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ECONOMIC BASIS FOR FY-1986 ESF SUPPORT

CONCEPTS PAPER

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SUMMARY

This document presents the economic basis for FY-1986 ESF support to the Dominican Republic. It summarizes the stabilization measures of January 1985 and examines how the economy has reacted to these reforms.

Based on the initial adjustments taken this year and the apparently strong demand for credits in support of export projects, a scenario is constructed for the 1985 to 1990 period in which non-traditional exports grow in absolute and relative importance, thus permitting the nation to enter the next decade with a strong, efficient export base. This export orientation is considered fundamental to achieving economic recovery from the current economic crisis, while moving the Dominican Republic toward broad-based, self-sustaining growth and development.

This scenario implies a substantial medium-term cost in terms of slow growth, monetary restraint and further painful adjustments to achieve a market oriented, export led strategy for growth and development. The role of USAID and other USG programs will be of great importance in encouraging this strategy. Development Assistance, ESF program, and PL-480 Title I can alleviate the suffering implicit in making structural changes.

ESF balance of payments (BOP) support will make a major contribution to cutting current account deficits. This program is especially important in FY-1986, in which a target amount of US$60 million is programmed in the scenario. However, even with this support, other BOP assistance must be found to sustain the scenario. From 1987 to 1990, annual amounts of US$50 million are introduced in the simulation of the Dominican economy. Fulfillment of the scenario's objectives may permit phasing out ESF by 1990.

ESF is essential not only to the BOP assistance, but also through investments financed by counterpart local currency and through conditionality designed to encourage the export led strategy. In FY-1986, continuation of the past year and new year conditionality is recommended to encourage private sector investment through the credit creation, tax modifications, export restriction liberalization, agricultural pricing reforms and government land access, and through support to the financial stabilization policy. Future conditionality is recommended to prepare a basis for reorganizing public enterprises, simplifying onerous customs procedures, permitting a better utilization of public lands, modifying the import substitution law and encouraging private savings.

The Concepts Paper stresses two crucial but extremely delicate balances. One concerns the need to maintain monetary discipline under the stabilization program without being so contractionary as to prevent investment needed for achieving recovery. The other implies encouragement of further needed reforms, many of which mean painful adjustments, while not provoking widespread dissatisfaction and social disruption. This requires a timely and careful programming of reforms which, whenever possible, should attempt to ameliorate their most negative social impacts.

Next year, 1986, will be crucial for the Dominican Republic. National elections are scheduled for May. The GODR's economic policies and the country's economic prospects will be the campaign's central theme. A successful political transition to a new government in August 1986 will reinforce the country's steady progress toward sustaining an open economy based on a solid democracy. Failure of the electoral process, possibly accompanied by political and civil instability, clearly will worsen the outlook. Despite the serious problems the country faces, there exists now genuine opportunity for the Dominican Republic to increase employment, investment, productivity, and foreign exchange earnings. U.S. assistance should help the country take advantage of that opportunity.

ECONOMIC BASIS FOR FY-1986 ESF SUPPORT

A. Introduction

This report presents the economic basis for the FY-1986 ESF PAAD. The report briefly analyzes Dominican economic performance with emphasis on the first half of 1985. Projections are then made of major macroeconomic variables through 1990, with special attention to problems and impediments to growth and development. Finally, the U.S. Mission program will support a course of action which permits the lowering of the barriers which impede the achievement of a healthy Dominican economy. These actions will be encouraged by conditionality, some accompanying the ESF program and others associated with PL-480 food assistance. This report stresses ESF conditionality. Local currency generated by U.S. BOP assistance is singled out as playing an important role in stimulating economic recovery and developing diversified export-led economic growth.

B. Background

1. The Nature of the Economic Crisis: Its Magnitude and Underlying Causes

As with most oil importing development economies, the Dominican Republic has suffered a serious long-term decline in its terms of trade as a result of the 1973 and 1979 oil shocks and the steady decline in global commodity prices, especially for sugar. Nevertheless, Dominican economic problems have originated, in part, from policy decisions dating back to 1965. Traditionally an agrarian society, the Dominican Republic only began to develop domestic industrial capacity under the Balaguer administration, with the 1968 enactment of the Industrial Incentives and Protection Law (Law 299), which stimulated development of an Import Substitution Industry (ISI).

Between 1968 and 1974, the Dominican economy experienced rapid economic growth with an average annual GDP growth of 11%. High industrial investment coincided with expanding world trade and high prices for traditional agricultural exports. As more ISIs were established, additional white-collar jobs were created, a middle class began to emerge, and the demand for middle-class consumer products increased, leading to more foreign imports. Demand for foreign exchange increased more rapidly than traditional exports (sugar and coffee) could supply, and the parallel exchange market began to show a 10% premium for U.S. dollars.

