República Dominicana

Ministerio de Hacienda

Path to Investment Grade

A Strategy for the Dominican Republic to Reach Investment Grade

Santo Domingo, República Dominicana

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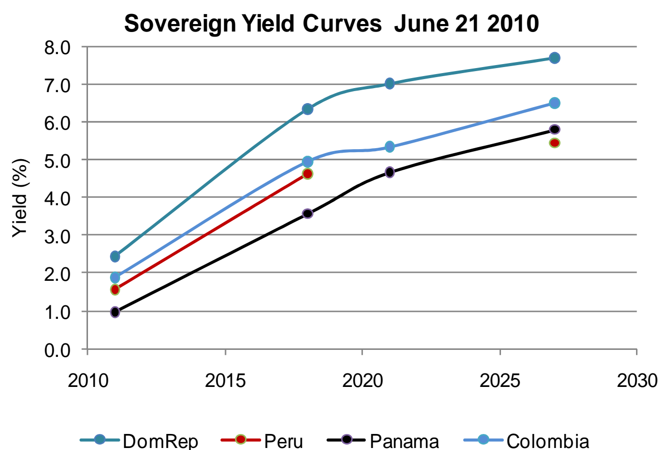
The purpose of this paper is to assist the Dominican Republic develop a strategy to improve its sovereign debt rating, with the goal of reaching an investment grade credit rating in the medium term. Section I describes the advantages of reaching investment grade which include a range of benefits from reduced interest costs for the sovereign and private sector to providing an indicator of the investment climate to international investors. Section II provides background on methodology used by rating agencies to evaluate a sovereign's creditworthiness by taking into consideration both quantitative and qualitative factors. Section III examines the key drivers for Dominican Republic's current rating and provides insight into the areas where the Dominican Republic should focus its strategy. This section also compares the Dominican Republic's indicators against 'B' rated and other higher rated peer countries. Section IV makes recommendations a two pronged strategy where the DR should focus its efforts with the objective of improving the country's rating over the short term (12-18 months) and medium term (10 years).

I. Benefits of Reaching Investment Grade

In March 2010, Fitch announced an upgrade of Panama to 'BBB-' placing the country in the ranks with four other Latin American countries that hold an investment grade qualification: Brazil, Mexico, Chile, and Peru. Over the past 15 years, Panama has worked to reach an investment grade qualification through the pursuit of a strategy that encompassed important economic reforms along with a commitment to fiscal discipline supported by a proactive public debt management program. The government of Panama played an important leadership role in this effort by establishing a high level commission led by the Ministry of Finance and made up of both the public and private sectors.



A recent Working Paper[1] published by the IMF provides insight into why sovereigns actively pursue investment grade ratings and identify some of the important benefits as follows:

*"**First**, they are a key determinant of a country's borrowing costs in international capital markets. **Second,** the sovereign rating generally sets a ceiling for the ratings assigned to domestic banks and companies, and therefore affects private financing costs. And **third**, higher ratings expand the universe of investors since some institutional investors have lower bounds for the risk they can assume in*

[1] Jaramillo, Laura. Determinants of Investment Grade Status in Emerging Markets, IMF Working paper WP/10/117. P. 3

their investments and will choose their portfolio composition taking into account the credit risk signaled by the rating notations."

As stated above, because the sovereign rating can affect private financing costs, a nation attaining investment grade for its bonds can lower borrowing costs for domestic banks and other corporates that borrow in international capital markets. An investment grade rating also sends a message to foreign investors that the investment climate provides more stability and the country level of economic and social development is more advanced.

A higher sovereign rating can translate into significant interest cost savings to sovereign issuers. For example, the graph above shows the yields on Dominican bonds versus bonds for higher rated countries such as Peru (BBB-), Panama (BBB-) and Colombia (BB+). For example, Peru's Global Bond with a maturity in 2027 trades at a yield of 5.44%, while the Dominican Republic's Global Bond maturing in 2027 is trading at yields of 7.87%, a difference of 243 basis points.[2] This difference is equivalent to $24 million annual interest cost assuming a $1 billion bullet bond issue.

II. Background on Sovereign Ratings

Sovereign debt ratings express opinions of rating agencies regarding the credit risk faced by an investor who holds the debt securities of a given government. Currently there are three internationally recognized rating agencies; Fitch, Moody's and Standard & Poor's. For the most part, ratings among agencies do not significantly diverge from one another although there may be differences in perspective and methodology (see box). Investment grade ratings fall into the range of AAA to BBB- while credit ratings below BBB- are considered speculative and present a much higher level of risk of default than sovereigns with investment grade ratings.

Sovereign Credit Ratings by Agency

Fitch	Moody's	S & P	
			Investment Grade
AAA	**Aaa**	**AAA**	Exceptional economic, financial and institutional strenghts resulting in unquestioned access to finance. No shock can conceivably disrupt payment capacity
AA	**Aa**	**AA**	Very high economic, institutional or government financial strength and no material medium-term repayment concern
A	**A**	**A**	High economic, financial or institutional strength and no material medium-term repayment concern.
BBB	**Baa**	**BBB**	A government would have the capacity to sustain a coherent economic policy framework and avoid any near-term debt repayment problems if confronted with a severe shock to public finances.
			Speculative Grade
BB	**Ba**	**BB**	No clear and present repayment concern and tangible adjustment capacity in a context of potentially severe economic, financial or political shocks.
B	**B**	**B**	One shock away from default, and/or material concerns about willingness to pay
CCC	**Caa**	**CCC**	Currently vulnerable and dependent on favorable economic conditions to meet its commitments
CC	**Ca**	**CC**	Highly vulnerable, very speculative bonds
C	**C**	**C**	Highly vulnerable, perhaps in bankruptcy or in arrears but still continuing to pay out on obligations

Rating agencies evaluate a sovereign's creditworthiness by combining both quantitative and qualitative factors. Each rating agency publishes a report explaining the rational for the rating

[2] Bloomberg, June 21, 2010

assigned and identifies issues or circumstances that enhance or constrain credit strength. Agencies generally compare data against similarly rated peer countries and against medians for that particular category. While rating agencies are making efforts to make their analysis more quantitative, agencies believe that no quantitative model is able to fully capture the variety of situations and interference of political factors that characterize sovereign risk[3]. Unlike private borrowers, sovereign governments are unique in that they can make a deliberate choice to not repay their debt even when they have sufficient resources to pay, thus there is no quantitative-based approach that will satisfactory replace an analyst's judgment.

