

REPORT ON THE ECONOMY OF THE DOMINICAN REPUBLIC
JANUARY – JUNE 2006
EXECUTIVE SUMMARY

Gross Domestic Product

The GDP calculated according to the newly applied base 1991, increased by 11.3% during the second quarter of 2006, making this the fourth consecutive quarter in which double digit expansion has occurred. Similarly, economic activity in the first half of the year expanded 11.7% in real terms and 16.0% in current terms, resulting in a growth rate of the implicit deflator of 3.8% compared to the same prior year period. It should be noted that the deflator growth rate is consistent with the performance of the Consumer Price Index for the period in question.

The sectors that registered positive real growth rates during the first half of 2006 are: agriculture and livestock (19.6%); mining (10.3%); local manufacturing (8.6%); construction (32.6%); energy and water (3.9%); commerce (10.7%); hospitality (6.8%); transportation and storage (10.3%); communications (28.0%); financial intermediation and insurance (8.9%); housing rentals (3.4%); public administration and defense (5.6%); education (0.3%); health (2.8%); and other services (7.0%). As a group, the above represented 90.6% of GDP growth. In contrast with these sectors, only petroleum refining (-2.0%) and industrial free zones (-8.1%) registered negative growth rates during the period in question.

On the **spending side**, contrary to what occurred the previous year when economic growth was driven by an increase in private consumption, this year the driving force came from public and private investment. Gross fixed capital formation rose significantly by 26.5%, mainly as a result of construction activity (32.6%) and its effect on job growth and the industrial and commercial sectors. In similar fashion, foreign direct investment reached US\$ 418.9 million during the first half of the year, increasing by 1.9%. Private consumption grew by 8.6%, reflecting a modest slowdown after the increase of 12.1% during the same prior year period.

Exports of goods and services (in real terms and RD\$) rose by 10.9% in the first two quarters of the year as a consequence of important increases in foreign sales of products such as raw sugar (32.6%), coffee (49.0%), and cacao (45.8%), as well as larger shipments of ferronickel (26.8%) due to the growing global demand for that mineral. Another contributing factor was an 8.6% increase (in US\$) in tourism related revenue. Imports of goods and services registered real growth of 9.1%, mainly due to raw materials imports, which grew by 26.0% in US\$.

Prices

During the first half of 2006, the cumulative inflation rate was 3.49%, basically due to the rising trend in international oil prices, and its effects on domestic fuel prices and transportation services. Accordingly, if the impact of the increase in oil prices (equivalent to 1.93% of the CPI) is not considered in the CPI, cumulative inflation rate for the first half would be 1.56%, indicating satisfactory control over domestic prices.

In annualized terms, as of June 2006 the inflation rate stood at 10.27%, while the inflation average for the last twelve months was 5.99%. The CPI results show that the Dominican

Republic is poised to meet the inflation targets for 2006, as established in the Central Bank Monetary Program.

Labor Market

Stable prices and strong growth were accompanied, as is to be expected, by a drop in unemployment. According to data published by the National Labor Force Survey of April 2006, the Broad Unemployment Rate fell from 17.5% in October 2005 to 16.4% in April 2006. Similarly, the Employment Rate rose by 0.8 percentage points, due to the creation of 109,460 jobs between the aforementioned months.

External Sector

The balance of payments corresponding to the first half of 2006, according to preliminary information, closed with a total positive balance of US\$ 1.5 billion. The current account was virtually in balance, with a deficit of only US\$ 3.9 million, while the financial account showed a surplus of US\$ 122.4 million. This financial account surplus was in contrast to the deficit for the same prior year period and maintained the trend established in September 2005. The adjustments, errors, and omissions caption had a negative balance of US\$ 117.0 million.

In the first half of 2006, the **current account** deficit was equal to only 0.02% of GDP, in contrast to a surplus of 0.6% of GDP in the same prior year period. During the period in question, high oil prices have been one of the determining factors in the country's external transactions. Accordingly, oil imports for the period in question represent 59.4% of the increase in the commercial deficit.

