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**FOR AGENDA**

EBS/05/9
Supplement 1
Correction 1

January 27, 2005

To: Members of the Executive Board

From: The Secretary

Subject: **Dominican Republic—Request for Stand-By Arrangement, Activation of the Trade Integration Mechanism, Cancellation of Current Arrangement, and Extension of Repurchase Obligation—Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding**

The attached factual corrections to EBS/05/9, Sup. 1 (1/18/05) have been provided by the staff:

**Page 4, para. 3, line 1**: for "is targeted to drop sharply from 37 percent during 2004"
read "is targeted to drop sharply from 29 percent during 2004"

**Page 5, para. 8, line 10**: for "and (vii) the scaling-back of public"
read "and (vi) the scaling-back of public"

**Page 18, Table 1, footnote 6**: for "Include reserve requirement on investment certificates."
read "Includes reserve requirements in the form of investment certificates."

Questions may be referred to Mr. S. Phillips (ext. 37187), Mr. Lopetegui (ext. 39688), and Mr. Cubeddu (ext. 36231) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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## DOMINICAN REPUBLIC—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

### I. INTRODUCTION

1. The Dominican Republic is in the process of emerging from the economic crisis triggered by inadequate management of the public finances and the banking crisis of 2003, which led to high inflation, a sharp depreciation of the peso, a disproportionate growth of public debt, and massive capital flight. Unfortunately, the large public assistance to contain the banking crisis was not accompanied by the needed fiscal adjustment and institutional reforms to restore confidence in the economy and access to private capital markets.

2. The new government is well-aware of the need for a strong and coherent program to allow the Dominican Republic to entrench the nascent stability and establish the conditions for sustaining growth over the medium-term. To this end, it is determined to implement a new program which aims at restoring fiscal discipline and financial stability, with a strong institutional component that addresses a wide range of governance and transparency concerns. The key elements of the new program are as follows:

- Macroeconomic and structural policies aimed at solidifying price stability and ensuring the resumption of sustained growth;
- A fiscal policy adjustment to improve the public accounts and reduce public debt, guaranteeing its sustainability in the medium term.
- A financing strategy that will allow the public sector to overcome its short-term liquidity crunch, consistent with medium-term debt sustainability;
- A strategy of strengthening the financial system to establish sound financial intermediation;
- A plan to improve the efficiency of the electricity sector to ensure its financial viability;
- Reform of the institutions in the public finance area to improve the design and execution of fiscal policy and permit the achievement of the needed large fiscal adjustment; and
- Further strengthening of the central bank and banking supervisory agency, in order to improve the implementation of monetary policy and guarantee the stability of a well-functioning financial system.

### II. MEDIUM-TERM MACROECONOMIC FRAMEWORK

3. Output growth is estimated at 2.0 percent in 2004 and is projected at 2 ½ percent for 2005 and 4.3 percent in 2006, as confidence builds and domestic demand recovers. Inflation

is targeted to drop sharply from 29 percent during 2004 to between 11 and 13 percent during 2005 and to the single digit range during 2006.

4. Given the expected economic recovery, the external current account surplus is projected to decline from 5.8 percent of GDP in 2004, to less than 1 percent of GDP in 2006. The strengthening in tourism receipts will be offset by an expected fall in textile exports as a consequence of the expiry of the textile quotas at end-2004 under the WTO's Agreement on Textiles and Clothing (ATC) and the recovery in imports, as private sector consumption and investment rise toward pre-crisis levels. In the capital account, private capital outflows are projected to decline, as confidence in the banking system and the economy recovers, and net international reserves are targeted to increase to more comfortable levels (by US$440 million over the program period).

5. The consolidation of public finances is central to the program. In this regard, the government is implementing the large fiscal adjustment needed to set the stage for a reduction in public debt and a recapitalization of the central bank. This adjustment reflects a significant improvement in the non-financial public sector (NFPS) balance, as well as a reduction in the quasi-fiscal deficit of the central bank. The government is committed to resolve the problem of the quasi-fiscal deficit through a program of capitalization and the transfer of assets to the central bank.

6. The government is committed to improving the overall balance of the NFPS in 2005 to -0.7 percent of GDP, compared to a projected deficit of 2.7 percent of GDP in 2004, and further to a surplus of 0.7 percent of GDP in 2006. To this end, the government has adopted measures (see following paragraphs) which will also allow for increased social spending and the partial recovery of some expenditures that had been reduced excessively over the past two years. After taking into account the projected decline in the quasi-fiscal deficit of the central bank (largely reflecting a drop in interest rates), the consolidated public sector balance is projected to improve by about 3 percentage points of GDP in 2005, to a deficit of 3.9 percent of GDP. The fiscal adjustment programmed over the two-year period would help reduce the consolidated public debt from 52 percent of GDP in 2004 to about 48 percent of GDP by end-2006.

