08 May 2020 | Affirmation

# Fitch Revises Dominican Republic's Outlook to Negative; Affirms at 'BB-'

Fitch Ratings-New York-08 May 2020:

Fitch Ratings has affirmed the Dominican Republic's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB-' and revised the Outlook to Negative from Stable.

## Key Rating Drivers

The Coronavirus pandemic led to a sharp fall in economic activity and exerted balance of payments pressures on the Dominican Republic given its reliance on tourism and remittances. The fiscal and monetary response will exacerbate pre-existing public-finance and monetary-policy weaknesses and lead to a deterioration of the government balance sheet. Prospects for renewed fiscal consolidation and policy reforms are uncertain given the potential outcome of the 2020 congressional and presidential elections. Downside risks to the economy and our forecasts are considerable given the uncertainty about the pandemic.

The main sources of current account external receipts (CXR) will decline in 2020, leading the current account deficit to widen to USD3.7 billion (4.6% of GDP) in 2020 (from 1.3% of GDP in 2019), broadly in line with the projected current 2020 'BB' median (4.7% of GDP). We expect large declines in tourism receipts (negative 50% change yoy) and remittances (negative 20% yoy), which represented 8.3% and 7.9% of GDP, respectively, and collectively 48% of CXR in 2019. However, lower demand together with lower oil prices will also lead to a steep fall in goods imports (negative 17% yoy) in 2020, which mitigates the deterioration in the current account.

As a result of the sharp fall in key FX-producing sectors and the lockdown measures, we expect the Dominican economy to contract by 3.5% in 2020, down sharply from the high 6.1% yoy average in the preceding five years. We expect a 5.6% rebound in 2021. The forecast assumes the economy progressively emerges from lockdown during May and June and hotels open by August. To support the economy, the Central Bank of the Dominican Republic (BCRD) provided monetary stimulus of up 3.4% of GDP, and the government announced 0.7% of GDP in government transfers to vulnerable households and wage-support payments to business in March. The government also further promised in April an economic reactivation package to kick start business, but no specific measures or financing plans have been announced yet. In our projections, Fitch assumes fiscal stimulus measures worth 1% of GDP.

Official sources will help the Dominican Republic meet higher external financing needs, but may still leave a financing gap that would be bridged from reserves. BCRD received a USD650 million Rapid Financing Instrument disbursement from the IMF in late April, available for either monetary or budgetary purposes. BCRD is in talks with two additional official institutions for external liquidity facilities of approximately USD450 million and USD1 billion-USD3 billion, respectively to address balance of payments pressures from the weaker current account, lower foreign investment inflows, and increased peso liquidity resulting from the monetary and fiscal stimuli.

International reserves fell by 16% (USD1.7 billion) to USD8.7 billion at the end of April 2020 since the government's USD2.5 billion issuance in January, as BCRD made net FX sales. Monthly outflows averaged USD589 million during February-April 2020 versus positive average inflows of USD76 million during the same period in 2019. International reserves/M2 was 0.4x at the end of April, consistent with December 2019 and starting stronger than previous stress periods in 2013, 2009-2010, and 2003. The trajectory of reserves will depend on the level and timing of external financing inflows and potentially private capital outflows.

The Dominican peso (DOP) depreciated relative to the U.S. dollar (USD), 8.0% yoy in April 2020, at the fastest rate since mid-2013, following the U.S. Taper Tantrum. A faster pace of central bank FX sales could pressure the managed exchange rate if external pressures intensify. The prominence of the DOP-USD exchange rate in public inflation expectations, the large share of FX-denominated government debt amid a partially dollarized economy (one-quarter of deposits are foreign currency [FC]-denominated) and the central bank's large negative equity position (market securities liabilities totaled 13.7% of GDP in April) constrain the effectiveness of monetary policy. Increased peso liquidity from the monetary stimulus absent external liquidity disbursements to (partially) sterilize could generate further depreciation pressure on the peso and trigger resident capital draining international reserves.

Fitch estimates USD3.8 billion private and public external debt service in 2020, USD2.5 billion of which is nonfinancial public-sector (NFPS) that the government pre-financed in January. Additionally, nonresidents hold USD1.3 billion of local securities, mainly Treasury notes, which we assume remain stable.