The **trade balance** for the period registered an increase of US\$ 465.5 million in its deficit, as the economic expansion led to a higher demand for imports. **Total imports** for the first half of the year equaled US\$ 5.24 billion, of which US\$ 3.96 billion were national imports. This rise in national imports was due in large measure to higher oil prices, which totaled US\$ 1.38 billion, or US\$ 276.4 higher than in the same prior year period.

National exports grew by 23.0%, mainly due to a rise in ferronickel exports (US\$ 67.3 million) as a consequence of a price recovery for that mineral on the international market. Except for tobacco and its derivatives, the export value of other products increased, notably sugar and related products (US\$ 16.6 million) cacao and coffee and related products (US\$ 20.0 million), as well as the minor products group (US\$ 58.5 million).

The **balance of services** closed with a positive balance of US\$ 1.54 billion, 10.1% higher than the same prior year period. The **revenue balance** ended the first half of the year with a US\$ 813.1 million deficit. This was mainly due to an increase of 87% in revenue received from overseas investments belonging to the local financial sector. **Net current transfers** rose by 10.0%, principally because of family remittances, which were 13.7% higher than in the same period in 2005.

The **capital and financial account** ended the first half of the year with a positive balance of US\$ 122.4 million. Its principal component is foreign direct investment, which rose to US\$ 418.9 million. Of this amount, new investments represented 36.8%, principally in tourism, industrial free zones, and real estate acquisitions. In addition to this, dividend

reinvestment rose by 6.9%. Finally, the investment portfolio had a notable positive balance due to the bond issue for the purpose of canceling the debt with Union FENOSA.

During the period in question, the D.R. public sector received US\$ 841.6 million in disbursements, an increase of 110.8% over the same prior year period. This increase was largely the product of mid- and long term loans contracted in the amount of US\$ 347.2 million, as well as US\$ 300.0 in income derived from the sovereign bonds issue. These bonds were issued at an interest rate of 8.63% for the purpose of canceling the debt with Union FENOSA, which was to mature in 2015.

External public sector debt service payments continued being met in timely fashion and obligations for all maturities were honored in the amount of US\$ 807.6 million. Of this amount, US\$ 296.0 million corresponds to prepayment of principal to Union FENOSA.

Given the exchange rate stability and greater capital inflows that were prevalent during the period in question, Central Bank gross international reserves held steady around US\$ 2.0 billion during the period. Similarly, net international reserves, as defined in the IMF Manual of Balance of Payments, rose to US\$ 1.58 billion at the June closing. Liquid international reserves reached US\$ 977.9 million, surpassing the US\$ 750.0 million floor established in the Stand-By Agreement.

This favorable performance allows for greater availability of foreign exchange, thus reducing risks and vulnerabilities that would accompany a low liquidity scenario. The increase in foreign exchange largely contributed to the international rating agencies' improvements in the country's risk rating, which strengthens our credit position in the international markets.

Fiscal Sector

During the first half of 2006 the fiscal accounts were influenced by an RD\$ 5.2 billion shortfall in central government projected revenues. However, spending stayed close to the level programmed in the IMF Agreement; thus, the central government suffered a cash flow deficit.

During the period in question, central government operations, below the line, had a deficit balance of RD\$ 5.71 billion, equal to 0.99% of GDP. This deficit was financed with internal and external resources. Net external financing rose to RD\$ 15.02 billion and internal financing consisted of banking sector credits of RD\$ 2.45 billion and arrears related to electrical energy sector subsidies.

Total central government revenues for the first half of 2006 increased by 16.2% compared to the same prior year period, reaching RD\$ 89.22 billion. This was due mainly to economic expansion, the impact of the (partial) fiscal reform of December 2005, and improving methods of tax collection.

Total central government spending for the first half of the year totaled RD\$ 94.57 billion, 32.4% higher than the figure for the same period 2005. The ratio of current to capital spending was comparable to the average for the first two quarters of 2004-2006.

Monetary Policy

During the first half of 2006, monetary policy focused its best efforts on complying with the inflation objective, within the framework of the goals set in the IMF Stand-By Agreement. As a result of the application of this policy focus, cumulative inflation as of June 2006 was 3.49%, which is within the Monetary Program guidelines.