**Main Macroeconomic Assumptions and Targets**

| | 2004 | 2005 | 2006 |
|---|---|---|---|
| GDP growth (percent change) | 2.0 | 2.5 | 4.3 |
| Inflation (12-month percent change, eop) | 28.7 | 11– 13 | 8.0 |
| External current account balance (in percent of GDP) | 5.8 | 2.0 | 0.5 |
| Gross international reserves (in US$ millions) | 825 | 1,257 | 1,844 |
| Net international reserves (in US$ millions, program definition) | 211 | 350 | 650 |

## III. Economic and Financial Policies for 2004–06

### A. Fiscal Policies

7. Shortly after assuming office, the new government implemented a set of adjustment measures—with an annual estimated yield of over 2.8 percent of GDP—aimed at correcting the inherited fiscal imbalance, significant arrears on public debt service, and liquidity problems more broadly. These measures included: (i) the enactment, effective October 1, of a tax reform that among other things increased the VAT (*ITBIS*) rate from 12 to 16 percent, and raised excise taxes on alcohol and tobacco products; (ii) a catch-up in the adjustment of fuel excises for inflation (in accordance with the law on fuel taxes); (iii) the targeting of liquefied gas (LPG) subsidies; and (iv) the reduction in the central government payroll.

**Public Sector Summary Accounts**
(in percent of GDP)

| | 2004 | 2005 | 2006 |
|---|---|---|---|
| Nonfinancial public sector balance | -2.7 | -0.7 | 0.7 |
| Quasi-fiscal balance of the central bank | -4.0 | -3.2 | -2.5 |
| Consolidated public sector balance | -6.7 | -3.9 | -1.8 |
| Primary balance | -0.9 | 1.9 | 3.3 |
| Interest payments | -5.8 | -5.9 | -5.1 |
| Gross public sector debt | 52.1 | 49.1 | 48.3 |
| External | 33.5 | 30.3 | 30.2 |
| Domestic | 18.6 | 18.8 | 18.2 |

8. On December 30, 2004, the congress approved the 2005 budget proposal (*Proyecto de Presupuesto de Ingresos y Ley de Gastos Públicos*). This budget is consistent with an overall balance for the NFPS of -0.7 percent of GDP. In addition to the recently adopted fiscal measures, the proposed budget assumes: i) an increase of 3 percentage points in the exchange commission tax (which more than offsets the effect of eliminating the 2 percent tax on imports at end-2004); ii) a further increase, of about 10 percent on average, on the excises applied to various fuels, to recover the revenues lost as the result of the delayed adjustment for inflation of that tax during 2003 and 2004; (iii) a freeze in the level of central government employment; (iv) the containment in the growth of non-priority recurrent spending; (v) the further retargeting of LPG subsidies; and (vi) the scaling-back of public investment projects. At the same time, the budget envisages a considerable increase in social expenditures and a reduction in payments arrears to avoid disruption in the provision of public services. The main policies underlying the budget follow:

- To partially reverse the recent compression in public sector real wages, the government plans to increase wages of central government employees by 30 percent (implemented in two equal installments on January 1 and July 1), while freezing employment at the level existing in October 2004. As a result, the central government wage bill is targeted to increase by RD$6.7 billion, to RD$35.8 billion in 2005.

- Spending on goods and services will be limited to RD$17.5 billion, mainly reflecting an increase in social spending in real terms. The government recently launched a new food assistance program (*Comer es Primero*), which is expected to benefit 125,000 families by end-2005, and this will be complemented by a strengthening in the flagship school breakfast program (*Desayuno Escolar*).

- Current transfers are projected at RD$ 43.0 billion, mainly reflecting an increase in: (i) transfers to the electricity sector (previously extrabudgetary) to cover the deficit estimated for that sector (see paragraph 38); (ii) pension payments in line with the increase in salaries; (iii) transfers to government agencies in line with the growth of fiscal revenues. These increases will be offset by the saving arising from the targeting of subsidies to users of energy. LPG subsidies will be limited to RD$ 2.8 billion through the implementation of a program involving the distribution of up to 500,000 magnetic cards to poor households effective April 2005 (following completion of a census aimed at identifying these households).

- Capital spending will be limited to RD$ 38.2 billion and will be directed to priority projects. The recent centralization of the management and control of investment projects financed from external sources (see paragraph 23) will assure that execution of such investment does not exceed RD$ 19.4 billion in 2005.