Moody's Sovereign Bond Ratings Methodology[4] report describes the approach taken by this agency to determine a sovereign rating.

Step 1: Country economic resiliency
The first step consists in determining the shock-absorption capacity of the country, based on the combination of two key factors:

> **Factor 1:** the country's economic strength, captured in particular by the GDP per capita – the single best indicator of economic robustness and, in turn, shock-absorption capacity.
>
> **Factor 2:** the institutional strength of the country, the key question being whether or not the quality of a country's institutional framework and governance – such as the respect of property right, transparency, the efficiency and predictability of government action, the degree of consensus on the key goals of political action – is conducive to the respect of contracts.

Combining these two indicators helps determine the degree of resiliency, and position the country in the rating scale: very high, high, moderate, low or very low. Rating agencies have found that the indicators GDP per capita and the World Governance Bank indicators (government effectiveness, control of corruption, political stability and rule of law) have a strong direct correlation to the country's economic and institutional strength.

Ratings of Latin American Countries

Country	Rating
Chile	A
Mexico	BBB
Aruba	BBB
Brazil	BBB-
Panama	BBB-
Peru	BBB-
Colombia	BB+
Guatemala	BB+
Costa Rica	BB
El Salvador	BB
Uruguay	BB-
Venezuela	B+
Dominican Republic	B
Bolivia	B
Argentina	B-
Jamaica	B-
Ecuador	CCC

Source: Fitch Ratings

Step 2: Government financial robustness
The second step focuses directly on debt matters, and especially the combination of two other factors:

[3] Moody's Sovereign Bond Ratings Methodology, September 2008.
[4] Ibid.

Factor 3: the financial strength of the government. The question is to determine what must be repaid (and how "tolerable" the debt compared to its resources) and the ability of the government to mobilize resources: raise taxes, cut spending, sell assets, and obtain foreign currency.

Factor 4: the susceptibility to event risk – that is the risk of a direct and immediate threat to debt repayment, and, for countries higher in the rating scale, the risk of a sudden multi-notch downgrade. The issue is to determine whether the debt situation may be (further) endangered by the occurrence of adverse economic, financial or political events.

Combining these two indicators helps determine degrees of financial robustness and refine the positioning of the country on the rating scale.

Step 3: Determining the rating

The third stage consists in adjusting the degree of economic resiliency to the degree of financial robustness of the government. This results in the identification of a rating range. The determination of the exact rating is done on the basis of a peer comparison, and weighting additional factors that may not have been adequately captured earlier.

Investment Grade – distinguishing characteristics

As noted in the previous section a country reaching a rating of BBB-/Baa3 or better would have the capacity to sustain a coherent economic policy framework and avoid any near-term debt repayment problems if confronted with a severe shock to public finances. It is also useful to review the conclusion of an IMF study[5] which found three important factors in determining whether a country reaches investment grade and comes to the following conclusions:

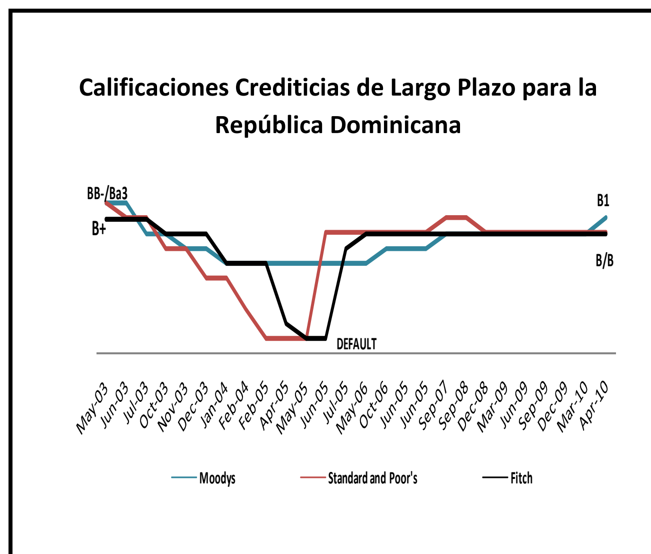
The level of debt matters for determining investment grade. However, the findings suggest that rating agencies do distinguish between types of debt. They tend to see risk in high public debt indicators, but do not seem to assign a significant weight to private external debt. Furthermore, rating agencies seem to attach greater risk to external public debt than to domestic public debt, with the coefficients of the former being more than 2½ times larger than the latter.

The political risk index was found to be significant and positively related to the investment grade rating. The political risk index serves as a proxy of a country's willingness to repay.

Exports to GDP and broad money to GDP were also found to be significant. The positive effect of exports on investment grade captures a country's capacity to obtain hard currency to repay foreign debt. Also the country's financial depth and a country's capacity to sustain a given domestic debt burden are significant factors.

[5] Jaramillo, Laura. Determinants of Investment Grade Status in Emerging Markets, IMF Working paper WP/10/117.