Gradual improvement in some of the Dominican Republic's external finance factors supports the baseline expectation in our rating affirmation that the Dominican Republic could weather the coronavirus shocks at the current rating level despite the downside risks. The country's current external receipts materially diversified over the past decade and are less concentrated than many tourism-dependent peers. The Dominican Republic's international liquidity ratio was adequate at

178% for 2019. External debt service/CXR of 12.3% was at the current 'BB' median in 2019 and the external NFPS debt-amortization profile is smooth, supported by active debt management. We expect external debt service/CXR to rise toward roughly 16.5% of CXR in 2020. The Dominican Republic's net external debt was high at 119% of CXR in 2019, prior to the pandemic, although it is in line with the current 'BB' median.

The Dominican banking system entered the coronavirus shock with supportive capitalization (11.6% tangible common equity to tangible assets, according to Fitch's financial institution analysis); firm profitability (15.9% return on average equity); low impaired loans (1.6% of gross loans), which were fully provisioned (176% coverage); and adequate liquidity as of December 2019. A larger stock of FC deposits than FC credits, and strengthened regulation and capital requirements since the 2003 banking crisis reduce its currency mismatch risks. In response to the coronavirus, BCRD cut its policy rate by 100bps to 3.5%, provided regulatory flexibility to the banks and provided financial institutions facilities for business support. Fitch continues to monitor the health of the financial system in view of the downside risks to the economy and asset quality.

Fitch expects the general government (NFPS) deficit to rise to 7.1% of GDP in 2020 due to the drop in tax revenues and newly announced spending measures to combat the coronavirus pandemic and support economic recovery. The government budgeted a central government deficit of 2.5% of GDP for 2020. In addition to this, we project a 2% of GDP tax revenue decline -- domestic tax revenues fell 12.7% yoy in March 2020, exacerbating the constraint of low overall government revenues; they were 14.4% of GDP in 2019. On the spending side, there are government transfers during April and May totaling 0.7% of GDP, then business reactivation measures Fitch estimates at 1% of GDP, and the other small NFPS deficit that we consolidate. We forecast the general government deficit will decline to 3.1% of GDP in 2021 as tax revenues gradually normalize and coronavirus-related spending fades in 2H20. However, the rising interest bill will stymie further automatic reduction. We estimate the interest/revenue ratio at 22.5% in 2020, more than double the projected current 'BB' median of 9.0% .

General government (NFPS) debt/GDP is forecast to rise to 53.3% of GDP in 2020 -- slightly below the current 'BB' median of 58.4%, which is also rising -- up from 41.7% in 2019. The jump reflects the higher borrowing requirement (7.8% of GDP excluding amortizations) and assuming the pace of peso depreciation is sustained (12% forecast yoy, causing 3.7% of GDP debt increase). Government arrears payments (1.0% of GDP as budgeted) and recurrent electricity utility losses will further pressure debt dynamics. General government debt/GDP rose 3.6 percentage points (pp) in 2019, 1.3pp more than the general government deficit of 2.3% of GDP, as a result of supplier arrears payments, the government's absorption of USD250 million of FC-denominated public electricity utility debt in December 2019 and peso depreciation.

Contingent liabilities from BCRD's large, rising market debt (12.8% of GDP at December 2019) remain structural concerns as quasi-fiscal losses increase future recapitalization needs. Consolidated public-sector debt of the NFPS and BCRD was 52.1% of GDP in 2019, according to MHCP and BCRD published data. This figure encompasses fewer institutions than our July 2019 estimate, which was partially based on unpublished data. The debt ratio is sensitive to currency movements, as two-thirds of government debt is denominated in U.S. dollars and other foreign currencies.

Fitch estimates an external financing gap of USD2.03 billion for 2020 (2.6% of GDP) that we expect will largely rely on multilateral financing. Absent the coronavirus shock, the USD2.5 billion January issuance would have covered the external market needs this year, including the government's external market debt service. The first, USD635 million round of fiscal stimulus was financed by USD261 million from the domestic labor risk fund, USD150 million from the World Bank and a USD224 million short-term facility from BCRD, permitted by its charter, that will have to be refinanced by YE.

To finance the reactivation program and revenue shortfall, the government sought multilateral and bilateral credits. The government has a USD90 million credit pending for disbursement. In addition to potential access to bilateral credit, the Dominican Republic has a sizable borrowing envelope available from multilaterals, which we expect would be sufficient to cover forecast external financing needs. Timing the mobilization of these resources is sensitive to the institutions' negotiation and approval processes amid a likely elevated volume of borrower requests. If a financing gap persists, Fitch expects the government would go to the capital market, likely after the presidential and congressional elections on July 5 (a second round, if necessary, would occur on July 26). The sovereign retains market access, although yields on the Dominican Republic's external USD bonds have risen substantially since January.

