INVESTMENT AND SOVEREIGN RESEARCH

SOVEREIGN: Dominican Republic

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Ratings: Moody's, Ba3/positive; and Standard &Poor's, BB/stable

Table 1: SWOT Analysis

Strength • The sovereign's business-friendly environment fosters investments in tourism and other sectors, facilitating a relatively high long-term growth rate. • Being a part of CAFTA-DR allows exports from the DR to access the US market duty-free, coupled with a free-floating currency. • High GDP growth has reduced unemployment and lifted large segments of society out of poverty
Weakness • Weather-related shocks disproportionately affect Caribbean countries, including the DR, resulting in significant infrastructure damage, rising fiscal deficits, and disrupted short-term growth. • With relatively wide fiscal deficits and growing debt levels, the elevated policy rate increases borrowing costs, putting pressure on government finances. If the policy rate remains high over an extended period without corrections in the fiscal accounts, it could lead to a debt trap.
Opportunities • The service-oriented economy and business-friendly environment make the sovereign an attractive destination for investments in tourism, related sectors, and manufacturing. • Strong ties with the US could benefit manufacturing outfits in the Dominican Republic as US corporations consider nearshoring their supply chains post-pandemic. • Higher gold prices could bolster growth in the mining sector and aid the recovery effort.
Threat • Increase in the fiscal deficit and debt buildup could pose medium-term challenges such as crowding put investments. Coupled with the slow pace of fiscal reform and high public sector costs, particularly in the electricity sector, this could result in a higher risk premium for government debt issuances. • Slowdown in growth in the US poses a major risk to the DR's growth rate as the sovereign is heavy reliant on the US for tourism and export sectors.

Summary

Following his re-election, President Luis Abinader and his party, Partido Revolucionario Moderno (PRM), are expected to push through fiscal reforms aimed at reducing the deficit and debt, although significant changes may not occur within the calendar year. The administration is likely to focus on enhancing revenue and cutting expenditures. Implementing the stalled Electricity Pact could reduce subsidies and government spending. While increasing taxes on high-growth sectors like tourism could boost short-term revenues, it might deter future investments and long-term growth. Inflation is well-contained, providing an environment for the central bank to reduce the policy rate. However, this is mitigated by the risk of volatility in the foreign exchange market due to capital flight and currency conversion arising from negative interest rate differential with the US. As a result, a measured pace of reduction synchronized with US rate cuts is envisaged. The outlook is for the currency to depreciate at a low to moderate pace within an environment of relatively low current account balances and strong external flows.

Table 2: Selected Macroeconomic Indicators

	2019	2020	2021	2022	2023	2024 (e)	2025 (f)	2026 (f)	2027 (f)
Population	10.4	10.4	10.5	10.6	10.7	10.8	10.9	11.0	11.1
GDP per capita, US$	8,595	7,554	8,962	10,711	11,187	11,774	12,492	13,259	14,095
Real GDP, %	5.1	-6.7	12.3	4.9	2.4	5.4	5.0	5.0	5.0
Inflation, eop, %	3.7	5.6	8.5	7.8	3.6	4.0	4.0	4.0	4.0
Unemployment rate, %	6.2	5.8	7.4	5.3	6.2	6.0	6.0	6.0	6.0
Revenues, % of GDP	14.4	14.2	15.6	15.3	16.0	15.9	15.3	15.3	15.3
Expenditure, % of GDP	17.9	22.1	18.5	18.5	19.3	18.8	17.8	17.6	17.7
Fiscal deficit (-)/surplus (+)	-3.5	-7.9	-2.9	-3.2	-3.3	-2.9	-2.5	-2.4	-2.4
General government gross debt, % of GDP	53.6	71.5	63.2	59.5	60.9	59.5	58.5	56.5	55.9
Current account balance, % of GDP	-1.3	-1.7	-2.8	-5.6	-3.9	-3.7	-3.5	-3.3	-3.3

Sources: IMF and JMMBIR

Growth Outlook

The growth outlook for the Dominican Republic remains positive over coming quarters aided by stable policies and robust activities across multiple sectors. We expect growth to rise to 5.0% in 2024 following it falling below potential in 2023. Improvements in external conditions, lower domestic inflation and less restrictive monetary policies are having a net positive effect on growth. During the first quarter, output rose 4.1% year over year. The service industries contributed immensely to the growth in output and recorded expansion of 5.4%. Hotel, bars and restaurants recorded growth of 11%; financial services, 5.9% and energy and water, 5.0%. All the sectors in the **real sector** recorded growth with the exception of mining and exploration which contracted by 20.7% and was a drag on overall growth. In coming quarters, we expect growth in the sectors that experience growth to remain elevated and decline in the mining sector to decelerate. Within that context, overall growth is likely to rise.