III. Dominican Republic's Sovereign Ratings



The world economic crisis and the downturn of the US economy has negatively affected many countries in Latin America making prospects for improved ratings over the short term more unlikely. However, in the case of the DR, the economy has shown to be more resilient with respect to those of its peers demonstrated by a recent upgrade to B1 from Moody's and an improvement in perspective from neutral to positive from S&P[6]. The foreign currency debt ratings assigned to Dominican Republic by the three agencies are similar but not identical. Fitch Ratings assigns a foreign currency debt rating of B, in the middle of its B-level range, with a stable outlook. Standard & Poor's also assigns the debt a rating of B, and in May 2010 upgraded the outlook from stable to positive. In April 2010, Moody's raised the Dominican Republic's debt rating from B2 to B1, the highest of its three B-level ratings. It also assigned a stable outlook to the rating, indicating that current trends are not likely to result in a rating change in the next 12-24 months.

As demonstrated in the chart, despite several years of strong economic growth and the fact that the DR has shown greater resiliency to external economic shocks it still has not fully recovered its 2003 pre-crisis rating of 'BB-/Ba3/B+'. The current rating suggests that rating agencies are reluctant to bring the rating to the pre-default levels of 2003 until the country demonstrates a track record of several years of unblemished payment history.

As discussed later in this paper, the Dominican Republic prospects for further upgrades in the future are encouraging assuming it takes specific short and medium term actions. Rating agency comments about the strengths and weaknesses they associate with the Dominican Republic's government debt offer useful insight regarding steps the government may take to improve its rating.

A review of their recently published reports and conversations with their analysts provide insight into the areas where the DR should focus:

1. Economic Strength
2. Institutional Strength
3. Government Financial Strength
4. Susceptibility to Event Risk

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[6] A revised rating report for from Fitch was not available at the time of this report.

Economic Strength - All three agencies recognize the economy and macroeconomic stability as a positive factor. In comparison to its 'B'-range peers, the Dominican republic has high GDP per capita – comparable to the median for 'BB-' (or 'Ba-') rated borrowers. The agencies characterize the economy as "dynamic" and "resilient," and consider its growth prospects for 2010 as "solid." Analysts did express concern regarding the manner in which economic growth figures are calculated. For example, the telecommunication sector makes up 17% of GDP but represent 68% of the growth.

The new Barrick gold project has potential to have a strong impact on the balance of payments position and increase economic growth in the future. Moody's has noted that "in addition to high GDP growth, a distinctive feature of the Dominican Republic's economic performance has been relative macroeconomic stability in terms of both inflation and the exchange rate." The major peso devaluation of 2003 and the high inflation of 2003-04 are seen as transitory and not likely to be repeated.

When evaluating GDP per capita, the Dominican Republic compares well to higher rated countries such as Peru and Colombia. However, analysts note that the Dominican Republic's economy still needs to become more diversified in order to stabilize growth and reduce volatility. Panama's recent upgrade to investment grade (BBB-) reflects the breadth of its economy which is based on businesses connected with the canal operations and the country's future capacity to generate sustainable fiscal revenues. The Dominican Republic's gross domestic investment to GDP, an important driver for economic growth, is low compared to all peers while foreign direct investment as a percentage of GDP is higher.

Table 1: Economic Indicators 2009

Indicator	Dom.Rep. (B/B+)	B median	BB median	BBB median	El Salvador BB (neg.)	Colombia BB+	Peru BBB-	Panamá BBB-
GDP per capita	4,671	3,913	3,427	8,099	3,427	5,118	4,342	7,041
Foreign Direct Investment % GDP	4.6	4.6	2.7	2.2	2.7	1.8	3.4	7.3
Gross dom. Investment/GDP	14.8	22.1	25.4	23.0	12.9	22.9	20.6	26.9

Source: Moody's and S&P

The World Bank "Doing Business" report ranks the Dominican Republic at 86th against 183 economies. The Dominican Republic ranks well compared to the 'B' and 'BB' median countries and higher rated countries such as Panama. In 2010 the DR's overall ranking showed an impressive increase from 102 in 2009 to 86, primarily due to the passage of the *Ley de Sociedades (479-08)* which substantially improved the country's laws in relation to the protection of investor rights. Also the Dominican Republic gained 3 positions in the category of paying taxes. However, for all other categories (8) the DR position deteriorated (6) or had no change (2). The DR's position worsened notably for the category of Starting a Business and

slightly for five other categories including Dealing with Construction Permits, Employing Workers, Registering Property, Getting Credit, and Enforcing Contracts. The Economic Forum Global Competitiveness report ranked the Dominican Republic 95 out of 133 countries evaluated and below the peer group in the chart below.

Table 2: Doing Business and Competitiveness Rankings 2010

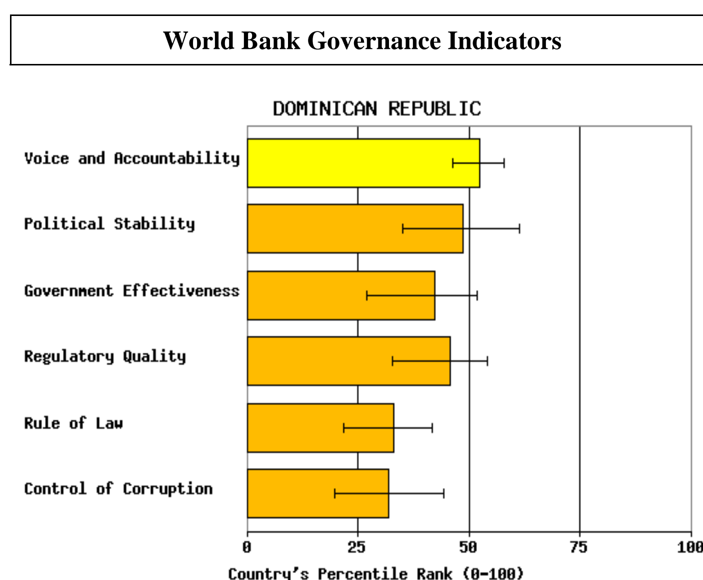
Indicator	Dom.Rep. (B/B+)	B median	BB median	BBB median	El Salvador BB (neg.)	Colombia BB+	Peru BBB-	Panamá BBB-
World Bank Doing Business Report 2010[7]	86	108	100	55	84	37	56	77
World Economic Forum Global Competitiveness[8]	95 out of 133	NA	NA	NA	77	69	78	59

