FOR AGENDA

EBS/86/65
Correction 1

CONFIDENTIAL

March 26, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Dominican Republic - Review Under Stand-By Arrangement

The following corrections have been made in EBS/86/65 (3/18/86):

Page 6, Table 3: Revised table

Page 17, second full para., line 6:	Delete footnote 1/
third full para., line 4:	for "2/" read "1/"
line 6:	for "2 years" read "3 years"
line 7:	for "1 3/4 percent" read "1 3/8 percent"
bottom of page:	footnote 1/ deleted footnote 2/ renumbered

Page 22, para. 1, lines 10 and 11: Delete "and quantitative performance criteria."

Att: (3)

arrears, and net foreign borrowing) for end-December have all been observed, in some cases, with substantial margins (Table 3). The reduction in the temporary export surcharge on traditional exports from 36 percent to 20 percent, which is a prior condition for the completion of the review, also has been implemented. 1/

The monthly rate of inflation declined from about 3 percent in the first half of 1985 to 1 percent in the second half, and by end-December the 12 month rate of inflation was 28 percent compared with 38 percent in December 1984 (see Table 2). However, the rapid rise in prices early in the year, because of the unification of the exchange market and corrective price adjustments, raised the average rate of inflation for the year as a whole to 38 percent compared with 24 percent originally projected. According to official estimates real GDP is estimated to have fallen by about 1 percent in 1985. The decline was apparently due to lower agricultural output related to adverse weather conditions, weak international demand conditions for sugar, and a fall in construction activity associated with the reduced availability of mortgage financing. 2/

The overall deficit of the public sector in 1985 (including the quasi-fiscal deficit of the Central Bank) is estimated to have been equivalent to 2.3 percent of GDP compared with the original program limit of 4.9 percent of GDP. 3/ External financing exceeded the overall fiscal deficit and permitted a reduction of close to RD$200 million in net public sector indebtedness to the Central Bank and the Reserve Bank, the state-owned commercial bank (Table 4). The large reduction in public sector bank indebtedness was influenced, in part, by some year-end disbursements of project loans and larger than programmed accumulation of counterpart deposits associated with PL-480 commodity loans.

Government revenues turned out to be slightly higher than originally programmed and total expenditures were less than had been programmed. The expenditure shortfall reflected markedly lower capital spending and savings on interest payments. Included in total expenditures are the operating losses of the public enterprises which in 1985 amounted to the equivalent of 8 percent of total public sector expenditure (as against a break even position envisaged in the program). Of the shortfall in interest payments of RD$237 million, RD$136 million

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1/ As is discussed below, the reduction in the export surcharge to 18 percent was effected through a mechanism whereby the exporter paid the 36 percent and was reimbursed 18 percent after 60 days. The staff has calculated that the effective rate of surcharge is 19 percent. In addition, the 5 percent surcharge on nontraditional exports was eliminated.

2/ This estimate is being re-examined because production and trade indicators do not support the conclusion that real GDP fell in 1985.

3/ If the cash deficit is corrected for scheduled interest payments not paid, the overall deficit is the equivalent of 2.7 percent of GDP.

Table 3. Dominican Republic: Quantitative Performance Criteria
Under Stand-By Arrangement, 1985

	1984 Dec. 31	1985 June 30	1985 Sept. 30	1985 Dec. 31
(In millions of Dominican pesos)				
Net credit to the public sector 1/				
Ceiling		1,902.0	1,852.0 2/	1,802.0 2/3/
Revised ceiling		1,910.8 3/	1,750.0 4/	1,785.9 4/
Actual	1,810.8	1,603.1	1,644.3	1,620.1 5/
Margin or excess (-)		307.7	55.7	165.8
Cumulative reduction in net domestic assets of the Central Bank				
Target		-50.0	-114.9 2/	-164.8 2/
Revised target			-180.0	-207.4
Adjustment for letters of credit and greater than programmed debt relief 6/		...	3.6	-21.3
Actual	1,632.1 7/	-309.4	-226.8	-238.4 8/
Margin or excess (-)		259.4	50.4	9.7
(In millions of U.S. dollars)				
Net foreign assets of the Central Bank				
Target		-300.0	-278.6 2/	-227.2 2/
Revised target			-335.0	-266.6
Adjustment for letters of credit 6/		-16.7	-1.2	-1.2
Actual	-335.9	-285.7	-310.1	-247.1 9/
Margin or excess (-)		31.0	26.1	20.7
Cumulative cash reductions in external arrears				
Target		64.0	74.0 2/	89.0 2/
Revised target			74.0	105.0
Actual	506.6 7/	65.1	79.5	106.7
Margin or excess (-)		1.1	5.5	1.7
External debt disbursements 10/				
Debt of 0-1 year (net)				
Ceiling on gross disbursements		90.7	...	...
Ceiling on net disbursements 11/		...	...	-19.3
Revised ceiling on net disbursements 11/		...	...	--
Actual gross disbursements		79.0	...	...
Actual net disbursement		...	...	--
Margin or excess (-)		11.7	...	--
Debt of 1-5 years				
Ceiling 12/		64.2	64.2	64.2
Actual		36.3	...	55.7
Margin or excess (-)		27.9	...	8.5
Debt of 1-12 years				
Ceiling		198.5	198.5	198.5
Actual		69.4	...	122.4
Margin or excess (-)		129.1	...	76.1

Sources: Technical Memorandum of Understanding; and Central Bank of the Dominican Republic.

