FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Dominican Republic at 'BB-'; Outlook Positive

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Fitch Ratings - New York/Santo Domingo - 21 Nov 2024: Fitch Ratings has affirmed Dominican Republic's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB-'. The Rating Outlook is Positive.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Positive Outlook, Ratings Affirmed: The Positive Outlook reflects a trend improvement in governance indicators, robust growth prospects that should lift per capita income, and the potential for fiscal reforms to improve the macro institutional framework. Constitutional reforms and a fiscal responsibility law (FRL) were approved following the administration's second term election victory by a wide margin in May.

However, a widely anticipated tax reform was withdrawn in October following a public backlash. Fitch will monitor the ability of the recently approved fiscal rule to anchor spending growth and alternative plans to raise revenue absent a broader tax reform, among other areas, to assess improvements in the policy framework and creditworthiness.

The Dominican Republic's ratings are supported by a track record of robust economic growth, a diversified export structure, high per-capita GDP and social indicators, and governance scores that compare favorably to peers. They are constrained by fiscal weaknesses including a high interest burden and subsidization of a loss-making electricity sector, heavy sovereign reliance on external bond market financing, and lingering weaknesses in the policy framework related to a large central-bank quasi-fiscal deficit and relatively modest external liquidity buffers (which have been under pressure this year) in the context of a heavily managed exchange-rate.

Second Abinader Term Begins: President Luis Abinader began his second term in August. The majorities of his PRM party in both houses of congress have enabled approval of constitutional reforms that limit presidents to two terms in office, enhance the autonomy of the public prosecutor's office and reduce the number of members in the chamber of deputies, while the FRL was approved during the interim period in July. However, the sudden withdrawal of the tax reform calls into question the ability to pass more difficult reforms, after prior efforts also did not advance during the administration's first term due to the impact of the pandemic and inflation. A less contentious labor reform remains on the agenda and was submitted to congress in October.

Growth Returns to Potential: Growth has resumed its historically robust pace this year, reaching 5.1% in 1H24, following a slowdown to 2.3% in 2023 due to the high interest rate environment. Free trade zones and tourism continue to be bright spots in the economy, with tourist arrivals continuing to reach record highs. Fitch forecasts growth of 5% in 2024 and 2025, well above the forecast 2024 'BB' median of 3.1%. Record levels of FDI, particularly in the tourism and energy sectors, are supportive of robust medium-term growth prospects.

One-Off Boosts 2024 Revenue: The 2024 budget targets a central government deficit of 3.1% of GDP, down slightly from 3.3% in 2023. A mid-year budget reformulation appears net neutral, with increased spending (up 13% through September) funded by higher-than-expected revenues, mainly a one-off 0.7% of GDP revenue boost from the Aerodom airport concession. Interest costs continue to rise quickly (15% through September). We project this will further lift the high interest-to-revenue burden, which continues to weigh on the credit profile, to 22.5% in 2025 from 20.1% in 2023, one of the highest in the 'BB' category.

Fiscal Rule Approved: A fiscal rule was approved by Congress in July, which establishes a real expenditure growth cap of 3% (7% in nominal terms) and a debt anchor of 40% of GDP by 2035. The new fiscal rule will face its first test with the 2025 budget, which targets a 3% of GDP deficit. The original budget proposal did not assume a tax reform, which according to the fiscal responsibility law would allow for a larger real spending increase above the 3% cap, and so it will not be directly affected by the withdrawal of the reform. We forecast the 2025 deficit to be broadly in line with the target, but without tax reform it will require significant expenditure restraint to compensate for the loss of this year's one-off revenues.

Tax Reform Withdrawn: The proposed tax reform aimed to raise 1.5% of GDP in additional revenue, primarily through reducing widespread tax exemptions and broadening the base of the 18% VAT rate. The primary focus of raising additional revenue was to enable higher spending in priority areas such as social spending and infrastructure, rather than for fiscal consolidation. The administration is in the process of outlining an alternative plan, based on more ad hoc tax administration measures where new legislation is not required and addressing high levels of tax evasion.

Foreign Currency Debt Share Falls: The share of foreign currency debt continues to gradually decline, falling to 67% as of September 2024 (its 2019 level) from 69% at end 2023, through greater issuance of global peso-linked bonds in recent years. Fitch expects the government debt stock to inch up to 47.9% of GDP in 2024 from 46.8% in 2023. Gradual fiscal consolidation should help stabilize debt over the medium-term. Consolidated public sector debt is higher at 62.5%, accounting for the large debt of the central bank (USD18.1 billion or 14.6% of GDP at end June 2024).

