equal to around US$ 80.0 million, and with regard to the holders of new bonds issued in 2005 after the bond exchange, the capitalization of interest due in July and September of that year, equal to US$ 49.3 million.

One of the most important results, derived from the re-stabilization of the macroeconomic environment and compliance with the country's external commitments, was seen in the gradual improvement of country risk indicators for the Dominican Republic. Fitch Ratings and Standard & Poors, two of the principal global rating firms, after maintaining the Dominican Republic during a large part of last year at default levels (DDD and D, respectively) improved the country's rating to B-. This news contributed to the enhancement of economic perspectives and the strengthening of capital flows to the Dominican Republic.

Central Bank gross international reserves rose by RD$ 1,104.5 million, reaching a total of US$ 1,929.3 million in December, 2005. As such, gross international reserves covered more than 3 months' national imports. Accordingly, net international reserves, as defined

in the IMF's Balance of Payments Manual, grew by US$ 917.5, from US$ 602.2 million in December, 2004 to US$ 1,519.7 million at end-December, 2005. Sources for the growth in reserves stemmed principally from purchases made by the Central Bank during the year, which avoided in turn a greater appreciation of the local currency. Liquid international reserves according to IMF program criteria reached US$ 849.9 million, or higher by US$ 499.9 million than the December 2005 target of US$ 350.0 million.

Fiscal Sector

Central Government fiscal operations on an accrual basis[1] ended 2005 with a moderate deficit of RD$ 6,532 million, which is equal to 0.7% of GDP. This is a clear improvement compared to the prior year's performance, which saw a deficit equal to 4.0% of GDP. This figure is consistent with the expected results as per the IMF Agreement.

Additionally, the government initiated a series of measures that affected this year's financial performance, and that are consistent with efforts to comply with Economic Program targets established in the IMF Stand-By Agreement. Among these, on the spending and funding side, are the renegotiation of public sector debt with the Paris Club, compliance with foreign and domestic commitments, and greater control over public spending and external disbursements. With regard to income, the authorities implemented a number of measures to generate greater resources and improve tax management; this in addition to the impact of the tax reform package of October, 2004 and 2005's economic growth.

As a result of these policies, the Non-Financial Public Sector (NFPS) balance ended with a deficit of 0.37% of GDP. This was in consonance with the Stand-By Agreement's fiscal target for 2005 of a NFPS deficit equal to 0.7% of GDP.

Monetary Policy

In 2005, monetary policy was successful in its performance, amply meeting its principal targets. During this year, monetary policy faced four important challenges: first, a return to single-digit inflation; second, managing liquidity by means of issuing lower yield instruments and greater maturities; third, a restructuring of net international reserves; and finally, the reduction of the quasi-fiscal deficit.

The objective of a single-digit inflation rate was achieved in closing the year with an increase of 7.44% in the CPI. This inflation was considerably lower than the 11-13% range originally agreed to with the IMF. It should be noted that the single-digit inflation objective was achieved in an environment marked by a reduction in rates and longer maturities for Central Bank certificates, used as the main policy instrument. Thus, the

[1] Accrual basis refers to all transactions recorded in a given period irrespective of whether or not payment was effected, and the calculation of the fiscal result is obtained on the basis of net foreign and domestic funding operations of the government. This method differs from the cash basis method, in which transactions are recorded as effectively perceived.

average Zero Coupon Bond interest rate fell from 25% IN December, 2004 to 13% in December, 2005. Similarly, the rates for direct placement certificates were reduced significantly, from 23% at year-end 2004 to 12% at year-end 2005 for the 30-day maturity.

The establishment of longer maturities for certificates was achieved through the placement of new instruments, such as fixed income notes, 18- and 24-month direct placement certificates, as well as securities referenced to multiple service bank liability rates and U. S. T-bill rates. These instruments permitted the debt profile of the Central Bank to be substantially modified, as average maturity lengthened from 7.5 months in December, 2004 to 13.4 months for December, 2005.

The longer certificate maturities and reduction of interest rates led to a reduction of liability expense for the Central Bank. While in December, 2004 the bank paid RD$ 2,528 million in interest on a certificate balance of RD$ 110,808.7 million, in December, 2005 it paid out RD$ 1,944 million on a balance of RD$ 141,614.4 million. It should also be noted that 70% of the increase in certificate balance is covered by the accumulation of freely available international reserves.

One of the most relevant points in the implementation of monetary policy in 2005 was that the reduction in inflation was achieved without aggravating the problem of the Central Bank quasi-fiscal deficit. On the contrary, the reduction in monthly interest payments on certificates contributed to a greater reduction in the quasi-fiscal deficit than provided for in the IMF Stand-By Agreement. As a share of GDP, the quasi-fiscal deficit fell from 4.0% in 2004 to 2.95% in 2005. Initially, the established target had been a reduction from 4.0% to 3.2% of GDP.

Financial Sector

Total assets of the financial sector as of December, 2005 reached RD $450,374.1 million, which represents an increase of 15.7% over December, 2004. Liabilities performed accordingly, growing by 15.1% to RD$ 375,947.7 million.

Variables having the greatest impact on asset operations of the sector were the local currency loan portfolio, which grew by 19.6%, compared to 9.2% as of December, 2004. On the other hand, investments in securities underwent a slower pace of growth at year-end compared to the two prior quarters, increasing by 16.1%, whereas the rate for December, 2004 was 64.4%. Total gross loan portfolio for the sector, which had fallen by 4.0% in the first quarter of 2005 compared to December, 2004, recovered significantly in the third quarter, when it rose by 6.2%, which had a positive impact on the levels of economic activity.

Accordingly, liability performance is largely due to deposit activity, both in local and foreign currency, which grew by 29.2% and 25.5%, respectively. Among local currency deposits, sight deposits and savings deposits rose by 38.3% and 25.6%, respectively.

Total liability growth was partially offset by a 29.1% drop in total funding, which is essentially explained by a 30.4% reduction in foreign currency funding, which continues to contract but at a lesser rate compared to the prior year.

Forecast

For 2006, we expect the Dominican economy to reflect a real GDP increase of 5.5% and an end-of-year inflation rate of 5% - 7%, contingent on the fluctuations in international oil prices.