

**REPORT ON THE DOMINICAN ECONOMY**  
**January – March 2006**  
**EXECUTIVE SUMMARY**

**Gross Domestic Product**

At the end of the first quarter of 2006, the Dominican Gross Domestic Product (GDP), using a new methodology (base 1991), registered a 12.6% growth rate compared to the same period in 2005, according to preliminary figures obtained from the companies and institutions that compose the sample of activities contained in the real GDP calculation. It should be noted that using the previously applied methodology (base 1970), the growth rate would have been 13.0% in real terms.

The value added by the activities composing the GDP rose by 12.1% and net taxes on product subsidies by 16.2%, which is in accordance with the vigor shown by the economy.

GDP at current prices, calculated by economic activity, which had not been done since 1985, increased by 16.0% compared to the same quarter 2005. This indicates that prices for all goods and services produced in the economy grew by only 3.0 percent. It is also evidence of stable prices in the Dominican economy, which is in line with results shown by the Consumer Price Index 12-month average ending March, 2006.

Growth in first quarter 2006 is a reflection that the economy is following the same trend which started in June of last year, in which 10.0% and 12.1% increases were seen for the third and fourth quarter 2005, respectively. These, together with the 12.6% for the first quarter of the current year, result in an average growth rate of 11.6% for the last three quarters.

As components of GDP, the fastest growing sectors were: agriculture and livestock (12.2%), mining (9.1%), local manufacturing (10.7%), construction (31.8%), commerce (30.3%), hospitality (4.8%), transportation (16.1%), communications (30.3%), financial intermediation and insurance (15.8%), public administration (5.4%), education (2.1%), and health (3.4%). These sectors collectively comprise 73.3% of total GDP.

On the spending side, real GDP growth is based on greater levels of internal gross investment (28.7%), both public and private. This is highlighted by significant increases in construction (31.8%), and machinery and equipment (29.4%), in accordance with the performance of capital goods imports in US dollars at current prices, which rose 17.0 percent.

Similarly, foreign direct investment reached US\$ 245.1 million during the quarter, an increase of 6%, compared to 2005. It should be noted that during that period public sector spending on capital goods (machinery and equipment) increased by 169.9% and spending on public sector construction by 117.4 percent.

Consumer activity, both public and private, was also positive by 7.2 percent. Private consumption rose by 7.1%, motivated by a higher level of purchasing power that resulted from the combined effect of salary increases in the public and private sectors, plus an appreciated local currency and controls on inflation. Imports of consumer goods valued in US dollars rose by 13.6 percent.

Accordingly, government consumption in real terms increased 9.4 percent. Public spending on personal services in current terms rose by RD 1.84 billion, due to the effects of a 15% salary increase for public sector employees that took place on July 1, 2005, and of a 4.9% increase in Central Government employees. Non-personal services as well as materials and supplies rose by 90.9% and 58.4%, respectively. This performance is influenced by government spending on social assistance programs.

Finally, exports grew by 15.8%, valued at 1991 prices. Current US dollar value of total exports increased 3.7 percent. A 4% increase in services was affected by service exports related to marine transport (18.3%) and income related to tourism (3.9%). An increase of 3.5% in the goods sector was mostly due to sugar and related products (128.2%) cacao and related products (47.9%), coffee and related products (27.3%), miscellaneous products (19.9%), ferronickel (13.0%), aircraft fuel (8.6%), and goods acquired in port (8.3%).

## Prices

In the first quarter of the year, the Consumer Price Index (CPI) increased by 1.52%, due primarily to increase in local prices during January, when the inflation rate was 1.55%, given that Law 557-05 on Tax Reform went into effect, and that there were adjustments in fuel prices, electrical energy, and transportation services. Annualized inflation from April 2005 to March 2006 stood at 8.26%, while the 12-month average was 3.95 percent.

If the first quarter CPI performance were to continue, the goal of ending the year with an inflation rate similar to 2005 would be achieved, as established in the Monetary Program of this Institution, provided that the upward trend in international oil prices does not persist.

## External Sector

The external sector of the Dominican economy, measured in terms of the global balance of payments results, ended the first quarter 2006 with a deficit of US\$ 40.5 million. The determining factor of that deficit was an increase in external payments, due to the payment in advance of the balance of the Union Fenosa debt.

The **current account** in the first quarter registered a surplus of US\$ 158.4 million, equal to 2.0% of GDP, despite greater imports needed by the growing economy and higher payments for oil imports. Contributing to this favorable result were the surplus balances in the services and transfers accounts, which were 10.6% higher than the deficit

balances in the trade and rent accounts, whereas in earlier years only around 80% of the deficits were covered.