Inflation Below Target: Inflation through October this year averaged 3.3%, below the BCRD's target of 4%. The BCRD has reduced its policy rate to 6.25% from a peak of 8.5% in May 2023. However, other interest rates in the economy remain high despite declines in the policy rate. Interbank lending rates stood at 12.3% at end-October. This could signal a still restrictive monetary policy stance, in particular to contain exchange-rate pressures.

Reserves Under Some Pressure: The exchange rate has been under some pressure in 2024, prompting foreign exchange intervention (data on which are not publicly available) to prevent a steeper depreciation (down 4% YTD). This has led international reserves to fall by USD2.1 billion to USD13.3 billion as of November 8 (or -14%), despite a large international bond issuance in June and an improving current account deficit.

The ongoing exchange-rate pressures and reserve losses in the context of improved balance-of-payments dynamics highlights lingering weaknesses in the policy framework, in our view. We forecast international reserves to partially recover due to seasonal effects in the remainder of the year and end 2024 at USD14.6 billion, equivalent 3.9 months of CXP, slightly above the 2019 level of 3.5 months and below the 'BB' median of 4.5 months.

ESG-Governance: Dominican Republic has ESG Relevance Scores (RS) of '5'[+] for Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality, and Control of Corruption. These scores reflect the high weight that the World Governance Indicator (WGI) have in our proprietary Sovereign Rating Model (SRM). Dominican Republic has a medium WGI ranking at the 51.9 percentile, reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity and rule of law and a fairly high degree of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Public Finances: Continued rise in government debt/GDP and interest/revenues ratios, for example, through the loosening of fiscal policy, lower-than-expected growth, or financial losses of the public electric utilities;

--External Finances: Further deterioration of the external liquidity position that increases external vulnerability;

--Macro: Sustained period of growth below historical averages.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Public finances/Structural: Implementation of policy measures that strengthen fiscal flexibility and/or enhanced credibility of the newly approved fiscal rule to anchor expenditure growth.

--Macro: Sustained high growth rates and an improved macroeconomic policy mix that improves monetary and exchange rate policy credibility and effectiveness.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

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

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign Currency IDR by applying its Qualitative Overlay (QO), relative to SRM data and output, as follows:

--Structural: Fitch has added a -1 notch as improvements in governance indicators and the government's significant political capital following elections have not yet been reflected in the ability to enact policy measures to address key longstanding issues and may understate constraints on policy.

--Public Finances: -1 notch to reflect structural fiscal vulnerabilities stemming from a relatively low tax take, budgetary rigidity and vulnerability posed by a heavily-subsidized electricity sector, and contingent liabilities related to the large market debt and sizeable quasi-fiscal deficit 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 Long-Term Foreign Currency 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.

COUNTRY CEILING

The Country Ceiling for the Dominican Republic is in line with the Long-Term Foreign Currency IDR. This reflects no material constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +1 notch above the IDR. Fitch's rating committee applied an offsetting -1 notch qualitative adjustment to this, under the Macro-Financial Stability Risks and Exchange Rate pillar. Membership in the CAFTA-DR trade agreement puts some limits on incentives for the use of transfer-and-convertibility restrictions, but this is balanced by a managed exchange-rate regime and fairly low international financial integration.

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

Dominican Republic has an ESG Relevance Score of '5'[+] for Political Stability and Rights as the WGIs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Dominican Republic has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Dominican Republic has an ESG Relevance Score of '5'[+] for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as the WGIs 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. As Dominican Republic has a percentile rank above 50 for the respective WGIs, this has a positive impact on the credit profile.

Dominican Republic has an ESG Relevance Score of '4'[+] for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WGIs is relevant to the rating and a rating driver. As Dominican Republic has a percentile rank above 50 for the respective WGI, this has a positive impact on the credit profile.

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 Dominican Republic, as for all sovereigns. As Dominican Republic has a fairly recent restructuring of public debt in 2005, this has a negative impact on the credit profile.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Dominican Republic	LT IDR BB- Rating Outlook Positive Affirmed	BB- Rating Outlook Positive
	ST IDR B Affirmed	B
	LC LT IDR BB- Rating Outlook Positive Affirmed	BB- Rating Outlook Positive
	LC ST IDR B Affirmed	B
	Country Ceiling BB- Affirmed	BB-
senior unsecured	LT BB- Affirmed	BB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceiling Criteria (pub. 24 Jul 2023)

Sovereign Rating Criteria (pub. 24 Oct 2024) (including rating assumption sensitivity)

APPLICABLE MODELS

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

Country Ceiling Model, v2.0.2 (1)

Debt Dynamics Model, v1.3.2 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.14.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Dominican Republic	EU Endorsed, UK Endorsed

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