The uptick in hotel, bars and restaurants reflects deceleration in inflation, improvements in job market conditions and positive growth in the US and in Europe to a lesser extent. Continued improvements in the near term in these economies will continue to fuel activities in this sector. passenger throughput at international airports for the period January to April amounted to 3.04 million persons, an increase of 10.2% over the corresponding period in 2023. We expect growth to remain robust for the remainder of the year. The injection of liquidity by the central bank into the market and policy rate cuts contributed to loan growing more than 12% at the end of Q1, a trajectory that will likely to persist in the near term. Robust loan growth will continue to have a positive impact on the spending power of households and businesses, as inflation remain subdued, and in the process fuel commercial activities.

Near term growth is fairly balanced with downside risk reflecting weather related shocks as the hurricane season draws near. On the upside, deep cuts in the domestic policy rate and stronger externa growth could push growth above our forecast path.

Election and fiscal Policy Outlook

With the election victory, we expect the president and his party to push through fiscal reforms to lower the deficit and debt. However, this may not happen within the calendar year. In the presidential election held on May 19th, incumbent president Luis Abinader was re-elected for another four-year term, while his political party, Partido Revolucionario Moderno (PRM), secured the most seats in the Senate and Chamber of Deputies. This victory cements the PRM's position as a dominant political force and gives Mr. Abinader a clear path to push through legislation with limited opposition.
Before taking office in his first term, Mr. Abinader campaigned on promises to embark on fiscal consolidation and reduce corruption. Although the government has largely avoided major missteps, fiscal deficits have persisted due to elevated social and health expenditures related to the COVID-19 pandemic in 2020 and 2021, coupled with a slow pace of unwinding these expenditures and low revenue growth.

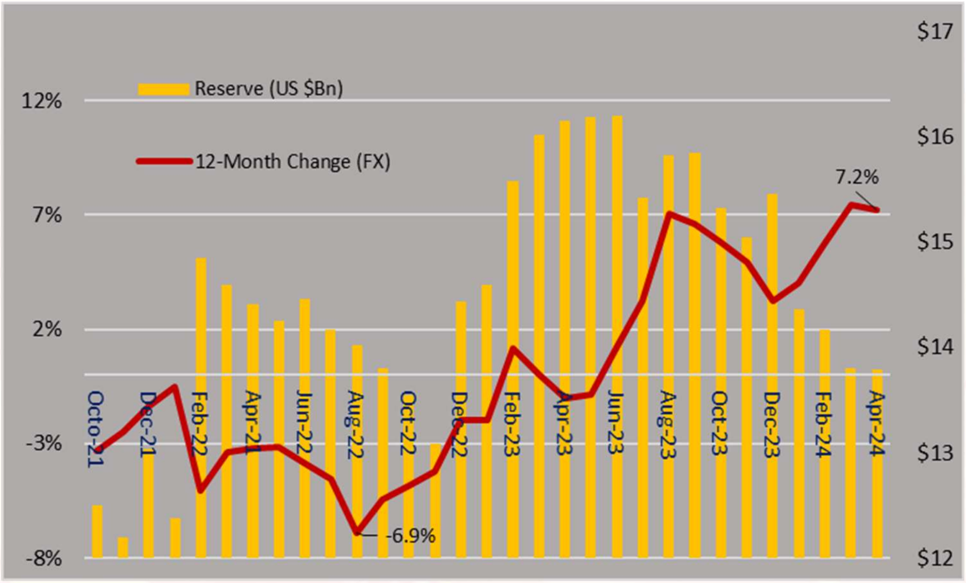
We believe that Mr. Abinader will use his new term to consolidate the fiscal account. Within this context, we expect him to contain spending and enhance revenue collection, driven mainly by tax efficiency. Like the International Monetary Fund, we believe that the implementation of the Electricity Pact, which has been put on hold, could reduce subsidies to the electricity sector and help lower spending over the medium term. It would be politically challenging to increase taxes without pushback from the business community. The Dominican Republic has used low tax rates to attract foreign direct investments in high-growth sectors such as tourism. Accordingly, we expect the government to put measures in place to minimize tax losses as opposed to increase taxes. Increasing taxation on high growth sectors would enhance short-term revenues but could undermine future investments and long-term growth.

