

Report on the Dominican Economy
January – June, 2008
Executive Summary

The components of the international environment that are relevant for the country conditioned macroeconomic performance for the Dominican Republic during the first half of 2008. Sustained price increases for petroleum and its derivatives, together with price increases for food and other commodities in international markets, exerted substantial pressures on domestic prices, the current account deficit, and the Non-Financial Public Sector. Similarly, the U.S. financial crisis has had a negative effect on the world economy, slowing down consumption and private investment, particularly in the United States itself.

In spite of the above, however, during the January-June period 2008 the Dominican economy experienced a growth rate of 7.3 percent, driven largely by private consumption and public spending. The greatest influence on economic performance came from Financial Intermediation, Insurance, and Related Activities, a sector that grew by 19%. This was mainly due to the performance of the multiple-service banking sector loan portfolio, which expanded due to higher levels of financing extended to the private sector (24.4%).

Other sectors leading the expansion were: Communications (15.7%); Commerce (11.0%); Energy and Water (11.2%); Construction (10.0%); Transportation and Storage (6.2%); Hospitality (6.1%); and Local Manufacturing (4.9%). Together, these sectors represent 80.0% of GDP. On the downside, the sectors registering negative growth were: Agriculture (-5.6%); Mining (-2.2%); and Industrial Free Zones (-1.9%). The performance of the latter sector is an improvement over the 12.5% contraction during the same prior-year period.

This rising internal demand, together with the persistent oil shock and food import price increases, resulted in a cumulative inflation rate of 7.57% as of month-end June. Among the components used to establish the Consumer Price Index, the sectors having the greatest impact were: Transportation (52.1%) and Food, Beverages, and Tobacco (30.6%). Cumulative underlying inflation for the period in question reached 4.15%. This indicator measures the inflation trends of monetary origin, and reflects the fact that these higher internal prices were mainly a function of adverse external factors.

The Dominican Republic's external account performance, measured through the balance of payments, reflected the negative impact of significant external shocks. Nevertheless, the balance of payments total for the first half of the year was only –US\$409.9 million, which was covered by the use of Central Bank reserves with no major consequences for the rest of the economy.

The balance of payments current account registered a deficit of US\$2.65 billion, which is higher by US\$2.15 billion compared to the figure for the same prior-year period. Of this increase, 60.5% corresponded to growth in the value of oil and food imports, as well as some commodities, including steel, as a consequence of international price increases. This deficit was partially financed by foreign direct investment inflows, which reached US\$1.51 billion, and also other income not identified in the balance of payments, equal to US\$ 815.9 million.

In that context, in January and February the monetary authorities chose to adjust the short-term rate on interest-bearing deposits, which in practice acts as the monetary policy interest rate. These adjustments sent a signal to the markets regarding the Central Bank's intention to apply all available instruments to confront growing inflationary pressures. These modifications to the overnight rate gradually led to increases in financial sector rates, observing the time lag in monetary transmission conduits.

However, banking sector interest rate increases did not translate into higher delinquency rates, as financial intermediation entities when granting credits run a tolerance analysis on debtors using higher interest rates than the ones agreed upon. The delinquency rate for the multiple-service bank credit portfolio at month-end June was 3.66%, which is below the 4.98% registered in the same prior-year period. This delinquency is covered by loan loss provisions in the amount of 133%. This ample coverage is indicative of the banking sector's having learned to protect its equity in the face of unfavorable market scenarios.

In addition to making adjustments to the overnight rate, the Central Bank continued undertaking open market operations, by means of indirect (Central Bank paper) or direct placings (over the counter). As a result of these placings and using international reserves to reduce liquidity, the money supply at month-end June stood at RD\$117.42 billion. This figure is within the $\pm 2\%$ band contemplated for the second quarter 2008 monetary base target, according to the Central Bank Monetary Program.

At the same time, outstanding securities reached RD\$189.28 billion. Despite this increase, interest payments dropped by 6.4% on an annualized basis. This was due to the restructuring of maturities, applying longer terms, and the lower rates that correspond to these instruments. Consequently, the balance for the quasi-fiscal deficit for month-end June 2008 came in some RD\$2.6 billion, or 21.75%, lower than the same prior-year figure.

Finally, it should be noted that public finances were severely impacted by higher disbursements related to subsidies on liquefied petroleum gas, fuel oil, the electrical sector, and some of the staple foods of the basic shopping basket. In this manner, spending surpassed the levels set out in the Income Budget and Public Spending Law for 2008.

For the January-June 2008 period, Central Government total income rose to RD\$128.99 billion, which is 8.9% higher than the figure for the same period in 2007. Accordingly, total expenditures stood at RD\$143.91 billion, or 32.3% above the same prior-year period. This situation produced a deficit in Central Government fiscal operations equal to RD\$20.91 billion, which included RD\$4.05 million for the first half of the year, representing the Central Government's contribution to the Central Bank's recapitalization bonds. This payment was in process at the time and was registered in the deficit by the accrual method. The funds were actually received in July.