Source : S&P

Institutional Strength

In their reports, rating agencies took into consideration the quality of the institution responsible for policy making and noted improvements in several areas. However, they expressed concerns about the institutionalization of reforms and future progress in certain key areas such as fiscal policy and the electric sector. Among the institutions recognized, the Central Bank's monetary policy has a good track record of providing a stable macroeconomic framework while the Superintendent of Banking stands out for making significant reforms to its regulatory and institutional capacity. In addition, the creation of a Public Credit Office was noted as by Moody's 2010 report stating "so far, the country has achieved the most progress in its

World Bank Governance Indicators



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2009: Governance Matters VIII: Governance Indicators for 1996-2008
Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

[7] Economies are ranked on their ease of doing business, from 1 – 183, with first place being the best. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business. This index averages the country's percentile rankings on 10 topics, made up of a variety of indicators, giving equal weight to each topic. The rankings are from the Doing Business 2010 report, covering the period June 2008 through May 2009. Source: http://www.doingbusiness.org/

[8] The Global Competitiveness Report 2009-2010, World Economic Forum, 2009 http://www.weforum.org/pdf/GCR09/GCR20092010fullrankings.pdf

domestic debt management."

Institutions are built over time and their negative aspects can be institutionalized and entrenched placing a burden on government's financial situation. This is case for the electric sector which now presents a challenge to reformers and threatens the fiscal sustainability of the country.

All three rating agencies have commented on the issue of volatility in fiscal performance and the influence of politics. Moody's has written that what it characterizes as a weak institutional framework "is mostly related to recurring instances where fiscal policy has been unduly influenced by political (electoral) considerations. . . . Repeatedly, and by design, expansionary fiscal policies have been the norm during pre-electoral periods, indicating a not-so-robust policy framework." Also, Standard & Poor's wrote that "execution risks related to weak institutions and the politicization of decision-making remain".

In the May 2010 credit analysis explaining the Dominican Republic's rating upgrade to B1 (from B2), Moody's noted, "Weak institutional strength continues to constrain the ratings even though progress has been made. Moody's comments on the presence of weak institutions are reflected in World Bank governance indicators, which place the DR "in the lower half of the spectrum . . . in terms of both government effectiveness and rule of law . . ."

Table 3: World Bank Governance Indicators[9]

Indicator	Dom.Rep. (B/B+)	B median	BB median	BBB median	El Salvador BB (neg.)	Colombia BB+	Peru BBB-	Panamá BBB-
WB Governance Indicators - Government effectiveness	42	31	53	61	49	60	46	61
- Control of corruption	31	32	48	57	51	50	49	54
- Political stability	48	35	29	56	48	8	19	49
- Rule of Law	33	31	43	54	30	37	25	50

Table 3 provides World Bank governance indicators for the Dominican Republic, median 'B', 'BB', and 'BBB' countries and other higher rated Latin American countries. The Dominican Republic ranks similar to its 'B' median peers in the areas of government effectiveness, control of corruption and rule of law while in the area of political stability it ranks at the same level as 'BBB' median countries and better than Peru and Colombia.

[9] Governance Matters – Worldwide Governance Indicators 1996-2008. http://info.worldbank.org/governance/wgi/index.asp

Government Financial Strength

All agencies mentioned that the IMF standby agreement serves as an anchor to guide fiscal decisions and for the need for a fiscal arrangement that would remove the political influence over fiscal decision making. In a May 2010 update announcing a change in the rating outlook to Positive (from Stable), Standard & Poor's wrote that "deviations from the fiscal and structural benchmarks established with the IMF [standby agreement] would undermine policy credibility and damage the country's creditworthiness. On the other hand, the gradual improvement in fiscal position – along with progress on the structural reform agenda – could lead us to consider an upgrade. Specifically, improvements in the electricity sector will be an important indicator. ." The fiscal inflexibility attributable to low government revenues relative to GDP and fiscal to expenditure rigidities, particularly related to electricity sector subsidies are factors that adversely affect the government's financial strength. Therefore, the government faces the challenge of funding important spending demands to finance infrastructure and social programs within a context of reduced fiscal revenues.

As illustrated in the chart below, the indicator *fiscal revenues as a percent of GDP* for the Dominican Republic falls below the 'B' median indicator and lower than all higher rated peers such as El Salvador, Colombia, Peru and Panama.

Table 4: General Government Revenue as a Percent of GDP 2009

Indicator	Dom.Rep. (B/B+)	B median	BB median	BBB median	El Salvador BB	Colombia BB+	Peru BBB-	Panamá BBB-
General Government Revenue % GDP	13.9	26.6	28.4	35	16.7	24.3	18.7	24.2

Source: S&P

When analyzing a country's debt burden, agencies evaluate the debt level but also the trends and composition of the debt. In the June 2010 rating report, S&P notes that "the debt structure and debt management are improving, both factors critical to stronger creditworthiness in the 'B' category." S&P goes on to say that "the deepening of the domestic government debt market is a positive credit factor, and in many ways, it can be attributed to a notable strengthening in the debt-management office (Credito Publico) and improved transparency". Moody's also confirms this opinion in its May 2010 report stating that "the creation of a domestic market for government bonds, while still in an early stage, is considered to be a material credit event. In time, the market should provide increased access to longer-term local-currency financing reducing credit vulnerabilities derived from the government's exposure to foreign currency debt".

As demonstrated in the chart below, there are several indictors which help to measure a country's debt burden. Dominican Republic's government debt burden, measured as *debt as a percentage of GDP* (35%), is positive and well below its higher rated peers with the exception of Peru (28%). Nevertheless, it is less positive when analyzing net general government debt. In regard to the debt service, S&P noted that "currently, debt service to fiscal revenues demonstrates the

ability of the DR to service the debt. However, an increasing debt burden would be a negative trend since it would reduce fiscal flexibility".

