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Dominican Republic Ba2/B-

Hard Part Proves Too Hard?

- **IMF stand-by has proven difficult to implement. . .**
- **. . .and the administration seems more committed to winning reelection than completing the program. . .**
- **. . .especially as Mejia's popularity continues to slide**

Market Outlook

Over the past month, little has seemed to go right for the Dominican Republic. The cautious optimism that followed the approval of about US$1.1 billion of IFI funding quickly evaporated as the Central Bank groped for control of monetary policy, squandering the peso's first dip below DOP30/US$ since June. In early September, the Senate passed a radically altered amendment to the Monetary and Financial Code, falling foul of a central pillar of the IMF program (the establishment of a unified and fully flexible exchange rate regime by year-end). It then rejected the 5% export tax, one of the main government proposals for coming up with additional revenues to plug the fiscal gap. On September 10, the government announced that it had reached an agreement with Union Fenosa of Spain to buy out the company's 50% managing stake in two debt-ridden, loss-making electricity distribution plants and assume the distributors' outstanding debt, raising the prospect of further fiscal pressures. To top it off, a fairly strong earthquake on September 22 damaged buildings in the north of the country. All in all, a hard month.

October did not start off on a much better note. The IMF team arrived in Santo Domingo for the first review (scheduled to be two weeks long), but returned to Washington after just two days to consult with Fund management about the government's takeover of the two electricity distribution companies and other pending issues. This is obviously a very bad sign and means delays in the review and disbursement schedule—at the very least. The government had to pay UF US$15 million upon delivery (September 30), and over the next 12 years will pay a further US$347 million, which the Mejia administration claims will come directly from those revenues that it manages to collect from customers, though in fact the deal opens up a significant fiscal hole. In addition, the government will have to figure out a way to settle the US$100 million that the electricity generating companies say they are owed by the two distribution companies, or face plant shutdowns and further blackouts.

Although the official creditors made no public statement of opposition to this agreement, their concern about the impact on the fiscal accounts was widely known. We are now likely to see renewed negotiations in Washington between the Fund and Dominican government representatives behind closed doors. There are several other issues to be resolved as well, such as the government's failure to get the export tax or any of the structural performance criteria passed through Congress by the end-of-September deadline. The expected lack of information on the status of the negotiations over the next weeks could spawn a great deal of speculation and noise; even in a positive scenario (i.e., assuming continued engagement with the Fund), these pending issues could be serious enough to make the negotiation of a new Letter of Intent necessary. While a new LOI could be negotiated with more realistic targets, we are not optimistic that the Mejia administration will give the fulfillment of the IMF program priority over its desire for reelection in May 2004, even amid the challenging external debt service schedule over the remainder of 2003 and 2004 (US$1 billion due). Although the administration has declared its intention to resell the companies within a year, this will be no easy task. In the meantime, it will have its hands full trying to supply electricity through the networks formerly operated by UF, and we are likely to see continued popular frustration in the face of blackouts and a further decline in the administration's already low popular support.

Investment Strategies

Underweight. Following two months of strong returns, the Dominican Republic was one of the worst performers in September, returning -3.36%. Given the likely impact of current uncertainties on domestic sentiment, there is a real possibility that the currency and the banking system will come under renewed pressure in the coming weeks. While bond prices have already reacted to the news (and to S&P's two-notch downgrade), we do not have any reason to believe that we have yet hit bottom, and therefore on October 2 we cut our exposure to Dominican debt to underweight.