The drastic increase of oil prices in 1974 further increased the demand for foreign exchange. Fortunately, rising world sugar and coffee prices, new gold exports, and a drawdown on foreign exchange reserves provided sufficient foreign exchange to maintain a precarious external balance with an average 20% parallel market premium. However, because of a relatively small domestic market, opportunities for ISI investment began to decline. Reduced industrial investment brought the average GDP growth rate down to 5%. Throughout the period, however, external debts were low and the debt service ratio did not exceed 11%. Public sector deficits rarely exceeded 0.5% of GDP, and there were even some years of budget surpluses. Nevertheless, the economy contained two basic weaknesses: agricultural output, under the burden of price controls, stagnated to less than 2% a year growth, and national unemployment exceeded 20%, even with annual GDP growth of over 10%.

When oil prices doubled in 1979 and sugar prices dropped in 1981, the Dominican economy went into a tail spin. Externally, trade imbalances became increasingly severe, and internally, the country was unable to adjust spending to income. Rising public spending was not supported by an adequate revenue base. Public sector deficits mounted rapidly. A major contributing factor to the government's fiscal deficit problem were the losses incurred by public sector enterprises. Much of the deficit was financed with expensive short-term external borrowing. By 1984, the country's external debt burden reached $3 billion. Structural imbalances in the private sector import-substitution industries further inhibited export growth needed to generate more foreign exchange. Price controls, inappropriate and unrealistic exchange rates, import-substitution and anti-export trade policies, and other structural inefficiencies also exacerbated the problem. As a result, by the end of 1984, the parallel market exchange rate increased from a 20% premium to 200%, real GDP growth declined to less than 2%, and official inflation reached more than 25%.

Since the initiation of the import substitution policies, the policy environment in the Dominican Republic could be classified as one which imposed severe restrictions on the long term prospects for growth and development. Scarce foreign exchange has been allocated to inefficient uses, many of which are import substitution industries producing for the local market behind the walls of tariffs and restriction of outside competition. Agricultural prices have been maintained artificially low, impeding local production while encouraging consumption, and frequently requiring imports to fill the deficit between consumption and domestic production. Electricity production by the parastatal CDE was subsidized through cheap petroleum imports at the official exchange rate. The electric company had few incentives to maintain a healthy financial performance, failing to enforce normal collection procedures. Government subsidies and poor financial performance also characterize other public sector enterprises. Tax procedures present severe disincentives to increased production and investment by the private sector. The tax system is highly complex, and the time-consuming procedures needed to get imported inputs out of customs, for instance, constitute an important barrier against expanded production.

In August 1982, the new Jorge Blanco government proposed a broad-based financial and economic reform program, and requested IMF support through a three-year Extended Fund Facility (EFF) arrangement. In January 1983, this was formally approved by the IMF for an amount equivalent to SDR 371.25 million (about US$450 million at the time) for the three-year period, 1983-1985. The EFF program established targets or limits on net domestic assets, domestic credit, international reserves, reduction of external payment arrears, foreign loan disbursements and import payment transfers. On the strength of this IMF agreement, negotiations were begun with foreign commercial banks to reschedule up to US$600 million in short- and medium-term commercial credits. This was concluded in late 1983 with an agreement that required a GODR down-payment of 5%, with amortization to be made in 17 quarterly installments starting January 1985.

The GODR met the performance criteria of the IMF-EFF agreement through September 1983, but by the end of the year, it was substantially out of compliance, due to excessive fiscal deficits. Subsequent EFF negotiations with the IMF for the second year program were not successful, and negotiations were suspended in May 1984 and subsequently terminated in July. The principal obstacle was the GODR's reluctance to carry out a schedule for completing transfers of all import payments, including petroleum, to a parallel market rate of exchange with an appropriate pass-through to consumers. The GODR political judgment was that continued rapid price increases could incite further violence like the rioting of April 1984, which resulted in more than 60 deaths. In subsequent discussions about a possible one-year Stand-By Arrangement, the GODR agreed to proceed with the transfer of petroleum imports to an appropriate intermediate exchange rate, but by then there was disagreement on other GODR subsidy policies.

In August 1984, the GODR issued an Economic Policy Statement outlining a set of Policy Reform and comprehensive adjustment measures through 1985. While not concluding any formal agreement, the IMF accepted this statement as "a transitional program leading into a comprehensive Stand-By arrangement", and negotiations were revived. The GODR moved petroleum imports to an intermediate exchange rate and raised petroleum product prices by an average of 70%. With this change, most import transactions were to be made at rates greater than the official parity. Exceptions remained, including public debt, private debts registered prior to April 17, 1984, some basic foods and medicine, and petroleum imports destined for use by the Dominican Electricity Corporation (CDE). The GODR also announced its intention to unify the exchange rate at "a realistic level by the end of 1985", and to take various measures to reduce public sector deficits, limit money supply, and maintain less than 10% a year inflation.