In the calendar year 2024, we expect the fiscal deficit to decrease to 2.9%, down from 3.3% in 2023. We project a 2.4% deficit by the end of the forecast period. The authority will be challenged to reduce the deficit more aggressively without serious disruptions to the economy due to structural constraints. Within the context of the moderation in the deficit and strong growth, we envisage debt-to-GDP to move from 59.5% in 2024 to 55.4% at the end of the forecast period. Despite the overall favorable outlook, the risk to the fiscal accounts is slightly tilted to the downside. A higher overall growth rate in the DR does not necessarily equate to strong growth in tax revenues due to the many incentive programs that restrict revenue growth. Conversely, a significant reduction in growth would lead to reduced revenues and minimal expenditure cuts, resulting in an increase in debt-to-GDP.

Current Account and Foreign Exchange

Higher exports and unilateral transfers (remittances) will resulting in marginal reduction in the current account deficit (CAD) over the medium term despite rising imports due to economic expansion. We envisage some improvement in the terms of trade and rising exports. In 2023, the sovereign generated a CAD of 3.9%. We expect the deficit to fall marginally to 3.7% in 2024, reflecting a combination of lower imports, especially oil; rising export flows from tourism and free zones; and continued growth in remittances. Regarding remittances, total inflows amounted to US$10.2 billion (8.5% of GDP) in 2023, 3% higher than the previous year.

Figure 1: exchange Rate Movement and Foreign reserve (US$ Billion)



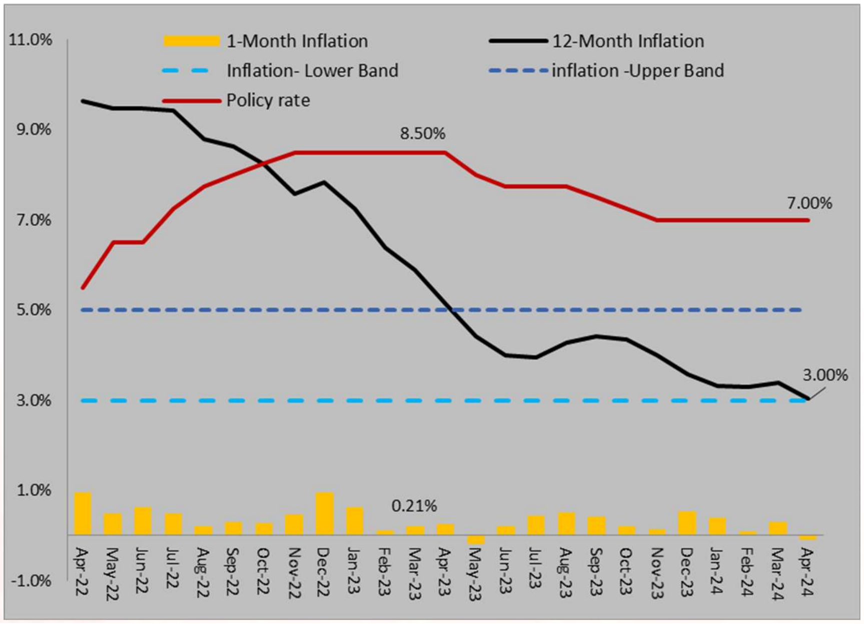
Sources: Central Bank of the Dominican Republic and JMMBIR

In 2023, the current account deficit was mainly financed by foreign direct investments (FDIs) and other official flows, resulting in growth in net reserves. Reserves amounted to US$15.4 billion (12.8% of GDP) at the end of the period, 7% higher than at it was in 2022. In April, amid robust domestic economic activities supporting increased imports and demand for foreign currency, reserves fell by US$1.7 billion (10.8%) to US$13.8 billion. Despite this tapering, we believe reserves will remain elevated over the short to medium term, supported by rising exports and elevated foreign direct investment inflows.