Interest cost to fiscal revenues and the *general government debt to government revenues* are two indicators which measure the burden of debt on government revenues. Both of these indicators show that debt is a greater burden on fiscal revenues for the Dominican Republic than similarly rated and higher rated peers, with the exception of El Salvador. The indicators below also show that despite a relatively high debt to GDP (67%), Panama's strong fiscal revenues provided sufficient comfort for the rating agencies to give the country an investment grade rating. In its April 2010 rating report Fitch states "while Panama's gross public debt ratios remain high relative to 'BBB' peers, official dollarization, a favorable amortization profile and the government's considerable financial and land assets offset this weakness."

Table 5: Debt Indicators 2009

Indicator	Dom. Rep. (B/B+)	B median	BB median	BBB median	El Salvador BB	Colombia BB+	Peru BBB-	Panamá BBB-
General Govt. Debt/GDP (%)	35.1	47.0	45.6	44.6	50.2	45.6	28.2	67.3
Net General Govt.[10] Debt/GDP (%)	35.1	34.1	29.7	29.7	41.0	31.6	15.6	26.7
General Government Debt /General Government Revenues (%)	252.8	145.6	155.4	144.2	261.8	165.6	128.4	185.9
GG interest/GG revenues (%)	20.8	4.5	7.4	8.5	14.7	12.4	6.8	12.0

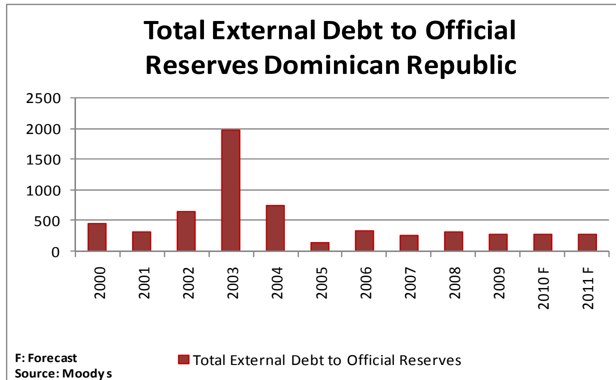
Source: S&P

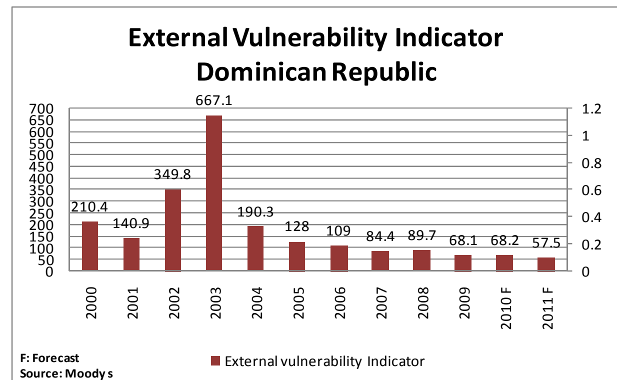
Brazil, Colombia and Peru serve as examples of sovereigns that have successfully improved their debt profile through an active debt management strategy that focuses on reducing their portfolio's foreign currency debt and increasing the issuance of local denominate debt instruments. Brazil and Peru also reduced the *percentage of public sector external debt as a percentage of total external debt*. Proactive debt management plays an important role in increasing fiscal flexibility by lengthening the yield curve which translates into lower debt servicing costs and higher sovereign ratings. For example, Fitch notes in its June 2010 rating report on Peru, "Peru continued to engage in liability management operations to smooth its amortization profile." In April 2010, the government reopened the 2033 global bonds in exchange for shorter - dated global and Eurobonds (2012, 2014, 2015 and 2016). This liability management exercise reduced medium - term amortizations by about USD1.8bn and resulted in a slight debt reduction of USD45m in nominal terms. Combined with increased flexibility in domestic financing options, this further supports the country's creditworthiness."

[10] General government debt less general government deposits held with the monetary authorities and/or domestic banks.

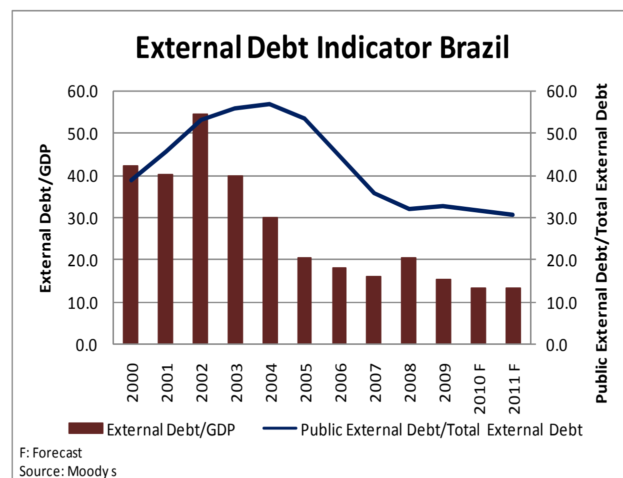
Susceptibility to Event Risk

Rating agencies expressed concerns about the Dominican Republic's vulnerabilities to "event risk" or shocks; particularly in light of comparatively low foreign exchange reserves and a high external financing requirement. Rating agencies such as Moody's categorized three types of event risk; political risk, economic risk and financial risk. Political risk which includes potential coups, political deadlock and other types of political events is considered to be low for the Dominican Republic. Economic risk encompasses events such as hurricanes, financial crisis, and reliance on single trading partner.





