

## **International Monetary Fund**

### **Dominican Republic: Letter of Intent**

January 7, 2009

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*Secretaría de Estado de Economía, Planificación y Desarrollo*  
*Secretaría de Estado de Hacienda*  
*Banco Central de la República Dominicana*

January 07, 2009

Dominique Strauss-Kahn  
Managing Director  
International Monetary Fund  
Washington, D.C.  
U.S.A.

Dear Mr. Strauss-Kahn:

1. In 2008, the Dominican economy suffered a series of internal and external shocks.: The shocks caused by high international food and oil prices during the first half of the year, combined with four tropical storms that seriously disrupted agricultural production, when the country was still recovering from the aftermath of the two storms that had struck us in the final months of 2007, with significant damage to infrastructure and many human casualties. Moreover, these events took place in the midst of a significant increase in both public and private domestic demand, which, in combination with the increase in fuel and food prices, put pressure on domestic prices and the country's external current account. In the second half of 2008 the situation changed significantly in response to the monetary policy measures that contributed to reduce economic activity. At the same time, the economy began to experience the effects of the global economy slowdown, especially in the United States, our main trading partner, as a result of the financial turbulence in the international capital markets that has affected the global macroeconomic outlook.

2. To combat the adverse effects of the shocks suffered by the poorest sectors of Dominican society, the Government felt compelled to increase expenditures in food assistance as well as subsidies for energy and public transportation. This increase in public expenditure together with the fall in government revenues due to the decrease in economic activity that began in the third quarter, the non-financial public sector (NFPS) deficit is projected to reach approximately 3.0% of GDP in 2008, including all resources necessary to cover the deficit in the electricity sector.

3. In this adverse external environment, monetary policy has served as an anchor to contain expectations and maintain macroeconomic stability, especially to slowdown a high peso-denominated domestic credit to the private sector growth rate, as well as the domestic demand, during the first part of 2008. The Central Bank raised its reference rate three times through August, from 7% to 9.5%, which helped to moderate inflationary expectations and maintain a relatively

stable exchange rate. The results obtained after the abrupt reduction in oil prices during the last quarter of 2008, allow the inflation rate to reach 4.52% at the end of the year, around fifty percent lower than 2007.

4. In the first quarter of this year, GDP experienced a high growth rate of 7.5 percent. But given the current international conditions and the effects of monetary policy, economic growth has moderated starting in the third quarter, and is expected to be close to 5% in 2008, compared with 8.5% in 2007. At the same time, annualized inflation accelerated in the first eight months of the year, reaching 14.58% in September, as a result of high global prices for food and fuel. However, with the large drop in international oil prices during the final months of the year, and having registered negative monthly inflation rates in October, November and December, annual inflation finished the year below the inflation target established in the Central Bank's Monetary Program for 2008. In addition, the negative shocks mentioned earlier caused the current account deficit to grow around 9.6% of GDP. This deficit is completely financed, partly with resources from Petrocaribe and with exceptional levels of foreign direct investment (FDI). An important element is that, despite the adverse external environment, the Central Bank's gross international reserves position continues to be strong, covering more than 100 percent of short-term public debt.

5. Despite the global financial turbulence, the most recent indicators show that the Dominican financial system has demonstrated a significant level of flexibility. The banks are well-capitalized, profitable, and have adequate liquidity and solvency levels. Furthermore, the stress tests carried out by the Bank Superintendency suggests that the banking sector is able to withstand the current global financial conditions without major problems. In any event, the SB is closely monitoring events in coordination with the Central Bank.

6. The macroeconomic outlook for 2009 is for a slowdown in growth, consistent with the decreased growth of our main trading partner, the United States, a reduction in inflationary pressures, and a lower external current account deficit. The economy is expected to grow around 3% in 2009 and inflation is expected to be in the 6%-7% range. The external current account deficit is expected to shrink below 6% of GDP, as a result of lower oil prices and the expectation that the deceleration in imports will outweigh the decline in exports. The current account will be completely financed, due chiefly to increased disbursements of multilateral and bilateral loans, around US\$1,400 millions, and substantial foreign direct investment. FDI is expected to remain strong owing to the development of a mining project that is about to begin, equivalent to 2.5%.

7. Given the slowdown in economic activity and the limited availability of international financing, the Dominican Government recognizes the need to implement a realistic fiscal program, while ensuring that the combination of macroeconomic policies promotes moderate and stable growth. To this end, we intend to create a fiscal environment that makes possible to implement a less restrictive monetary policy. The key element of this combination of policies is the 2009 fiscal budget, which is based on a realistic estimate of revenues and sources of financing, considering a timely delivery of the resources needed to recapitalize the Central Bank.

8. The fiscal budget approved for 2009 is consistent with an NFPS deficit of 1.7% of GDP, which represents a 1.3 percentage points adjustment compared with the 2008 outcome. The adjustment in the central government primary balance is even larger. Preliminary estimations suggest a primary deficit of 2.0% of GDP in 2008, and a surplus of 0.5% of GDP in 2009, a 2.5 percentage points adjustment. In addition, the budget considers a significant improvement in the quality of expenditure, as subsidies will be better focused, particularly those related to energy, which are expected to be sharply reduced given the prospects of lower oil prices. This situation should provide the room necessary to increase spending on health and education. In addition to the reduction in global fuel prices, the projected fiscal adjustment also reflects the effects of our reform program for the electricity sector that focuses on: (i) continued progress in cost recovery; (ii) a pricing policy that reflects marginal costs; and (iii) strict enforcement of the bill criminalizing electricity theft. Recently, the President appointed a group of representatives from the private sector and government officials to the Presidential Committee for the Strengthening of the Electricity Sector, which is expected to contribute to the solutions of its prevalent difficulties. In addition, the diminishing pressures of domestic demand, together with the significant reduction in domestic inflation, have allowed the monetary and financial authorities to reduce the monetary policy rate (Overnight) from 9.5% to 8.5% and the Lombard rate from 16% to 14%, sending a signal of a more flexible monetary policy stance. Once progress is made in fiscal consolidation and the delivery process of the recapitalization resources is restarted, the Central Bank will be able to further reduce its reference rates during the first months of the year.

9. The Banks Superintendency will continue to fortify bank surveillance through consolidated supervision. We are currently awaiting the joint IMF-World Bank mission aimed at conducting an updated evaluation of the financial sector. Our banking regulatory framework will be strengthened through the proposed amendments to the Monetary and Financial Law, which will be submitted to Congress in the first half of 2009.

10. The Dominican authorities reiterate their commitment to macroeconomic stability and structural reforms aimed at ensuring sustainable economic growth, increasing employment, and above all, reducing poverty and inequality. For 2009, we are committed to making the necessary decisions to ensure a successful implementation of the IMF's Post-Program Monitoring, which will involve at least two supervisory visits in addition to the evaluation of the financial system. We expect that the IMF Executive Board will have the opportunity to examine the country's economic plan on January 12th.

\_\_\_\_\_/s/  
Temístocles Montás  
Secretary of Economy,  
Planning, and Development

\_\_\_\_\_/s/  
Vicente Bengoa  
Secretary of Hacienda

\_\_\_\_\_/s/  
Héctor Valdez Albizu  
Governor  
Central Bank