- The brackets used to determine individual income tax will not be adjusted for inflation (consistent with the recent modification of the law in this area)

- Budgeted expenditures are slightly lower than envisaged under the program for 2005, providing some room to deal with unexpected developments. Moreover, if necessary to protect the program's fiscal target from unexpected developments, the government will take additional measures. We will execute the budget prudently, in light of monthly reviews of the performance of tax collections, so as to ensure that any shortfall in revenue (for example, deriving from nominal GDP being lower than projected at the time the budget was formulated) would be offset by appropriate expenditure restraint. The evolution of the plan to reduce losses in the electricity sector (see paragraph 38) also will be closely monitored. In March 2005, we will analyze with World Bank and IMF staff the latest electricity sector developments and determine whether or not these imply a need to adopt an alternative electricity plan and/or compensatory fiscal measures, including the possibility of bringing forward elements of the planned tax reform (see paragraph 19).

## V. Improving Timeliness and Accuracy of Economic Information

39. We are committed to strengthen our internal data preparation and reconciliation, and review systems to improve the quality of economic data and to broaden the scope of information currently available. In this regard, the government plans to (i) publish by June 2005 detailed statistics for public corporations, municipalities and decentralized institutions, including the social security system, and (ii) establish by March 2005 a centralized database on public and publicly-guaranteed external debt, including external project financing. In addition, the monetary authorities are well-advanced in implementing the recommendations of IMF safeguards assessment mission. Remaining actions include:

- The central bank's internal audit committee will develop by March 2005 an audit plan with the advice of a tendered international auditor. To this end, earlier this year, the central bank established an independent committee, directly accountable to the Monetary Board, to oversee the bank's external and internal audit functions.

- The central bank established in December 2004 an interdepartmental committee in charge of reviewing and analyzing the composition of international reserves and other program data.

- An independent audit of the central bank's accounting records, internal control system and risk evaluation process was recently finalized. The report was presented to the Monetary Board in December 2004 and will be shared with IMF staff shortly.

- The central bank will publish, by January 2005, its audited financial statements for 2003. The audited statements for 2004 will be published by April 2005

40. To improve transparency and make information easily available to the general public, the central bank will update regularly the information disseminated through its web page, including external arrears, net international reserves, and the saving-investment account of the central government. In addition, the authorities will participate in a Data ROSC, for which an IMF mission is planned for May 2005, and the report will be published by end-2005.

Table 1. Dominican Republic: Quantitative Performance Criteria and Indicative Targets for 2005–06

| | Estimate | Performance criteria | | Indicative targets | | |
|---|---|---|---|---|---|---|
| | Dec-04 | Mar-05 | Jun-05 | Sep-05 | Dec-05 | Dec-06 |
| **I. Quantitative Performance Criteria 1/** | | | | | | |
| (In billions of Dominican Republic pesos) | | | | | | |
| A. Nonfinancial public sector (NFPS) balance (cumulative floor) 2/ | -2.7 | -6.0 | -6.6 | -7.3 | -9.1 | 7.1 |
| B. Central Bank net domestic assets (ceiling) 3/ | 25.1 | 26.0 | 24.5 | 22.5 | 26.5 | 21.3 |
| (In millions of U.S. dollars) | | | | | | |
| C. Gross accumulation of public sector external arrears (continuous ceiling) | 0 | 0 | 0 | 0 | 0 | 0 |
| D. Contracting of external debt by the public sector (cumulative ceiling) 2/ 4/ | 200 | 380 | 655 | 855 | 1,105 | 950 |
| E. Central Bank NIR, excluding bank's foreign currency deposits (floor) | 211 | 150 | 200 | 225 | 350 | 650 |
| **II. Indicative Targets** | | | | | | |
| (In billions of Dominican Republic pesos) | | | | | | |
| A. Change in NFPS net credit from the domestic banking system (cumulative ceiling) 2/ 5/ | 4.8 | 6.5 | 5.0 | 3.0 | 1.0 | -7.5 |
| B. Monetary base, excluding reserves on foreign currency deposits (ceiling) 6/ | 91.1 | 89.4 | 91.8 | 93.0 | 104.0 | 117.4 |

1/ As defined in the Technical Memorandum of Understanding. Performance criteria are proposed for March and June 2005. At the time of the first review, performance criteria will be set for September and December 2005.

2/ For 2005, cumulative from end-September 2004. For 2006, cumulative from the beginning of the year.

3/ Defined as currency in circulation less NIR (program definition) valued at the accounting exchange rate of DR$35 per US$.

4/ Ceilings exclude any new debt instruments issued as part of the process of debt restructuring and rescheduling.

5/ Credit is defined on a net (of deposits) basis, and includes the central bank.

6/ Includes reserve requirements in the form of investment certificates.