2. The Stabilization Measures of January 1985

The exchange rate was unified on January 23, 1985. After that date, virtually all foreign exchange transactions have been at floating prices determined by free market forces outside the direct influence of the monetary authorities. Subsequently, the GODR announced in the April 15 IMF Stand-By Agreement its intention to implement a series of complementary measures, which included:

— In order to offset Central Bank operating losses and to compensate the public sector for the cost of the unification, a temporary exchange tax of 36% on traditional exports and some services and 5% on non-traditional exports (excluding tourism) was initiated. The tax was not subject to legislative approval. Its proceeds are deposited in the Central Bank in an account earmarked only for compensations to CDE, Central Bank, and the central government.

— The combined net credit of the Central Bank and the Banco de Reservas to the public sector (estimated at RD$1,802 million on December 31, 1984) cannot exceed RD$1,902 million on June 30, 1985, RD$1,852 million on September 30, 1985, and RD$1,802 on December 31, 1985. This implies a one-year freeze on the full year credit expansion to the public sector.

— The Central Bank would eliminate arrears consisting of unpaid letters of credit for which deposits of about RD$35 million were received.

— Net foreign assets of the Central Bank which were negative US$335.9 million on December 31, 1984 would be no more than negative US$300 million on June 30, 1985, and would not to exceed negative US$279 million on September 30, 1985 and negative US$227 on December 31, 1985. No new arrears on external debt service are permitted in 1985.

— Ceilings were placed on disbursements of non-concessional external public and publicly guaranteed debt (excluding restructuring and refinancing), calling for net repayments of US$19.3 million during 1985 of debt having a maturity of one year or less. The gross disbursements of non-concessional debt maturing in less than one year cannot exceed US$90.7 million. Disbursements in 1985 are limited to US$198.5 million for this type of debt having maturities from one to twelve years of which US$64.2 million is the ceiling on disbursements for non-concessional debt maturing in one to five years.

On the basis of the commitments, the GODR and the IMF were able to successfully conclude negotiations for a one-year Stand-by agreement. On February 28, 1985, a Letter of Intent was signed between the two parties which makes reference to the following:

-- The net financing requirements of the public sector should decrease from 7.5% of GDP in 1984 to 4.9% in 1985.

-- The budget presented to the Congress for 1985 contained tax increases which were rejected.

-- Public enterprises would cover their current costs and gradually make an adequate return on investment.

-- The electricity company would lower generation costs from US$0.08 per KWH in 1984 to US$0.037 in 1987 by substituting coal for oil in thermal electric generation and by using hydropower. A monthly increase of 2% in rates for users of more than 300 KWH is to be applied until the deficit is eliminated. The increase in revenue from rate increases should be RD$125 million in 1985 while the export taxes should cover the remaining deficit of RD$225 million.

-- The government would intensify its efforts to improve the operations of the Price Stabilization Institute (INESPRE), reducing its deficit to RD$67 million in 1985.

-- Wage restraint would be maintained, however, some adjustments will be made and certain subsidies on basic food items will be maintained.

-- Nominal interest deposit rates would be set at between 9 1/2 to 18% per annum for financial institutions subject to regulation.

The IMF Board of Directors subsequently approved the terms outlined above for a one year Stand-by for SDR 78.5 commencing on April 15, 1985. In April, the first of four tranches was approved and all the targets specified for June 30, 1985 have been satisfied or exceeded, thereby permitting the continuation of the Stand-by.

As the GODR began to intensify its structural adjustment efforts, the Mission supported the GODR stabilization efforts by providing an FY-1984 Supplemental ESF contribution of $50 million, on December 26, 1984, on the promise that the GODR would unify the exchange rate and would undertake additional measures, including: petroleum price; electricity rates; and GODR budgetary adjustments, liberalization of interest rates, stabilization of reserve deficits, and the issuance of stabilization bonds. An additional disbursement of the FY-1985 ESF contribution of $45 million took place in

April 1985, as the GODR met and exceeded the above conditions and were undertaking negotiations for the Paris Club and commercial debt rescheduling.

3. Debt Reschedulings in 1985

Subsequent to the IMF agreement, there were two important debt reschedulings involving bilateral obligations at the Paris Club and commercial bank debt. Both of these agreements resulted in short-term relief of pressing arrears and burdensome interest and principal payments.

a. Paris Club

At the Paris Club meetings, held in May 20-21, 1985, overdue principal and interest as well as payments due through April 1, 1986, were rescheduled. The rescheduling applies to debt contracted prior to June 30, 1984, and excludes nations to whom principal and interest falling due in the reorganization period, including arrears, are less than SDR 1 million. The servicing of the covered debt divides it into two groups, that which was in arrears as of December 31, 1984, and that falling due from January 1, 1985 through April 1, 1986.

