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Dominican Republic Macro View

Fiscal reform… it's now or never

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- President Danilo Medina presented the long-awaited fiscal reform, which is looking to turn around fiscal accounts by roughly 4% of GDP. The government is planning to achieve this turnaround through a combination of expenditure cuts (1.9% of GDP) and higher tax revenues (2.2%) of GDP.

- Before the fiscal proposal goes to Congress, it will be reviewed by the *Consejo Económico Social e Institucional* (CES). We expect the government to be receptive to the CES's comments and to give up some of the reform's points. Congress should not be regarded as a potential problem for the approval of the reform, as it is dominated by the ruling party. We are skeptical about the possibility of accomplishing the aforementioned amount of expenditure cuts, but we acknowledge that some savings appear likely to be achieved.

- Even if the potential turnaround of 4% of GDP were to be shaved off, the government, in our view, should try to get back to a deficit of at least 2.5-3% of GDP. According to our estimates, this fiscal deficit (which is equivalent to a primary fiscal surplus of 0.5-1% of GDP) stabilizes debt dynamics.

- We expect the fiscal reform to increase the possibility of eventually reaching a deal with the IMF. This time around, the value of an IMF program is more closely associated with the fiscal outlook than with the need to bring relief to the balance of payments.

- The passage of the fiscal reform could produce a near-term outperformance in Dominican Republic bonds. We caution however that this scope for outperformance is somewhat limited giving the fact that DomRep spreads are already fairly valued to similarly rated sovereigns, albeit with less idiosyncratic near-term risk than most of those credits.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

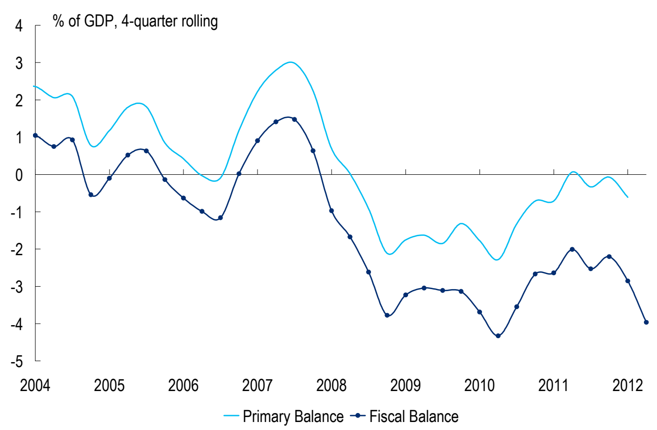
Fiscal reform… it's now or never

Mixing expenditure cuts with higher taxes

President Danilo Medina presented the long-awaited fiscal reform proposal. Last week, President Medina made public the details of his government's proposal to turn around fiscal accounts. The proposal includes a mix of both higher taxes and lower expenditures. This goes in line with what we have been expecting since the presidential campaign (see Dominican Republic Macro View - Trip Report—Political Risk is Overrated, February 17, 2012). We think that the fiscal situation underscores the need for an adjustment, and the political environment to undertake it is more supportive than on previous occasions.

The government is looking to turnaround the fiscal accounts by roughly 4% of GDP. According to a statement by the presidential office, the government is planning to cut expenditures by 1.9% of GDP and to raise tax revenues by 2.2% of GDP. The overhaul is needed after the disappointing fiscal data of 1H12 highlighted how the government's finances derailed during the electoral year (see Caribbean and Central America Macro and Strategy Outlook - You Better Tighten Your Belt, September 24, 2012). Although a fiscal deterioration was somehow expected, it went beyond our own forecasts. According to our own estimations, the four-quarter rolling central government fiscal deficit was slightly below 4% of GDP in 2Q12 (see Figure 1). We expect this deficit to have widened further in 3Q12.