Monetary issuance closed June 2006 at RD\$ 87.40 billion. This is 11.6% higher than the same prior year period. The money supply (M1) composed of bills and coins in circulation and sight deposits at multiple service banks, rose to RD\$ 93.16 billion as of June 2006, reflecting a 9.9% rise over June 2005.

Broad money supply rose to RD\$ 313.91 billion, which represents an increase of RD\$ 31.04 billion over June 2005. A determining factor in this increase is a 31.2% growth in savings deposits. Time deposits grew by 2.5% between June 2005 and June 2006.

Central Bank outstanding securities closed at RD\$148.93 billion as of June 2006. This is higher by RD\$15.81 billion than the December 2005 balance. Despite this increase, it should be noted that between the first and second quarters of 2006 this figure fell by RD\$ 1.02 billion.

Similar to what occurred in 2005, in the first half of the current period, the ratio of interest expense to total certificates outstanding fell sharply. During the period in question, interest payments on issues of securities and short term deposits at the Central Bank decreased by RD\$ 1.77 billion compared to the same prior year period. This reduction, equal to 12.2%, was a product of the phasing down of average interest rates on rollovers and new placings.

Insofar as investor breakdown, there was a further shift toward individuals, increasing from 45.3% during the first half of 2005 to 60.1% in the current period. On the other hand, the holdings of financial institutions in outstanding securities decreased from 50.5% to 37.5% between the two periods.

Financial Sector

During the first half of 2006, the financial sector experienced a continuing process of change in its institutional structure, an improving equity position, operational growth, as a result of the renewed macroeconomic stability in the country. The sector's favorable performance during this period was driven by expanding trends in the credit portfolio and deposit base.

In conformity with the prevailing framework of standards, during the first half of 2006 the Regulation on the insurance known as FHA (*Fomento de Hipotecas Aseguradas*, or Promotion of Insured Mortgages) was approved in its definitive form. This regulation sets the standards that financial intermediaries should follow in order to obtain FHA Insurance, as well as all applicable criteria, policies and procedures, and claims. An important aspect is that, during the period in question, the Liquidity Risk and Market Risk standards became effective. With regard to liquidity risk, the new standards will allow the evaluation of the liquidity management process employed by the part of the financial intermediaries and their levels of exposure to this risk. The market risk standards include measurement, evaluation, and control of market risk, the capital requirements of which will take effect in September, 2006.

Total financial sector assets increased by 12.6% as of June 30, 2006 compared with the same date in 2005. This represents a total volume for the end of the current half of RD\$ 474.60 billion. Accordingly, liabilities grew 8.7%, reaching RD\$ 385.15 billion for the same period.

The credit portfolio continues to lead total asset performance, with an annualized growth of 24.2% as of June 2006, given the expansion of credits granted both in local and foreign currency. Investments in deposits, securities, and stocks rose by 10.4% compared with December 2005 levels, principally because of foreign currency investment activity.

On the liability side, growth was mainly influenced by deposits from individuals in local and foreign currency, which had risen by 21.9% as of June 2006 compared with the same prior year period. Local and foreign currency deposits increased 21.7% and 22.4% respectively over June 2005 levels.

The equity position of financial intermediaries continued improving during the period in question, expanding by 16.3%. This is attributable to a 23.8% increase in paid-in capital, as well as increases in other equity accounts.

At the close of the first half of 2006, financial sector interest rates continued their downward trajectory, resulting from the reduction of Central Bank monetary policy instrument interest rates and from high levels of liquidity in the banking sector. Thus, as at June 2006, asset and liability interest rates for multiple service banks had an annualized average of 19.77% and 11.08%, respectively. These are below the levels corresponding to the same prior year period, which were 21.01% and 11.34%.

Forecast

The Dominican economy continues to grow in an environment of stability, and we expect an increase in GDP for the end of the year similar to that of last year (9.3%). We also expect single digit year-end levels of inflation (5%-7%). This will allow satisfactory compliance with the quantitative performance criteria and indicative targets established in the Stand-By Agreement with the IMF.