The **trade balance** concluded the quarter with a deficit of US\$ 1.00 billion, 28.4% higher than the same prior year period. This increase was determined by a stronger economy driving a growth in imports of goods. Another factor was the reduction in exports from industrial free zones, mainly textiles and electronic products.

Exports of national goods (27.8% of total exports) turned in the best performance, growing by US\$ 74.0 million with respect to the same prior year period. This growth compensated a drop in industrial free zone exports.

The **balance of services** ended the period with a positive balance of US\$933.6 million, which is 4.4% higher than in the same prior year period. This is because tourist related income, representing 93.0% of the total balance of services, grew by 3.9 percent. This increase was in line with an increase in the number of visitors (7%), given that both average spending per visitor and average length of stay fell by 0.59 and 3.67%, respectively. Tourist services continue being the main source of foreign exchange for the country, contributing US\$ 1.20 billion during the first quarter of the year.

The **balance for rents** registered a deficit of US\$ 489.7 million in the first quarter of this year, or 3.5% lower than the same prior year period. This performance is attributable to a 30.1% increase in foreign portfolio income. On the other hand, direct investment income, which makes up 74.9% of the total, rose by only 0.3% compared to the same period of last year. This was a result of, among other things, a 5.6% reduction in free zone exports.

The **balance of net current transfers** increased 9.9 percent. This was driven by a 14.3% in family remittances. This performance can be explained by a lower unemployment rate among Hispanic immigrants in the U.S., which fell from 6.1% in March, 2005 to 5.5% in March, 2006, and a 5.4% increase in the average income of these immigrants. Another probable factor was the assumed continuing growth of Dominican emigration to the U.S., as has been the case for the two previous decades.

The **financial and capital account** ended the period with a positive balance of US\$22.9 million. This is higher by US\$ 17.8 million than the same prior year period. Contributing factors were the performance of foreign direct investment and portfolio investment.

Foreign direct investment registered a positive result of US\$ 245.1 million during the period under consideration. This represents a 6.0% increase over the same prior year period, due to the continuation of several tourist projects in the eastern region of the country and investments in two free zone industrial parks that are expected to be concluded this year. Another factor was a 4.0% growth in reinvested profits, which have grown for the third consecutive period. This reflects the confidence of foreign investors in the continuing stability and favorable outlook of the Dominican economy.

The **Foreign Public Debt** during the period under analysis was marked by disbursements of US\$ 509.3 million, an increase of 106.2% over the same prior year period. This was mainly due to an issuance of US\$ 300.0 million in Sovereign Bonds at 8.63%, for purposes of canceling the Union Fenosa debt that matured in 2015. This cancellation represented a savings of US\$ 29.3 million in the payment of the debt.

Accordingly, foreign public debt service payments continued to be met in a timely fashion. During the period in question, US\$ 519.4 million in obligations were met. This is an increase of 209.0% over the same prior year period. The above mentioned pre-cancellation of Union Fenosa debt represented 85% of this increase. Of the total paid, 77.9% corresponds to principal and the rest to interest.

Central Bank Gross International Reserves maintained levels that permitted coverage of three and a half months of imports (US\$ 1.93 billion at month-end March, 2006). Likewise, Net International Reserves, in accordance with the definition set forth in the IMF Balance of Payments Manual, reached US\$1.52 billion for the period. Liquid international reserves<sup>1</sup> reached US\$ 879.9 million, which surpasses the US\$ 750.0 million minimum for liquid international reserves agreed to in the IMF program.

It is important to note that credit agencies and some financial institutions consider international reserves to be an important factor that affects the availability and cost of foreign finance, as well as financial sector liquidity position vulnerability. Accordingly, the increase in international reserves represented an important contribution to the improvement in the Dominican Republic's risk rating.

## **Fiscal Sector**

Consistent with the parameters established in the IMF agreement, the Central Government registered a deficit of 0.4% of GDP in the first quarter of 2006, equal to RD\$ 1.28 billion. This result is measured "below the line" based on variances in internal and external financial operations.

It should be noted that the Non-Financial Public Sector (NFPS) generated a surplus of RD\$ 699.4 million. This represents a positive margin of RD\$ 399.4 million with respect to the NFPS target established in the New Letter of Intent for the IMF Stand-By Agreement for June, 2006.