The terms of payment for the unpaid principal and interest as of December 31, 1984 are as follows:

13.5%	to be paid on December 31, 1985	(US$ 23.3 million)
11.5%	to be paid on December 31, 1986	(US$ 19.8 million)
18.75%	to be paid on December 31, 1987	(US$ 32.32 million)
18.75%	to be paid on December 31, 1988	(US$ 32.32 million)
18.75%	to be paid on December 31, 1989	(US$ 32.32 million)
18.75%	to be paid on December 31, 1990	(US$ 32.32 million)
SUB-TOTAL		US$172.4 million

Payments of principal and interest coming due from January 1, 1985 to April 30, 1986 will be paid as follows:

2.5%	to be paid on June 30, 1986	(US$ 3.175 million)
2.5%	to be paid on June 30, 1987	(US$ 3.175 million)
2.5%	to be paid on June 30, 1988	(US$ 3,175 million)
2.5%	to be paid on June 30, 1989	(US$ 3.175 million)
9%	to be paid on Feb. 15, 1991	(US$ 11.43 million)
9%	to be paid on Aug. 15, 1991	(US$ 11.43 million)
9%	to be paid on Feb. 15, 1992	(US$ 11.43 million)
9%	to be paid on Aug. 15, 1992	(US$ 11.43 million)
9%	to be paid on Feb. 15, 1993	(US$ 11.43 million)
9%	to be paid on Aug. 15, 1993	(US$ 11.43 million)
9%	to be paid on Feb. 15, 1994	(US$ 11.43 million)
9%	to be paid on Aug. 15, 1994	(US$ 11.43 million)

9%	to be paid on Feb. 15, 1995	(US$ 11.43	million)
9%	to be paid on Aug. 15, 1995	(US$ 11.43	million)
	SUB-TOTAL	US$127.0	million
	GRAND TOTAL	US$299.4	million

The debt relief obtained by the Paris Club rescheduling is estimated at approximately US$240 million in 1985 and US$60 million in 1986.

b. Commercial Bank Debt

In late 1983, based on the EFF agreement, the GODR negotiated a repayment schedule of US$454 million of medium- and short-term debt to commercial banks. However, a continuing shortage of foreign exchange forced the GODR to seek a second renegotiation in 1985. Total commercial bank arrears at the end of 1984 amounted to $79.9 million which was projected to increase to $291.9 million at the end of 1985. Completion of negotiations with an 87-bank consortium concluded June 21, 1985 an agreement in principle to rescheduling of US$786.9 million, including debt service and amortization through 1989.

The total rescheduled debt will now be paid in 13 years, with a grace period of 4 years. Interest rate has been established as 3 months U.S. dollar LIBOR plus 1 and 3/8%. The interest and amortization payment schedule is as follows:

1. For 1984/1985 included debt: 2.0% and 4.0% for the years 1988 and 1989, and 11.75% thereafter.

2. For 1986 included debt: 2 and 4% for the first two years starting 1989, and 13.42% thereafter.

3. For 1987 included debt: 2 and 4% for the years 1990 and 1991 respectively, and 15.65% thereafter.

4. For 1988 included debt: 2 and 4% for the years 1991 and 1992 respectively, and 18.8% thereafter.

5. For 1989 included debt: 2 and 4% for the years 1992 and 1993 respectively, and 23.5% thereafter.

Interest will be paid in quarterly installments commencing three months following the first conversion date for debt converted under the refinancing agreement. Estimated interest payments will be $32.1 million, $52.0 million, and $67.7 million for the years 1986, 1987, and 1988, respectively.

Amortization will be in 41 consecutive quarterly installments commencing January 1, 1988. Estimated payments will be $5.8 million, $6.8 million, and $18.5 million for the years 1988, 1989, and 1990, respectively.

Certain conditions set for refinancing include: (a) approval by National Congress of the Agreement, (b) 1985 IMF Stand-by agreement being in effect and all drawings that could have been made under the said agreement having been made, (c) all interest on included debt to be current, (d) all letters of credit affected by the May 10, 1984 Monetary Board resolution have been paid, and (e) no defaults under existing public sector loan agreements.

The stabilization/economic adjustment package consisting of the IMF Stand-by and the two debt reschedulings represents a major step forward after fourteen months of difficult GODR actions, domestic uncertainty and instability, and very tought negotiations. The GODR, the IMF, the commercial bank, and the U.S. government worked together to achieve this result which averted a much more serious financial crisis and laid the foundation for the approach advocated in this paper.

4. The Performance of the Dominican Economy in 1985

Based on the June-August 1985 IMF review of Dominican economic performance, the GODR not only undertook the specific measures to which they had agreed, but their overall performance exceeded all expectations of USAID, the IMF, and the commercial banks. For example, net domestic assets declined, fiscal revenues increased, expenditures decreased, the peso maintained its value, the money supply remained generally constant, and commercial bank credits to the public sector remained steady, but increased to the private sector. As a result of the GODR's impressive performance, the IMF staff will recommend disbursement of the third quarter tranche.