Figure 1. Dominican Republic: The fiscal deficit widened in 2Q12



Source: BCRD, Hacienda and Citi Research

Figure 2. Dominican Republic: Tax revenues have not recovered

Source: BCRD, Hacienda and Citi Research

In our view, the proposal to raise taxes looks more solid than the plan to cut expenditures. According to Economy and Planning Minister Temístocles Montás,[1] the government would freeze wages and reduce purchases. These actions, plus other measures, would save the government the aforementioned 1.9% of GDP. We are skeptical that said amount could be saved by the combination of those actions, but we acknowledge that some savings would be achieved. The plan to increase tax collection is more explicit and could turn around the decrease in revenues witnessed during and after the global crisis (see Figure 2).

The tax reform is more specific and is aiming to push tax collection to about 15% of GDP. The proposal calls for an increase in the goods and services transfers tax (ITBIS, to 18% from 16%) and in alcoholic beverage taxes (to 15% from 7.5%). It also looks for new taxes on *Zonas Francas* (10% on dividends and 2.5-5% on

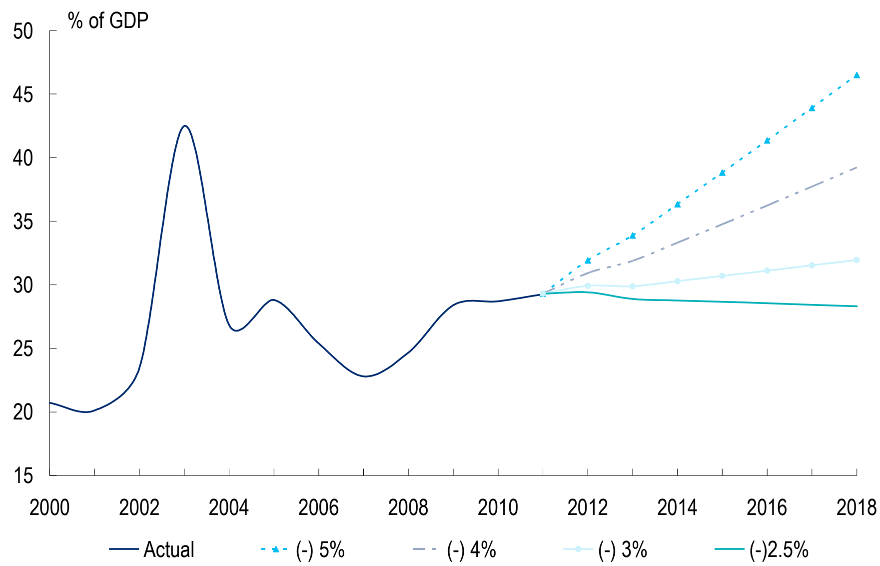
[1] Quoted by Hoy Digital on October 4, 2012.

local sales), high-end housing (1%), interest revenues (10%), telecommunications & cable TV (10%), new automobiles (17%) and yearly car registration (1%). There are several other tax measures, but it would to be too unexciting to go through every single change in the tax reform.

Shaving a few points off

The local Congress should not be a roadblock to approval of the reform, but we have yet to see what the reform looks like upon arrival in Congress. The ruling party (PLD or *Partido de la Liberación Dominicana*) dominates both the Lower House and the Senate. In that vein, we are not expecting major changes once the final proposal arrives to Congress. However, we would expect the bill that the government ends up sending to Congress to be less ambitious than the original proposal. Before going to Congress, the proposal was sent to the *Consejo Económico, Social e Institucional* (Economic, Social and Institutional Council or CES), which will then give its opinions. The CES is formed by businessmen, unions, academic and professional organizations. We would expect the CES to push for a softening on some measures associated with higher taxes. We would expect the government to be receptive to the council's comments and relinquish some of the reform's points. However, we are not expecting the government to end up submitting a severely watered down reform to Congress.