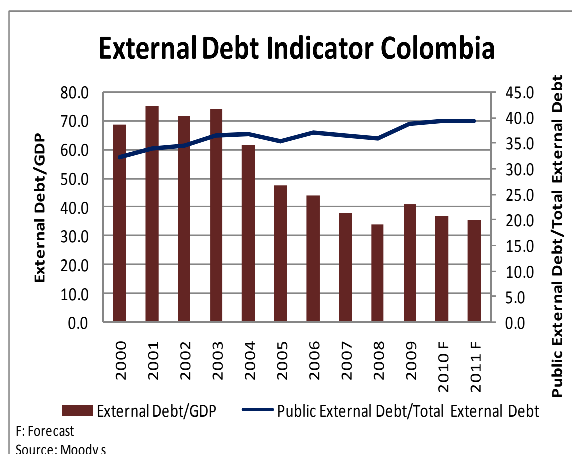
The recent international financial crisis demonstrates that the Dominican Republic has a certain level of resilience in the face of external economic shocks. In particular, the Dominican banking sector remained strong primarily due to improved regulations and good oversight by the Superintendent of Banks. Finally, financial risk relates to the structure of the debt portfolio and includes risks such as foreign exchange risk, roll-over risk and interest rate risk.



All three rating agencies note the importance of external indicators to the Dominican Republic's credit quality, although from different perspectives. Moody's, in its May 2010 report, commented on "vulnerabilities associated to the country's condition as a small open economy frequently exposed to external shocks. Exchange-rate event risk is a relevant factor as foreign currency-denominated financial obligations account for a significant share of the country's debt." But it also noted that "the external component of financial vulnerability is an area where the DR's credit profile has reported notable improvement . . . a clear departure from years when the country's external financing needs were a multiple of reserves." Fitch also said that "The Dominican Republic's ratings would benefit from stronger external liquidity and the maintenance of macroeconomic stability. By contrast, a sustained increase in external financing requirements, as well as a sharp

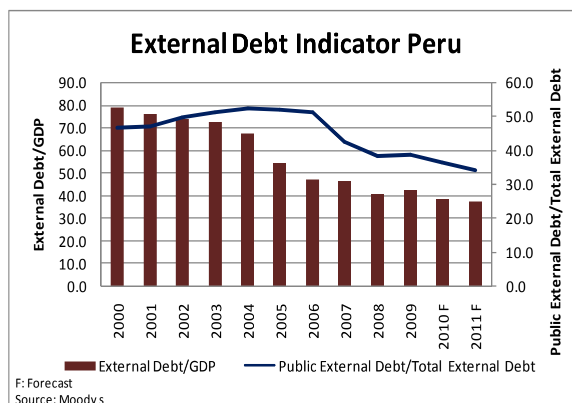
decline in non-debt-creating capital inflows or a return of capital flight which resulted in downward pressures on the peso and a continual erosion of international reserves would be a credit negative." As illustrated in the two graphs above, the Dominican Republic's external indicators, *total debt to official reserves*[11] and *external vulnerability* indicator[12] have remained stable for the past few years after improving considerably from the 2002-2005 period.

The Dominican Republic's *external financing needs to available reserves* indicator (table 6) illustrates that the country's external financing requirements when measured against its reserves is much larger than 'B', 'BB' and 'BBB' median countries and other sovereigns such as El Salvador, Colombia and Peru. However, Moody's expects further improvement in the Dominican Republic's external position with the development of a domestic market for government bonds. The domestic bond market is – "a major achievement" – that leads to diversification of funding sources and reduction of the government's foreign currency debt exposure. But because Moody's measure of external debt seeks to include not only the government's foreign currency obligations but also those of the private sector, their analysts have expressed concern about the absence of definitive information from official sources about private sector external debt.



It is important to note that Panama's external indicators below (table 6) appear to be high in all categories, but, this partly reflects Panama's monetary regime, whereby the authorities do not technically maintain international reserves since the national currency is the US Dollar.

When examining peer countries' indicators for *net external central government debt versus current account receipts*, it is noteworthy that both 'BB' and 'BBB' median countries as well as Peru (-31.3%) have negative indicators. A negative number indicates that the country is a net creditor rather than a net borrower with the outside world. In its 2010 Peru rating report, Fitch notes "Both the public and private sector's limited reliance on external debt financing has helped bolster Peru against financial market turbulence witnessed in other investment grade emerging markets.



[11] Source: Moody's.

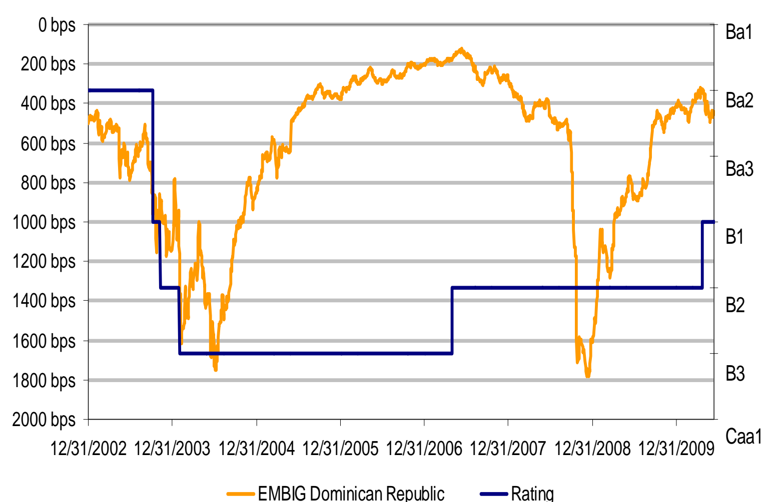
[12] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves. Source: Moody's

Table 6: External Indicators 2009

Indicator	Dom. Rep. (B/B+)	B median	BB median	BBB median	El Salvador BB	Colombia BB+	Peru BBB-	Panamá BBB-
Gross ext. fin. req. / usable reserves (%)	380.9	110.1	91.3	110.9	91.3	67.9	31.3	1,057.3
Gross External Debt/Current Account Receipts (%)	95.7	96.2	110.8	115.8	111.1	112.6	104.5	519.4
Net Ext. Central Govt. Debt / Current Account Receipts (%)	37.2	0.7	-0.1	-27.0	36.1	1.3	-31.3	62.5