However, as may be expected, the overall economic performance of the Dominican Republic reflects the contractionary impact of the financial stabilization program. Although data are still incomplete, some indicators show how the economy has responded to exchange rate unification and complementary measures. This section examines briefly several of these indicators.

a. Production

Production fell during the first half of 1985. For the first six months of the year, the Central Bank estimated a change in GDP as -1.9%, while during the same period of the previous year, GDP increased by about 0.8%. The principal sectors contributing to the fall in production during the first six months of 1985 are: (1) agriculture/animal products, (2) manufacturing, and (3) construction whose growth rates were estimated at, respectively, -4.5%, -3.4%, and -8.5%.

Crop production fell -4.4% due to drought. Especially noteworthy is a -16.0% loss in rice production following a -3% reduction in the same period a year earlier. Rice also suffered from increased production costs, credit restrictions, and delays in payments from INESPRE. Sugar cane, constituting 30% of production within the agricultural sector, declined by 9.9%, due to the unfavorable world sugar prices and generally poor marketing prospects. If sugar were excluded, agricultural production would have registered a 1.8% reduction. Some sugar land has been converted to other crops and this trend is expected to continue.

Animal products component registered a decrease of 5.3% in the first half of 1985. This is primarily due to poultry, milk, and egg production which declined, respectively, by 3.2%, 18.7%, and 4.9%. Due to price controls, these activities are no longer profitable, with producer prices currently below production costs for both chickens and milk. Cattle production increased by 5.4% as expectations continue of gaining entry to the U.S. market. Swine production increased by 35% following 187% last year.

Manufacturing activities, which decreased by 3.1% in the first semester, were affected primarily by declines in the production of sugar mills, rum, cement, milk, and soya oil. Paint production increased by 45.7% mainly due to speculation of higher prices.

The fall in construction activity by 8.5% is consonant with a stabilization policy of establishing realistic interest rates. It is interesting to note that public construction appears to be greater in the first half of 1985 than in the same period of 1984 due to the continuation of public housing projects, social infrastructure, and the Duarte Highway construction.

Electricity figures show increased consumption of 5.0% in the first half of 1985 in relation to the same period a year earlier. This apparent increment may be more closely connected to the metering of consumption by public institutions than an actual increase in usage. Given the magnitude of electricity price increases and the general performance of the economy, a real increase in electric consumption is quite unlikely.

For the whole year, official Central Bank estimates project a decrease in real GDP of about -0.7%. In this paper a growth rate of 0% is utilized, which is derived from the earlier Central Bank figures and updated based on recent rains which the Mission believes will increase overall agricultural production in 1985.

b. External Sector

During the first six months of 1985, foreign exchange receipts for commodity exports have fallen by 18.1% (from US$509.2 million to US$417.2 million) relative to the same period of 1984. The overall decrease in export revenues in the January to June period was expected, and the decrease of US$92.0 million in export receipts is partially explained by a drop in raw sugar sales of US$47.6 million. The poor performance of sugar is due to a 29%

cut in U.S. quota and to lower prices. Other traditional exports, particularly tobacco and gold, also showed general declines in export receipts.

For the year 1985, exports are estimated at US$783 million, a decrease of 11% from the preliminary figure of US$872.9 million for 1984. This is considered a conservative estimation for 1985, and could be surpassed if the export increases registered in April and May continue in the last seven months of the year.

Imports, on the other hand, decreased by only US$23.3 million in the first six months of 1985. This is primarily due to lower petroleum imports as a result of domestic price increases. The Institute for Price Stabilization (INESPRE) has also reduced its food imports. For the year 1985, imports are projected to decrease by about 4%.

Important debt relief has been obtained in 1985, principally through the Paris Club and commercial bank renegotiations following the approval of a Stand-by agreement by the IMF. The ESF support has also been very important. While there is relief for 1985 and the pressure on the foreign exchange side has been alleviated somewhat for 1986, continued Paris Club renegotiations may be necessary along with other forms of future debt relief until exports show significant increases. The sooner exports increase, the better will be the prospects for a normalization of the external sector and, in turn, for reassuming a path of growth and development.

c. Prices

As can be seen by examining Table I, the consumer price index has shown strong increases in 1984 and the first six months of 1985. During 1985, strong price rises accompanied the unification of the exchange rate and the adjustment of prices for goods and services. After the initial impact of the measures, the rate of increase declined sharply in March and April, but increased again during the months of May and June based on expectations of crop reduction due to drought. Now that the drought is over, the CPI is expected to continue at the rate observed in March and April (about a 1.35% monthly increase) for the rest of 1985. The December 1985 CPI would be at 310.21, representing a point to point (December 1984 to December 1985) inflation rate of 26.9%. If the rate is calculated by the more commonly used twelve month averages for 1984 and 1985, the 1985 CPI would be 287.74%, giving an inflation rate of 36.8%.