1/ Combined net credit of the Central Bank and the Reserve Bank to the nonfinancial public sector.
2/ *Indicative ceiling or target.*
3/ Ceiling was adjusted to reflect revision in the outstanding stock as of December 31, 1984.
4/ Ceilings adjusted as indicated in footnote 1 to Table 2 annexed to the Technical Memorandum of Understanding and for greater than programmed debt relief.
5/ Adjusted for deposits of Plan Reagan funds credited to public sector.
6/ Reflects use of collateral deposits to liquidate letters of credit. See footnote 2 to Table 3 annexed to the Technical Memorandum of Understanding.
7/ Stock outstanding.
8/ For the definition of NDA the changes of NFA are valued at the monthly average exchange rate.
9/ Adjusted for US$1.2 million of arrears with the Bank of Nova Scotia converted to medium- and long-term debt.
10/ Disbursements under nonconcessional external public and publicly guaranteed debt.
11/ Applies to the period December 31, 1984-December 31, 1985.
12 Subceiling within the disbursements of debt of 1-12 years maturity.

expected to continue to increase. Taking into account debt relief already lined up (mainly from the commercial banks) and allowing the elimination of external payments arrears (US$100 million) the prospect is for an overall balance of payments deficit of US$140 million compared with a deficit of US$189 million in 1985.

In 1986, total exports are projected to increase by 8 percent with sugar receipts declining by 5 percent in reflection of a further reduction in the Dominican Republic's quota in the U.S. market as well as a contraction in exports to the world market where export prices (about 6 U.S. cents a pound) are one-half the cost of production. Coffee export receipts are projected to increase by 22 percent as a result of the increase in prices. Total imports are projected to decline by 7 percent, reflecting a reduction of US$125 million in fuel imports, while nonfuel imports would increase by about 5 percent.

The consolidation period under the 1985 Paris Club agreement ends April 1, 1986 and, in the absence of a new agreement, debt service to Paris Club creditors in the period April-December 1986, would amount to US$106 million, of which US$35 million would be for interest payments. In addition, moratorium interest payments of US$15 million related to the last agreement, fall due in early 1986. Also to be paid in 1986 are interest payments amounting to US$30 million which fell due in 1985 but were deferred to be paid by April 15, 1986.

On February 24, 1986, the Dominican Republic signed a multiyear rescheduling agreement (MYRA) with commercial banks. The rescheduling covers all maturities that fell or will fall due in the period 1984-89 1/ estimated at US$797 million (of which US$183 million is in respect of 1986). Repayments are refinanced with a grace period of 3 years and a final maturity of 12 years. The interest rate will be 1 3/8 percent over LIBOR or over the adjusted CD rate, at the option of the lender. It has been stipulated that the agreement will become effective only if it is approved by the Government before end-July 1986 and if the Government is in a financial arrangement with a multilateral institution. If these conditions are not met, the 1986 maturities will be deferred as were the 1984 and 1985 maturities.

As mentioned earlier, the program provided for the reduction of the export surcharge on traditional exports from 36 percent to 20 percent in early 1986. On January 19, 1986, the Government announced a reduction in the surcharge on traditional exports from 36 percent to 18 percent as well as the elimination of the 5 percent surcharge on nontraditional exports. The reduction in the surcharge on traditional exports is to be effected through a "reimbursement" mechanism whereby the exporter pays the 36 percent and is reimbursed the equivalent of 9 percentage points after 30 days and another 9 percentage points after 60 days.

1/ Maturities that fell due in 1984 and 1985 had been deferred pending the finalization of this agreement.

The authorities explained that, as the first quarter of the year was a peak period for export receipts, the "reimbursement" mechanism was devised to prevent a sudden expansion of liquidity which would undermine the fight against inflation and perhaps facilitate capital flight in the pre-election period. They undertook however to terminate the "reimbursement" mechanism by end-May and expressed the intention to reduce the surcharge to 10 percent by end-June. The authorities noted that pending congressional approval of new revenue measures, the surcharge was the most assured means of raising resources to assist in the servicing of central government debt. They expected that by the time of the 1987 budget, at the latest, the remaining surcharge would be replaced by more permanent fiscal measures.