Polls in February and April indicate that Luis Abinader, candidate of the Modern Revolutionary Party (PRM) and allied parties who has a firm lead over the official Dominican Liberation Party (PLD) nominee Gonzalo Castillo, is likely to win July's presidential elections in the first round (Economic Center of Cibao, April: Abinader 53.4% v Castillo 23.7%; Greenberg/Diario Libre, February: Abinader 52% v Castillo 24%). This is expectation was reinforced by the PRM's strong results in the March municipal elections. Current President Danilo Medina (2012-2020, PLD) did not seek a constitutional amendment to enable a third consecutive term in July 2019. Former President Fernandez alleged fraud in the PLD primary in October 2019, which split the party, and municipal polls were postponed to March from February due to electronic voting problems, pointing to potential governability risks surrounding July's vote, which was delayed from May as a social distancing measure. Fitch expects macro policy continuity. However, in Fitch's view, prospects for three key stalled reforms -- public finances, central bank recapitalization (although the executive submitted a proposal to congress), and electricity utility losses -- are uncertain depending on the extent to which the next president will need to balance interest groups in the likely more diversified congress.

ESG - Governance: Dominican Republic has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights, and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. The Dominican Republic has a medium WBGI ranking at the 42nd percentile, reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

## Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns the Dominican Republic a score equivalent to a rating of 'BB' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

--Public finances: -1 notch, to reflect weaknesses in the fiscal structure owing to low revenues and rigidity of large current expenditures; and material contingent liabilities from ongoing financial losses of public utilities and the large market debt of the central bank.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--External financing constraints, such as limited external multilateral disbursements or loss of capital market access, or private capital outflows that contribute to international reserve drain;

--Weaker medium-term growth prospects; for example, a prolonged slump in tourism, remittance or manufactured export receipts that undermines CXR growth or weak business recovery that hampers economic performance in 2021-2022;

--Deterioration of the government debt dynamics; for example, as a result of increased post-crisis budget deficits, weaker growth or crystallization of contingent liabilities.

Factors that could, individually or collectively, lead positive rating action/upgrade:

--Reduction of external liquidity pressures; for example, through timely external financing actions and abatement of coronavirus-related pressures on tourism, remittance and manufactured export receipts;

--Policy reforms that strengthen public and external finances; for example, government and electricity system reforms that reduce total and external borrowing needs and lead to stabilization or reduction of the government debt burden;

--Entrenchment of the central bank's inflation-targeting regime resulting in greater monetary policy credibility and effectiveness.

## Best/Worst Case Rating Scenario

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

## Key Assumptions

Fitch expects global economic trends and commodity prices to develop as outlined in Global Economic Outlook: Crisis Update Late April 2020 - Coronavirus Recession Unparalleled published April 22, 2020.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The Dominican Republic has an ESG Relevance Score of '5' for Political Stability and Rights, as World Bank Governance Indicators have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight.

The Dominican Republic has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption, as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

The Dominican Republic has an ESG Relevance Score of '4' for Human Rights and Political Freedoms, as strong social stability, and voice and accountability are reflected in the World Bank Governance Indicators that have the highest weight in the SRM. They are relevant to the rating and a rating driver.

The Dominican Republic has an ESG Relevance Score of '4' for Creditor Rights, as willingness to service and repay debt is relevant to the rating and is a rating driver for the U.S., as for all sovereigns.

The Dominican Republic has an ESG Relevance Score of '4' for Energy Management, as the inefficiency of the fossil-fuel-intensive national electricity system is a rating driver affecting Dominican Republic's public financial performance.

The Dominican Republic has an ESG Relevance Score of '4' for Human Development, Health and Education, as managing the impact of the coronavirus crisis is having an adverse impact on public finances, which is relevant to the rating and a rating driver.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Dominican Republic; Long Term Issuer Default Rating; Affirmed; BB-; RO:Neg
----; Short Term Issuer Default Rating; Affirmed; B

----; Local Currency Long Term Issuer Default Rating; Affirmed; BB-; RO:Neg

----; Local Currency Short Term Issuer Default Rating; Affirmed; B

----; Country Ceiling; Affirmed; BB-

----senior unsecured; Long Term Rating; Affirmed; BB-

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**Applicable Criteria**

Country Ceilings Criteria (pub. 05 Jul 2019)

Sovereign Rating Criteria (pub. 27 Apr 2020) (including rating assumption sensitivity)

**Applicable Model**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)
Sovereign Rating Model, v3.12.0 (1)

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