TABLE I

Consumer Price Index in the Dominican Republic
(BASE: 1976 - 1977 = 100)

Year/Month	CPI	Inflation (%) Annual	Inflation (%) Monthly
1978	107.11	7.11	
1979	116.93	9.17	
1980	136.53	16.76	
1981	146.81	7.53	
1982	158.02	7.64	
1983	168.97	6.93	
1984	210.27	24.45	
December 1983	173.53		
January 1984	179.51		3.45
February 1984	187.19		4.28
March 1984	185.75		-0.77
April 1984	189.84		2.20
May 1984	197.68		4.13
June 1984	206.97		4.70
July 1984	211.55		2.21
August 1984	215.45		1.84
September 1984	224.61		4.25
October 1984	238.12		6.01
November 1984	242.08		1.66
December 1984	244.47		0.99
January 1985	259.21		6.03
February 1985	271.30		4.66
March 1985	274.58		1.21
April 1985	278.67		1.49
May 1985	286.06		2.65
June 1985	293.04		2.44

SOURCE: Central Bank of the Dominican Republic.

d. Exchange Rate

An official exchange rate of RD$1 = US$1 prevailed for many years, but throughout the decade of the 1970s there existed a parallel market in which a premium of 10% to 30% was paid for the dollar. With growing balance of payments deficits in the 1980s, the peso came under increasing pressure to devalue. In 1980, the premium remained near 25% but increased to 33% by January 1982, and reached 50% in October 1982. The buying rate for the dollar was over RD$2 throughout 1984, occasionally reaching and surpassing RD$3. In early 1985, all transactions were transferred to a freely operating market where the purchasing price for the dollar initially was about RD$3.30 in the first quarter of the year. Toward the middle of 1985, the exchange rate dropped slightly below RD$3 = US$1, reflecting several factors:

— Renewed optimism due to the success of the stabilization policies (all the IMF June 1985 targets were met or exceeded), and signs that the economic recession may have passed its lowest point.

— Capital inflows which may represent the return of funds which previously left the economy. These are hypothesized to come from Dominicans abroad, who are investing in the country with the aim of eventually returning.

— Lower petroleum prices and prospects of continued decreases.

— Successful rescheduling of the bilateral debt in the Paris Club in May 1985 and the commercial bank debt in June 1985.

While the above factors do not constitute firm evidence that the economic recession has bottomed out (and many severe problems remain), the fall in the price of dollar relative to the peso does reaffirm a guarded optimism that stabilization measures are succeeding, thus reducing inflation and permitting an expansion of diversified export-led growth by non-traditional products. Although much remains to be done, the initial signs are encouraging for the establishment of an overall framework for economic growth and recovery.

e. Public Finances

During the first semester of 1985, the net central government surplus was RD$35.9 million (current revenues were RD$792.8 million and current expenses were RD$756.9 million), compared to a deficit of RD$41.3 million during the same six month period a year earlier when current revenues were RD$504.5 million and expenses RD$545.8 million. The increase in incomes is principally due to increments in revenues on foreign trade, higher direct taxes and increased collection from indirect taxes, while increased expenses reflected, among other payments, higher wages and salaries by RD$24.0 million (due to the increased minimum salary and 2,775 more central government employees), additional payments for non-personal services of RD$30.6 million (a large part is for electricity payments), RD$172.7 million for transfers to public sector institutions (principally subsidies to INESPRE, CDE, and Molinos Dominicanos), and RD$27.2 million more for interest payments on the foreign debt.

The Jorge Blanco government has come under increasing pressure to raise the wages and salaries of the public sector workforce. Although the President consented, this was conditioned upon the legislative branch raising revenues sufficient to cover the increases without deficit financing. The Congress refused to pass the necessary revenue package, and the President finally consented to a wage increase for the rest of 1985 (announced on July 8, 1985) to be financed from deposits of the State Mining Company, Rosario Dominicana, in 1985. The continuation of the higher wages in subsequent years was again conditioned upon financing through increased revenues.

Probably the most onerous drain on the public sector is the deficit sustained by the public enterprises. The current deficit of the three major public enterprises (Dominican Electricity Corporation--CDE, Price Stabilization Institute--INESPRE, and State Sugar Company--CEA) could exceed RD$300 million in 1985. If the capital spending is included, the overall deficit will exceed RD$700 million, requiring substantial subsidies. The overall deficit is expected to be covered through transfers of about RD$750 million from the central government, of which RD$712 million is expected to be covered by the temporary export surcharge.

