

Focus: Dominican Republic

Tax Reform Passes But Paris Club Is Going to Get Another Call

The tax reform has finally passed...now what? Is there more upside in the short term after the notable rally we have seen in recent weeks? Not likely. The problem is that an IMF program that is needed to prevent a substantial default to the official and private sector in 2005 is still weeks away. The obstacle is a large financing gap.

- The tax reform passed yesterday provides 1.5% of GDP in savings, less than the 2.5% targeted. Add this to the 1% in savings from announced spending cuts and the primary surplus in 2005 is on target for roughly 2% of GDP. Given roughly 2% of GDP in interest payments, the non-financial public sector deficit would be balanced.
- However, below the line, there is US\$1.1 billion in amortizations in 2005 (\$220 million to IFIs, US\$500 million to bilaterals, US\$300 million to private sector, and US\$100 million to other creditors). Thus far, one can identify only US\$750 million in disbursements: US\$400 million from the multilateral development banks and US\$350 million from the bilateral governments.

This leaves a financing gap of US\$350 million, liberally assuming domestic sources roll over their claims at 100%. Even aggressive scenarios of restructuring interest payments to the private sector in 2005 (total payments are US\$100 million in interest on globals, US\$160 million in interest on commercial bank debt) would leave a financing gap.

The IMF appears likely to be flexible on a deficit **if** it can be financed. But where will the additional resources come from? The official sector is not considering another package. Further fiscal adjustment appears unlikely given how difficult the process has been thus far. Domestic sources, namely banks, appear unlikely to take on net new government exposure given their already fragile state. And 50% of the US\$1.1 billion in external debt service in 2005 is non-restructurable: either to the international financial institutions or post-cut off date bilateral debt.

The market has accepted that the government is likely to treat some portion of the US\$261 million in debt service to the private sector in 2005 (of which US\$100 million is on globals). But this alone will not be adequate to close the US\$350 million financing gap. This leaves the Paris Club.

The government owes US\$123 million to the Paris Club in 2005. The Paris Club will be willing to provide further relief but will make clear that they will not provide it until a private sector restructuring is completed. Furthermore, the relief provided by the private sector will have to reflect comparable treatment relative to both the previous and the prospective Paris Club restructurings.

Thus, what's next? First, an IMF technical mission goes to Santo Domingo next week to look for additional financing or adjustment from the authorities. We don't expect any Letter of Intent to be signed as some tough decisions still need to be made. But, sooner or later, we see the authorities admitting that they can't do more than the existing 2% primary surplus in 2005. Given that the authorities are eager to get the IMF program and the Fund board will only go forward with a fully financed program, the government will agree to go back to the Paris Club. With such an agreement, the government should be ready for an IMF program.

GG

Total Central Government Debt Service, 2005			
	Principle	Interest	Total
Total	618.6	387	1005.6
IFIs	88	84	172
Bilateral	347	131.6	478.6
Paris Club	92	30	122
Potential Paris Club	22	2.6	24.6
Non-Paris Club	233	99	332
Commercial Banks	140	121	261
Bradies	0	0	0
Non-Restructured	140	20	160
Globals	0	101	101
Other	43.6	50.4	94

Source: Banco Central de la Republica