TRIP NOTE: DOMINICAN REPUBLIC

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GlobalEvolution

GLOBAL EVOLUTION TRIP NOTE

We visited the Dominican Republic in October to meet the Central bank (BCRD), the Finance Ministry and local investors and analysts. After the devastating hurricane season, we were interested in the impact on the country and its important tourist industry. Will the BCRD continue to ease on the back of the hurricane or will the country even benefit from a substitution effect? Further topics were the latest developments on the electricity and fiscal pact given the finalization of Punta Catalina in 2018 and the direction for the currency given the sharply improving external accounts.

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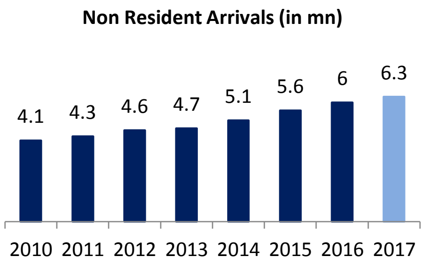
Economy:

Hurricanes Irma and Maria's economic impact will be modest

After years of roaring growth (GDP averaged 7.0% in 2014-2016) and being the highest growth country in the Caribbean, momentum hit a speed bump in Q2:17. Growth fell to 2.7% y/y due to lower investment spending (mainly public) and slower retail demand, albeit base effects also played a role. Hurricanes Irma and Maria hit the country in Sep 17, raising the risk of a prolonged slump in activity. However, the damage was significantly lower than in other parts of the Caribbean and mostly limited to the north. The key tourist areas escaped largely unscathed. In fact, tourist numbers remain on track to set a new record for the year at an expected 6.3m (see chart 1) up 5.7% from 2016. The risks seem largely to the upside according to local analysts given potential holiday substitution in favor of the Dominican Republic.

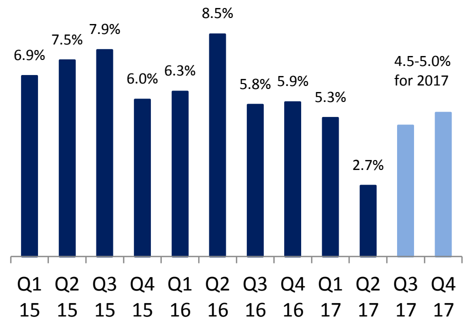
Chart 1: New record for tourist arrival



Source: BCRD and Global Evolution

With the key tourism sector unaffected and growing strongly, GDP looks set to recover in H2:17 as the drag from lower public investments is poised to reverse. GDP growth is expected to come in at 4.8-5.0% for 2017 and 5.0-5.5% for 2018 with total estimated costs from the hurricane at about 0.5-0.8% of GDP.

Chart 2: Growth hit the bottom in Q2 17



Source: BCRD and Global Evolution

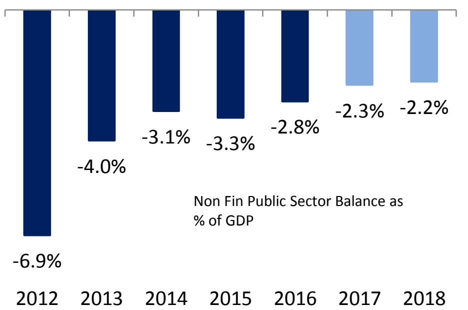
Fiscal:

Fiscal numbers continue to improve with the central government running a primary surplus

The positive fiscal adjustment continued in 2017 as revenues increased strongly due to an improvement in tax administration and a reduction of tax evasion. For the first 7 months revenues are up 10.6% y/y to DOP312.5m while expenditures increased by 5.0% to DOP357m. The resulting deficit for the central government was 1.3% of GDP, well on track to meet the target of 2.3% for the full year.

The primary balance for the central government shows a surplus of 0.5% of GDP for the first 7 months and very likely to hit the target of +0.8% of GDP for 2017. The ongoing fiscal improvement paves the way for an upgrade to investment grade (Moody's upgraded DomRep to Ba3 in Jul17). In order to achieve IG status, politicians will need to approve the so called fiscal pact.

Chart 3: Budget Deficit adjustment continues



Source: Ministry of Finance and Global Evolution

Assuming the fiscal adjustment continues, central government debt/GDP is expected to peak in 2019 at about 43% from 39% in 2017. The external debt share is currently at 75.3% but expected to decline in the next years to about 70% as issuance will favor local debt. Gross financing requirements for 2018 are 5.5% of GDP or USD4.26bn with USD2.1bn penciled in from the issuance of new Global bonds.

Energy/Fiscal Pact:

Electricity pact to lead any fiscal pact

After years of electricity shortfalls and unreliable supply the new Punta Catalina coal power plant is expected to bring relief and diversify the energy mix away from oil. With about 85% of total energy coming from mostly (imported) oil and gas driven power plants, fluctuations in the oil price were a key uncertainty for the fiscal accounts given relatively generous electricity subsidies (around 18% of expenditures). Hence, by lowering the production costs the government expects to gain more fiscal room. Savings are estimated to be up to USD200m. After 3 years of talks between the government and the private sector on how to reduce the burden on the fiscal accounts, an electricity pact seems imminent.