Of the public enterprises, perhaps the one with the greatest problems is the CDE. It was traditionally subsidized through its access to petroleum imports at the official exchange rates plus transfers from the central government. With the unification of the exchange rate on January 23, 1985, tariffs were raised by approximately 50% and are projected to increase by 2% monthly for users of more than 300 KWH until the deficits are eliminated. In the meantime, CDE will receive 33.5% of the temporary export tax to cover its deficit. Between January and June 1985, this amounted to RD$117.3 million.

It is important to note that CDE's problems run much deeper than simply the sale of cheap electricity. Historically, its collection procedures have been deficient and it has been discouraged from seeking more efficient operations and cheaper sources of fuel by the assurance of ample subsidies. In reference to collections, the difference between electricity generated and billed has varied from 21% to 27% during the decade of the 1970s. In the 1980s, this deteriorated to 28.7% in 1981, to 33.7% in 1982, to 37.5% in 1983, and was 31.0% in 1984. Although normal transmission losses might be expected to be about 15% in the Dominican Republic (compared to about 10% in the U.S.), the rest of the loss is largely related to unbilled consumption. This has been due to failures to bill some users (principally from the public sector) and outright fraud for many residences, and commercial and industrial establishments, which avoid the metering of part or all of their consumption. During 1984 and the first part of 1985, the public sector was required to pay for its electricity (although not necessarily on time) and measures were taken to combat residential, industrial, and commercial fraud. Although these results are reflected in the decline in unbilled electricity, much remains to be done.

A related problem concerns delinquent accounts. Many users pay late or not at all. In 1984, some 11.4% of the electricity billed was not paid. This percentage increased to 20.0% during the first five months of 1985, but this increase may be due to later payments of the sharply increased rates in effect this year. In combining losses with unpaid bills, only 57% of distributed electricity was covered by payments during January to May 1985, as compared to 59% during the same period in 1984. The collection procedures appear to be improving gradually. USAID is currently providing assistance to CDE and proposes to step up this support. CDE is also giving increased attention to coal and the D.R.'s hydro-electric possibilities, and recently announced to the IMF that it expects to cut generating costs in half by 1987. Although this may be a very optimistic goal, its pursuit is worthwhile.

The Institute for Price Stabilization (INESPRE) has also required extensive subsidies, both through direct budgetary support and through imports at subsidized exchange rates. As may be expected, INESPRE has contributed to low agricultural production since it is basically a monopsonistic buyer of certain crops. At the same time, there is a larger demand for some subsidized grains than is supplied by local producers. This has often forced imports, sometimes at world market prices implicitly subsidized by "official" exchange rates and, at other times, by PL-480 assistance. Net subsidies to INESPRE in 1985 are projected at RD$35 million in 1985.

The State Sugar Corporation (CEA) has required an RD$68.2 million transfer in 1985, and has undertaken an advance sale of a portion of next year's crop, receiving another RD$42.5 million. Thus, CEA's general deficit is being financed through the roll-over of current capital, overall domestic price increases, advance sales, and transfer payments.

The Corporation of State Enterprises (CORDE) projects a small 1985 surplus; however, the performance of various companies within the CORDE is extremely unbalanced. In achieving an overall surplus, the relatively more efficient companies, such as the tobacco companies, must subsidize the more inefficient, such as the cement company.

f. Savings and Investment

There is little concrete information concerning the performance of savings and investment during the first part of 1985. Public investment could increase strongly if investments in the pipeline for external financing are undertaken. On June 30, 1984, undisbursed, but contracted, external debt reached US$738 million, up by 16% from the US$635 million figure of a year earlier. However, an increased utilization of these funds would necessitate a more receptive attitude by Congress to approve additional external financing. Such an attitude appears unlikely as Congress has refused to ratify several important credits.

On the private side, there appears to be ample interest in expanding investments. The unification of the exchange rate makes investments in export industries look especially attractive. Nevertheless, domestic credit is severely restricted due to the stabilization measures. This widespread problem applies to both credit to support working capital as well as financing for investment projects.

The liberalization of interest rates early in 1985 has contributed to a better balance between savings deposits and loans; the maximum interest payable to savers of 18%, while still negative when compared to short-term inflation, provides a better incentive to save. Since the projected average inflation rate for the second half of 1985 is 1.35% per month, the annual rate of inflation beginning on July 1, 1985 would be 17.4%, converting a nominal interest rate of 18% to a real rate of 0.6%, a small but positive rate. The going loan rate of 24% - 26% is sufficiently high to discourage low return investments.