The Dominican authorities said that they were satisfied with the workings of the exchange system and emphasized that it was free of official interference. Moreover, they were not unduly concerned about the recent appreciation of the Dominican peso which, in their view, was the result of sizable capital inflows, the exceptional tourist season and the improved economic outlook for the country. They expected that with the leveling off of capital inflows, the end of the tourist season, and the usual anxieties of the pre-election period, some of the recent appreciation would be reversed.

The medium-term balance of payments outlook presented during the first review has been revised in light of developments in 1985 and the 1986 outlook (see Table 8). As noted earlier, the current account deficit in 1986 is projected at about 2 percent of GDP mainly as a result of the reduction in petroleum imports and the projected increase in coffee exports. With the poor prospects for traditional exports, the trade deficit is expected to widen from about US$400 million in 1986 to about US$530 million in 1990. However, the services account is projected to shift from a deficit of US$17 million in 1986 to a surplus of US$86 million in 1990. On this basis, the current account is projected to register a deficit of around 1 percent of GDP in 1990. This balance of payments scenario assumes a strong performance of nontraditional exports and tourism which would depend critically on a shift of resources to these sectors and on an exchange rate policy which provides adequate incentives over the coming years.

The capital account projections are essentially the same as in the first program review. They imply that, given the debt relief already negotiated with the commercial banks and the target of a modest improvement in the net foreign asset position of the Central Bank over the medium term, there will be a financing gap of around US$50 million a year in 1986-87. This gap is likely to be closed through additional debt relief. From 1988, the balance of payments would appear to be fully financed.

On the basis of the policies described by the authorities, inflation may be expected to come down further in 1986, while output would show some growth following declines in the past two years. With the anticipated recovery in public investment and increased use of foreign credits, the overall fiscal deficit is expected to widen a little to 3 percent of GDP. However, the external current account deficit is projected to decline to about 2 percent of GDP in 1986 as a result of modest growth in export receipts and a reduction in imports related to the weakening in oil prices.

The major fiscal problem at the present time is the underlying weakness of the state enterprises. Despite the price increases and other adjustment measures undertaken in 1985, many of these enterprises continue to require large transfers from the Central Government, notwithstanding sizable arrears to the Reserve Bank and to domestic suppliers (mostly the rice and sugar farmers). These arrears have weakened the financial position of the state-owned commercial bank and may have adversely affected the performance of the agricultural sector. The staff urges that action be taken in respect of the finances of the public enterprises to make possible an increase in public investment in a setting of a declining deficit.

On monetary policy, the main area of concern is the over-regulation of the banking system and particularly the system of interest rate ceilings on the commercial banks. These ceilings have affected the banks' ability to mobilize savings and have given rise to an increase in disintermediation. The authorities are currently studying a report prepared by the Central Banking Department of the Fund on ways of integrating the formal and informal financial market. In the meantime, the staff urges the early removal of the interest rate ceilings.

The staff welcomes the elimination of the surcharge on nontraditional exports and the reduction in the surcharge on traditional exports announced in early January 1986, and notes the commitment given by the authorities to terminate the reimbursement mechanism applicable to the surcharge on traditional exports by the end of May and to reduce the surcharge to 10 percent by end-June. The staff further recommends that the surcharge be eliminated by the end of 1986, at the latest, with compensatory fiscal action.

In real effective terms, the peso appreciated by 13 percent during 1985, although its real effective value remains well below the level in the period 1980-82. The medium-term outlook for the Dominican Republic, including in particular the difficult prospects for traditional exports, underscores the need for an intensification of the adjustment effort involving the continued pursuit of tight demand management policies and an exchange rate policy that provides adequate incentives to exports.

In summary, the staff believes that despite the weaknesses apparent in certain areas, the policies followed in 1985 have helped to improve the performance of the economy and that the policies described for 1986 should contribute to a consolidation of recent gains.

VII. Proposed Decision

Review Under Stand-By Arrangement

The following draft decision is proposed for adoption by the Executive Board:

1. The Dominican Republic has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for the Dominican Republic (EBS/85/75, Supplement 1, 4/17/85) and paragraph 30 of the letter of February 28, 1985 attached to the stand-by arrangement, supplemented and modified by the letter of October 28, 1985 with annexed technical memorandum, in order to review progress made in implementation of the program and to reach understandings for the remaining period of the arrangement on exchange rate policy, interest rate policy, the reduction in external payments arrears, and on external financing policies.

2. The Fund finds that no additional understandings are necessary on exchange rate policy, interest rate policy, the reduction in external payments arrears, and on external financing and decides that the review under paragraph 4(c) of the stand-by arrangement is completed.