Source: S&P

IV. Strategy and Specific Actions to Reach Investment Grade



By analyzing the rating drivers and the country's strengths and weaknesses it is possible to identify where the DR should focus its efforts with the objective of improving the country's rating over the short and medium term. Experiences in other Latin American countries demonstrates that significant improvements in sovereign debt ratings requires a long term vision and the capacity of the government to consistently implement economic and social policies over a multi-year period. S&P has noted in its August 2009 report that "tackling institutional and structural issues [in the DR] will take more time and strong political will, but if addressed will augur for a higher rating." Thus a strategy that focuses on some specific short term actions and longer term structural reforms could result in a rating improvement within the next 12-18 months. The government should set a goal of reaching a BB- rating within a 12 to 18 month timeframe (one notch above the Moody's rating and two notches above S&P and Fitch). It is noteworthy that in June 2010, the Republic's bonds were trading in the global capital markets at yields attributable to higher rated sovereign bonds with ratings of 'Ba2'.[13] Therefore, the capital markets are pricing Dominican risk at levels indicating that the markets have agreed that the Dominican Republic's fundamentals are equivalent to a higher rated sovereign.

[13] EMBIG spread: U.S. dollar-denominated emerging market debt benchmark. Includes U.S. dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities. Rating agency: Moody's. Graph prepared by Barclays Capital.

Reaching an investment grade rating will require a concerted effort on part of the government and the private sector to implement some significant reforms over the medium term. The selection below presents a dual prong approach which makes recommendations for 1) specific short-term actions that can be implemented quickly and will render measurable results towards improving the rating, and 2) medium term structural reforms which if successful could mean an investment grade rating for the Dominican Republic in the medium term (10 years).

Short-term actions

Create a high level committee responsible for improving the country's sovereign rating. Panama utilized this strategy in its successful efforts to reach investment grade. The President of Panama promised in his election campaign that Panama would improve its rating and subsequently after the election established a high level commission that met monthly to revise and oversee the completion of an action plan. The committee was led by the Ministry of Finance and included three prominent representatives from the private sector. Their work plan included an outreach campaign to improve the quality and accessibility of information with the goal of developing stronger relationships with the rating agencies.

Similar to the successful strategy in Panama, a private/public sector committee led by the President and supported by the Ministry of Finance (DGCP and UPF) would be extremely useful in the Dominican Republic particularly if it focused on the following actions:

- Provide leadership and credibility to the government's commitment to making reforms. This committee would bring executive attention to areas were reforms are slow or behind schedule.
- Oversee progress and identify key issues to be addressed in the path to investment grade.
- Communicate the benefits of a higher credit rating to the public and private sectors.
- Strengthen the DR's credibility and the relationship with the rating agencies by ensuring that agencies receive timely and accurate data from both the private and public sectors.
- Maintain agencies informed about any important reforms or unexpected events that may have a material effect on the rating.
- Maintain a close and direct relationship at the highest levels with the rating agencies.

Short-term actions to be taken at the Ministry of Finance. The Ministry of Finance's Strategic Planning processes offers an excellent opportunity to identify those actions which could be implemented relatively quickly (within 12 months) that would have a measureable impact on the DR's credit rating. Examples of such actions include:

- **Impeccable debt payment track record with no arrears** - The Ministry of Finance should continue to build upon its excellent debt repayment track record established over the past 2 years. Ensuring that the debt payment track record is perfect without arrears is one of the most important actions to be taken over the short and medium term.
- **Treasury Single Account and Cash flow Projections** - Further consolidation of the treasury single account (CUT) and a cash management program which includes 12 month cash flow projections. Cash management program which includes central control over government bank accounts and cash flow forecasts.

- **Progress towards a fully Functioning Fiscal Programming Unit (UPF**) - The Fiscal Programming Unit should be fully staffed and a director should be hired to oversee its operation. The UPF should have a much higher profile in the fiscal policy making process in order to accomplish its mandate as set out in the law.
- **Progress Towards Budget Programming –** Efforts that demonstrate measurable improvement in budget programming and execution processes particularly in the area of planning and expenditure control. A good annual budget preparation which utilizes realistic projections for macro variables, and budget revenues; top-down spending ceilings; clear presentation of budget: objectives, targets, priorities, and risks. This would also encompass controlled budget execution which includes firm spending controls; adequate internal audit and no payment arrears.
- **Transparency of Financial Information** – Rating agencies noted that transparency of financial information in the past was not a strong point for the DR. However, recent initiatives such as the Public Credit's new website and the publication of the IMF Article IV reviews on the Central Bank's website were noted and viewed favorably by the rating agencies. To further transparency efforts the Fiscal Programming Unit (UPF) should publish the fiscal data which includes budget programming and execution information in a timely and understandable manner. Also reliable data on private sector external debt is difficult to find and should be included on the Public Credit's website.
- **Debt management operations that reduce portfolio risk** - Any debt management operations that reduce the risk of the portfolio while not substantially increasing debt servicing costs should be a priority. In addition, the development of the local debt market was recognized as determining factor in the recent upgrade by Moody's since it will widen the breath of financing options and help to reduce the portfolio's foreign exchange exposure risk. Steps towards developing the secondary market such as the creation of a market makers program would demonstrate more progress.

<u>Medium term actions</u>

A reduction in "event risk" has been a key factor to support decisions to move countries to investment grade. The main event risk facing the Dominican Republic is related to a major devaluation of the peso relative to other currencies such as the US dollar and the Euro. Specifically, a devaluation shock would negatively impact the DR's fiscal sustainability since its debt portfolio is primarily denominated (84%) in foreign currency. Also, depending upon the size of the devaluation domestic businesses or banking institutions holding US dollar liabilities could be severely impacted.