With regard to the performance of "above the line" variables, Central Government total income was mainly affected by strong economic growth and the partial impact of by the modifications introduced in the Tax Reform Law No. 557-05 of December, 2005. The later widened the base for value added taxes (ITBIS) and taxes on earnings were raised, as were excise taxes on fuel, alcoholic beverages, tobacco and certain other goods. It

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<sup>1</sup> According to IMF program criteria, liquid international reserves are obtained subtracting the following from net reserves: banking sector legal reserve balances and their deposits in foreign currency, government dollar deposits, contingency and consolidation funds in foreign currency, certificates in dollars, and loan disbursements corresponding to the government and its institutions.

should be noted that the full impact of these reforms will be evident in the coming months.

### **Monetary Policy**

During first quarter 2006, the Central Bank continued the implementation of a monetary policy oriented toward maintaining low inflation and complying with the goals established in the IMF Stand-By Agreement. As a result of the application of this policy, cumulative inflation as of March was 1.52%, which is consistent with the Monetary Program. It should be noted that the positive performance with regard to inflation coincided with a period of rising oil prices in the overseas markets.

During the period in question, steps were taken to adapt Central Bank investment certificate interest rates and maturities to a changing monetary environment. For purposes of restructuring the profile of the certificates and reducing the risk of early redemption of certificates placed directly with the public, a new certificate was introduced. The first issuance of these certificates, totaling RD\$ 10 billion, took place at the end of January, 2006, at 20% for a one-year maturity and 24% for a two-year maturity. Investments equal to RD\$ 9.5 billion were received, of which 41% were substitutions of redeemable certificates.

In mid-February, a second issuance took place, totaling RD\$ 13 billion, at 19% for a one-year maturity and 23% for a two-year maturity. For this second issuance, the penalty was eliminated for those investors wishing an early redemption of their certificates in exchange for fixed term certificates. The elimination of the penalty, together with the confidence placed in the monetary policies of the Central Bank, created an environment in which 58.1% of total second issue placings originated from conversions of instruments with early redemption to certificates with no early redemption.

In addition, the Open Market Committee (COMA), by its abbreviations in Spanish, lowered the interest rates on redeemable certificates, in an attempt to reduce “window” investments and increase placings through zero coupon auctions. Accordingly, in March, the third issuance of fixed term non-redeemable certificates, for RD\$ 10 billion, offered rates of 17%, 18%, and 20% for 12, 18 and 30-month maturities, respectively.

The increase in certificates resulted in total outstanding securities as of the end of March of RD\$ 159.14 billion. This is higher by 25.8% than the figure for the same prior year period. Despite this increase, total monthly interest paid fell from RD\$ 2.58 billion in March 2005 to RD\$ 2.22 billion during the current quarter. Lower monthly interest payments on certificates contributed to a reduction of RD\$ 961.1 million in the quasifiscal deficit during the period.

## **Financial Sector**

During the first quarter of 2006, the financial sector continued its process of institutional strengthening and transformation, in order to adapt to applicable laws and regulations and to the requirements of the IMF Stand-By Agreement. Thus, the financial sector equity position have risen 24.4%, annualized to March 2006. Similarly, the growth in economic activity led to operational growth in the principal categories of assets and liabilities, both in local and foreign currency.

At the end of March, the financial sector's positive performance was evident as reflected by growth of 9.8% and 7.9%, respectively, in asset and liability operations. Asset operations equaled RD\$ 444.89 billion, and liabilities RD\$ 368.63 billion. Multiple service banks make up the largest share of the consolidated financial sector, their assets representing 76.4% of the sector's gross assets.

Asset performance was driven by a 21.0% increase in the credit portfolio compared to the same prior year period. This was largely due to an expansion in local currency loans, as a result of the increase in economic activity. Investments in deposits, securities, and stock, which had been the fastest growing asset category, fell by 0.2% compared to March 2005.

Liability performance is explained by total deposits held by the public, both in local and foreign currency, which showed levels 21.0% higher in March 2006 compared to the same prior year period.

During the first quarter of 2006, growth in local and foreign currency deposits was 18.9% and 25.5%, respectively. This was partially offset by reductions of 26.4% in financing and 6.0% in outstanding securities. As a consequence, total liabilities rose by 7.9% compared to March 2005.

During the period in question, capital enhancement of financial intermediaries continued their positive trend, growing 24.4 percent. This was evident in the growth of paid-in capital accounts and other equity captions. In first quarter 2006, these grew by 4.5%.

## **Outlook**

For 2006 we expect GDP growth to be around 5.5% and inflation to hover near 5-7%, contingent on the performance of the international oil market.