Although details are being finalized, the pact should reduce transfers to the sector and help the transition to a market based tariff system. More importantly, it is essential for the fiscal pact, which is probably necessary for the eventual IG status.

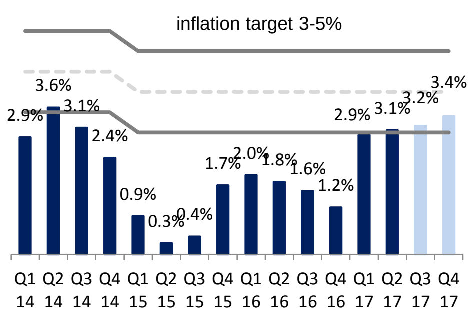
The fiscal pact is seen as the key policy priority for 2018 and should bring some important tax reforms designed to increase transparency, broadening the tax base, reduce tax exemptions, overhaul the VAT system and potentially reduce the corporate income tax. At 27%, this is comparably high and will appear even higher if the US reduces their corporate tax rate to 20%.

Monetary/FX policy:

Interest rates on hold, while the currency has a weakening bias in real terms verus USD

The BCRD cut rates by 50bp to 5.25% in Jul 17 and eased reserve requirements (RR) by 2.2%, which freed up DOP20bn in the banking sector to support the economy after the weak Q2:17. With inflation still well behaved and in the lower part of the 3-5.0% target range, more easing may come to spur a rebound in investment activity. The BCRD may however not use interest rates but rather will either reduce the stock of outstanding bills or reduce the RR further in order to meet its 3.5-4.0% real policy rate. According to the BCRD, inflation expectations remain well anchored and inflation is expected to converge back to mid-target by 2018.

Chart 4: Inflation to converge back to mid target by 2018

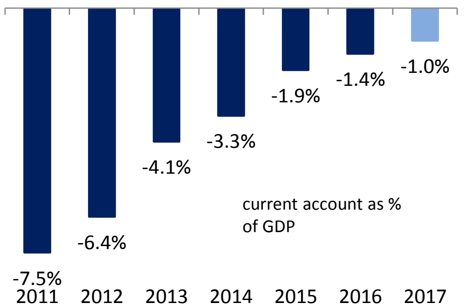


Source: BCRD and Global Evolution

Reflecting the strong BOP position, FX reserves have doubled since 2011 to USD6.3bn, which equates to 4.1 months of imports and above the IMF target of 3.0.

The current account has improved significantly and is expected to show a deficit of 1.0% of GDP in 2017 compared to -7.5% in 2011. The strong improvement comes on the back of another year of record tourism revenues projected to rise to USD7.37bn (+9.6% y/y) and record remittances projected at USD5.83bn (+10.8% y/y). FDI is expected to rise to USD2.6bn (+7.3% y/y). Hence, after the usual seasonal low, the BCRD expects FX reserves to increase in Q4:17.

Chart 5: strong improvement in the current account



Source: Central Bank of the Dominican Rep. and Global Evolution

The DOP has depreciated on average by 2.3% annually in real terms versus the USD in the period 2012-2017, which has helped to improve the C/A. The BCRD seems determined to continue this path despite the strong BOP performance (and their models) pointing to the DOP valuation being line with macroeconomic fundamentals. Interestingly, local analysts and investors still see the DOP as expensive and expect a higher depreciation. This is however at odds with the fundamentals and our take away was clearly that if anything there is upside potential for the DOP barring external shocks.

Politics:

Another term for Medina?

Although the next presidential elections are only in 2020, they are already generating political risk. According to the constitution, Medina cannot run for a third term but speculation is mounting that he may use his majority in parliament to change it to allow a third term. Although Medina has not voiced openly such intentions, locals attach a higher than 50% probability to it. That said, his popularity has taken a hit after the eruption of Odebrecht scandal, with DomRep the second highest recipient of bribes after Venezuela. Any attempts to change the presidential terms will probably depend on his popularity going forward. Despite the recent scandal, Medina standing with the public still appears strong and likely to remain solid on the back of a well performing economy.

Conclusion:

Economy to rebound, fiscal and external accounts performing well

The economy is poised to rebound after the weakness in Q2:17, as monetary easing and increasing fiscal expenditure lift activity in H2. The hurricanes only left relatively limited damage in the Dominican Republic and should not dent growth much as the key tourism areas were not severely hit. The adjustments in the fiscal and external accounts continue, with the central government running a primary surplus and the current account deficit almost closing. The key for further rating upgrades down the line are a sound fiscal pact. This has become more likely now with the progress on energy reforms and the electricity pact. We were reasonably constructive when we visited the country and left arguably more positive still.

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