Rating agencies have identified two strategies to address the effect of a devaluation shock on the country's debt portfolio; 1) increase the composition of local currency denominated debt in the portfolio, and/or; 2) structure the portfolio such that roll-over risk is low and there is a sufficient cushion (revenues to debt service) to allow for an important increase in debt service payments. For example, Panama investment grade rating reflects the fact that its currency is the US Dollar; therefore it faces no devaluation risk. Peru has successfully combined both strategies with an innovative portfolio management strategy. Over a period of 10 years the country reduced its

foreign currency debt portfolio from 80% to slightly over 40% and substantially lengthened its debt profile by issuing maturities as long 2033.

Recent steps taken by the Public Credit Office to develop the local debt market marks an important step forward in increasing local currency denominated debt, and was recognized by Moody's as a major credit event support its decision to upgrade the DR. However, the Medium Term Debt Strategy (MTDS) concludes that it will be difficult to measurably reduce the portfolio's foreign exchange exposure from actual levels since most funding sources available to the Dominican Republic are in US Dollars. Due to the limited sources of local currency funding, the portfolio's composition of domestic and foreign debt is expected to stay at current levels into the future.

Absent a prompt reduction in the share of foreign currency debt, the DGCP should seek to extend the debt's maturity profile and spread maturities over a large number of years. Where possible liability management operations should be implemented to further reduce the portfolio's currency, roll over and interest rate risk.

Finally, rating agencies expressed the importance of implementing a fully floating foreign exchange regime as a strategy to further reduce the Dominican Republic's exposure to event risk. A managed exchange regime requires Central Bank intervention to stabilize the peso at a cost of using its limited reserves. Thus, the policy of managing the peso exchange rate does not strengthen the Central Bank's reserve and liquidity position and is seen as a risk factor by the rating agencies.

Need for rules to make fiscal policy more predictable, less subject to change with the electoral cycle. The IMF agreement provides a multi-year macro and fiscal framework that serves as the basis on which the strategy for the "Path to Investment Grade" is constructed. Improved coordination has occurred as a result of the Agreement but economic policy makers at the highest levels should work towards an institutionalized process for fiscal policy making that results in a multi-year macro and fiscal framework, with or without an IMF agreement. Rating analysts would favorably view the passage of a Fiscal Responsibility Law that creates a framework establishing clear rules and checks and balances for the execution of fiscal policy. This framework would ensure continuity and consistency while establishing limits on the fiscal deficit and other indicators. Brazil, Panama, Peru and Colombia all have passed fiscal responsibility laws. In July 2010, Standard and Poor's (S&P) raised its outlook for Colombia to positive from stable for its foreign currency rating of BB+. S&P noted that a rating upgrade is likely if, "the next administration pursues policies that strengthen the growing resiliency of the economy, including reducing its vulnerability to external shocks. One such policy could be a fiscal rule (Chile has undertaken this policy measure) which was recommended by an expert panel of officials from the central bank and the finance ministry for adoption beginning in 2011."

Other types of agreements have proved to be useful to ensure policy continuity. For example, Barbados (BBB) has institutionalized a consensus mechanism between unions, government and the private sector in the form of a Tripartite Union. The objective of such agreements is to expand reform efforts and provide continuity that extends beyond administrations.

Work to improve the perception that government policy makers are serious and are committed to the country's development which includes respecting its obligations and contracts and showing a commitment to transparency. Concrete actions taken over time that demonstrate the government is committed to making reforms and to respecting its obligations all contribute to improving the Dominican Republic's reputation. Rating agencies recognize recent progress particularly in the area of debt repayment, however they express concern regarding the commitment of the government to reforms, transparency and respect for its future obligations. The recent replacement of the General Director of CDEEE with a respected private sector businessman is an example of a positive action that builds credibility and demonstrates the government's commitment to electrical reform. The presidential committee for the "Path to Investment Grade" should serve as a catalyst to improving the government's reputation by ensuring that government officials are held accountable for any actions which serve to diminish the reputation of the Dominican Republic.

Reform the electric sector following the targets established by the World Bank and the IDB. The electric subsidy represents one of the most important threats to the country's fiscal sustainability and its reform is a requirement to reaching investment grade. The expected deficit in the electric sector is expected to reach $850 million in 2010 exceeding the original amount budgeted for the year of $380 million. In July 2010, Moody's expressed its concerns about the structural problems plaguing the country's electric sector and their potential impact on government finances. "Until reforms are introduced to effectively address fundamental issues (i.e., collection problems by government-owned electricity distributors, electricity theft, transmission losses, etc.) financial problems in the electricity sector will continue to constrain the country's sovereign credit quality and rating at its current B1 level."

Continue to recapitalize the Central Bank to ensure macroeconomic stability and the development of a local capital market. The 2010 budget does not sufficiently fund the interest payment as stipulated by the Recapitalization Law and presents a scenario where the government will be at best in arrears and at worst in default on its debt obligation to the Central Bank. The reputation of the government rests on respecting its financial commitments and underfunding this interest transfer will be viewed negatively by both the rating agencies and investors. A situation where the Central Bank fails to reduce its debt, but rather continues to roll over a growing debt stock (interest is capitalized) is unsustainable and will result in higher overall interest costs for the Central Government. In addition, the local capital market does not have the absorption capacity to support two government issuers that are issuing the same maturities (2-10 years) and with increasing funding requirements.

Strengthen the effort led by the MEPyD and CONARE to address the ten most important structural obstacles. There is a need for expansion of the reform efforts and a plan to ensure policy continuity that extends beyond individual administrations. The Dominican government has taken an important step to building a coherent vision regarding the country's economic and social development which goes beyond the current political cycle. The Ministry of Planning, Economy and Development in partnership with CONARE recently facilitated and drafted the first National Development Strategy for 2010-2030 that outlined a vision of the future. This strategy identifies ten structural obstacles that currently prevent the country from progressing

towards this vision, most of which are also those identified by the rating agencies as structural obstacles in the path to attaining investment grade.