We expect the domestic currency to depreciate at a low to moderate rate at the end of the year, as demand for US dollar weigh on the foreign exchange market. Amid a series of sharp appreciation in early 2023 and as the demand for US dollar rises thereafter, the 12-month depreciation rate accelerated in first half of the year and was recorded at 7.2% in April. Despite the sharp uptick in the 12-month depreciation rate, for the period January to May, the depreciation rate was 0.6%. We expect condition in the foreign currency market to remain relatively stable over the next 12-18 months resulting in containment in the movements in the peso versus the US dollar. As a result, we envisage a low pace of depreciation over the forecast horizon.

Inflation and the Policy Rate

Figure 2: Inflation and the Policy Rate



Sources: Central Bank of the Dominican Republic and JMMBIR

Inflation has fallen to within the policy range of 3%-5%% and is expected to remain at these levels over the next 18-24 months due to a combination of favorable external and domestic conditions. In April, the 12-month inflation rate was 3.03% compared to 5.13% in April 2023, a 200 basis points reduction. Inflation has decelerated over the past 22 months owing to a combination of low international prices, improved domestic weather condition, and tight monetary policy. Prices for most commodities used for final consumption or as inputs in manufacturing process fell significantly during this period. Given the global outlook on growth and the underwhelming growth expectation of the Chinese economy, we envisage relatively stable commodity over multiple quarters. Despite the easing of inflation, the central bank has been cautious with the pace of injection of liquidity into the market while slowly adjusting the policy rate to balance inflation risk. After cutting the policy rate 150 basis points in the second half of 2023, there was has been no further the start of the year. In this context, aggregate demand among households and businesses has risen moderately, but not sufficiently to cause prices to rise.

We anticipate that the central bank to embark on at least two rate cuts in the second half of the year and reduce the policy rate by 100 – 150 basis points. The central bank as to be mindful of the differential between US and DR interest rates, a positive differential could cause persons to convert the savings from pesos to US dollar. Additionally, funds from portfolio would be forced to move in search of higher dollar returns. Under either scenario, the domestic currency would come under pressure, which has a second round inflation effect. Within this context, higher US inflation and the Fed failure to cut rates could case US interest rates to remain higher for longer and force the CBDR not pause rate reduction in 2024.

Outlook

Having assessed the wider macroeconomic metrics, our core view is that the Dominican Republic (DR) economy will remain stable over the short to medium term, characterized by moderate growth and stability in most salient variables. The DR is on track to be one of the fastest-growing economies in Latin America in 2024, following years of cultivating a business-friendly environment supported by stable governance and pragmatic policies. Steady and positive growth in the US, and by extension Europe, has favourably impacted the DR's growth momentum in several areas, including exports and tourism. Additionally, the dynamism within the economy has led to rising purchasing power for households and businesses, driving growth in commerce and agriculture. High foreign direct investment (FDI) flows to build projects in tourism are complemented by elevated capital spending by the government, resulting in a high growth rate in construction that is likely to continue over the medium term.

With the presidential election concluded and the economy on a steady growth path, we believe that President Abinader will embark on fiscal consolidation, primarily through expenditure cuts. It will be politically challenging to increase revenues without raising taxes on high-growth sectors like tourism and exports from the free zones. Doing so could boost revenues in the short run but might dampen growth in the long run as higher taxes disincentivise foreign direct investments. Our core view is that the government will revive the Electricity Pact, as this area can realize relatively large savings over the medium to long run without negatively impacting public sector employment or the social safety net.

Globally, inflation is generally on the decline, supported by weak to moderate growth in major economies. This trend will likely help contain commodity prices and, by extension, import prices for the DR. Low imported inflation and stable domestic agricultural output will help support low inflation over the medium term. With inflation under control, the central bank is likely to cut the policy rate in the second half of 2024. However, the pace of these adjustments will be influenced by changes in the US policy rate to limit the risk of currency conversion and capital flight, both of which could lead to increase foreign exchange volatility.

Sources: IMF and Bloomberg