Figure 3. Dominican Republic: Debt dynamics under different fiscal deficit scenarios



Source: IMF, BCRD, Hacienda and Citi Research

Even if the potential turnaround of 4% of GDP were to be shaved off, we believe the government should try to get back to a deficit of at least 2.5-3% of GDP. At this point it is too early to say in which areas the government would be willing to accept some kind of modification. In addition, we are skeptical about the government's potential success when it comes to reducing expenditures by 1.9% of GDP. However, that does not mean that the government would totally fail in putting fiscal accounts on track. According to our estimates, the primary fiscal surplus that stabilizes debt is between 0.5-1% of GDP (see Figure 3), which is equivalent to a central government deficit of 2.5-3% of GDP.

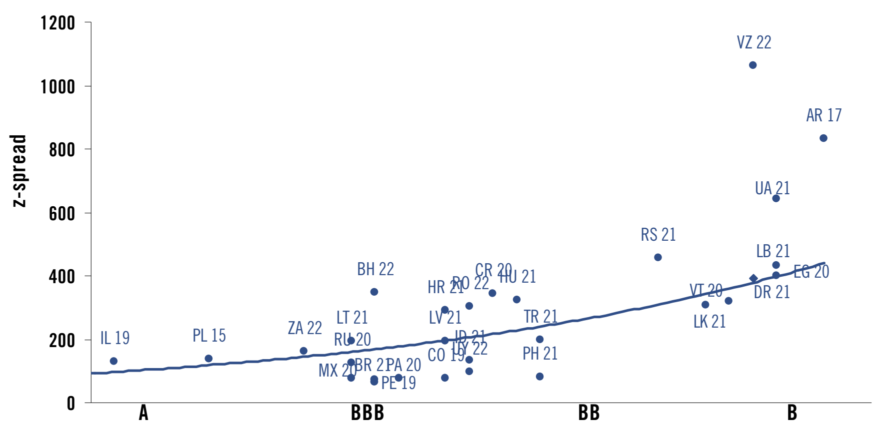
Fiscal reform would be welcomed by the IMF

We expect the fiscal reform to increase the possibility of eventually reaching a deal with the IMF. The road to a Stand-by Agreement (SBA) looks longer than we originally expected before the presidential election. The Article IV Consultation and the Post-Program Monitoring would need to be settled before an SBA can be discussed and approved. It is reasonable to think the fiscal proposal was discussed with the International Monetary Fund (IMF) when its mission visited the country last September. In our view, the Medina administration has the goal of seeking a program with the IMF, and therefore we would expect the fiscal plan to help reach such a deal. However, we must note that, the fiscal reform would not be the only input for the IMF agreement. All the problems associated with the electricity sector will still be there when the IMF visits the country again — probably next month.

This time around, the value of an IMF program is more closely associated with the fiscal outlook than with the balance of payments. Under the previous SBA, the IMF disbursements provided comfort not only to fiscal accounts, but also to the balance of payments. In our view, mining projects (ferronickel and gold) will continue reining in the current account deficit (particularly next year), thereby bringing relief to external financing needs. Moreover, now that worries about potential changes in Petrocaribe are off the table (see Dominican Republic Macro Flash - Concerns about Petrocaribe are behind us, October 8, 2012), we would expect the negotiations with the IMF to be less centered on balance of payments topics. We also think that, under IMF surveillance, the likelihood of accomplishing expenditures cuts is higher.

The passage of the fiscal reform could produce a near-term outperformance in Dominican Republic bonds. Investors continue to monitor developments regarding an IMF program, and this should put them an important step closer. While overall spread compression will depend on a continuation of the recently benign global risk environment, we think DomRep is likely to outperform in the near term. We caution however that this scope for outperformance is somewhat limited giving the fact that DomRep spreads are already fairly valued to similarly rated sovereigns, albeit with less idiosyncratic near-term risk than most of those credits.

Figure 4. DomRep spreads are fairly valued to similarly rated sovereigns, but we think there is some room for outperformance



Source: Citi Research, S&P, Moody's, Fitch

Appendix A-1

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