In addition to the formal financing institutions, there are numerous small financial intermediaries which capture savings and make loans at much higher interest rates. The fact that these institutions are engaged in extremely short-term, high risk money lending activities is evidence that the 24%-26% nominal rate is sufficient for longer term capital investment.

g. Monetary Policy

In the past, monetary policy in the Dominican Republic has been erratic, varying from expansionary to extremely tight. Periods of tight money often accompanied attempts to obtain support from the IMF or to remain in compliance with IMF-supported programs. Since January 1985, monetary policy could be characterized as extremely tight. This is principally due to the restriction on the expansion of net domestic assets by the Central Bank. These must show no increase over the 12 months of 1985. However, this restriction does not prevent the purchase of foreign currency needed to meet external obligations. While the purchase of foreign exchange would not, in itself, violate the Stand-by agreement, it would have undesirable inflationary consequences if accompanied by expansion of the money supply. Central Bank authorities show considerable concern about the possibility of having to purchase large amounts of foreign exchange in the open market to pay obligations coming due at the end of 1985. These purchases could drive up the exchange rate, thus contracting imports and, in turn, production. Offsetting factors could be the continued inflow of what appear to be strong capital flows from abroad and a drop in oil prices.

h. Social Cost of the Economic Crisis

Although there is no one indicator of the suffering associated with an economic crisis of the magnitude faced by the Dominican Republic, an idea of its impact on lower income people may be seen by comparing the minimum wage with the consumer price index. Of course, this indicator does not take into consideration the effects of the crisis on those who are not subject to minimum wage legislation, in particular the unemployed, underemployed, and employed in what has come to be known as the informal sector. The national CPI was used as a deflator of the minimum wage even though it would have been better to use the CPI adjusted for low income earners. The adjusted CPI would have yielded slightly higher increments in living costs for the lowest income groups and, therefore, would also show a more marked deterioration in the purchasing power of the minimum wage.

In Table II, it can be seen that the purchasing power of the minimum wage has demonstrated a decline from the base years of 1976/1977 to 1985. The largest drops correspond to the 1980s, especially in 1982 and 1983. While a minimum wage increase in 1984 improved purchasing power in that year relative to the year before, the country is projected to lose additional purchasing power in 1985. The latter projection takes into consideration the assumption of a RD$250 minimum monthly wage from July to December 1985, and the continuation of the observed inflation rates in March and April for the rest of the year.

Even though the estimates contained in Table II are subject to large errors, a decline in the purchasing power by low income earners of anywhere near 20% is indeed a serious matter. This figure is indicative not only of suffering but also of a social situation which could be disruptive unless the introduction of new stabilization measures is carefully planned to avoid an undue burden on low income groups. While the low purchasing power resulting from the impacts of the measures taken in January 1985 appears to have been alleviated by the wage increase of July (see footnote 5, Table II), an increase in the projected rate of inflation could easily lower the purchasing power again.

Unemployment is also a serious problem with open unemployment having been estimated at 24.8% in November 1984. This is the highest percentage registered since 1969, when it reached 27.7%. In 1983, open unemployment was estimated at 21.7% of the labor force. Of an increase in the labor force of 87,000 persons in 1984, the National Survey of Family Incomes and Expenditures estimates that only 7,600 found full time work.

TABLE II

DOMINICAN REPUBLIC: The Minimum Wage in the National District and Its Purchasing Power, 1976 to 1985

Year	Minimum Wage 1/	Index	CPI	Index (Minimun Wage/CPI) 2/
1976/1977	RD$ 95	100.0	100	100
1978	RD$ 95	100.0	107.11	93.4
1979	RD$115	121.1	116.93	103.5
1980	RD$125	131.6	136.53	96.4
1981	RD$125	131.6	146.81	89.6
1982	RD$125	131.6	158.02	83.3
1983	RD$125	131.6	168.97	77.9
1984	RD$158	166.3	210.27	79.1
1985	RD$212 3/	223.2	287.74 4/	77.6 5/

1/ Weighted in years of new minimum wage laws.
2/ 1976/1977 = 100.
3/ Assumed to remain at RD$250 during the last half of 1985.
4/ Assumes the inflation rate during the months of May to December follows the average of the March/April rates.
5/ At a minimum wage of RD$175 and CPI of 275.40 during the first half of 1985, the index would be 66.9, rising to 87.7 during the last half of the year as the minimum wage is assumed to be RD$250 and the CPI 300.10.

C. Perspectives and Problems

1. Scenario of the Dominican Economy to 1990

In order to provide an approximation of how the USAID/DR program may contribute to an improvement in the economic performance of the Dominican Republic, this section offers a scenario of a possible recovery from the economic crisis. The scenario was developed by the U.S. Mission and AID/W consultants in consultation with the Central Bank of the Dominican Republic and the International Monetary Fund (IMF). Most of the results are from tentative IMF staff estimates with Mission modifications consisting of:

— A lower estimate of imports and GDP growth for 1985, with the latter forecast being revised downward to 0%. a/

— Changes in the amount of ESF support which, in turn, affects transfers in the current accounts of the balance of payments. Other modifications are also made in USG projected assistance.

— Some minor changes in selected items in the current and capital accounts, as well as in the form of financing the overall balance of payments deficit.

Keeping in mind the tentative nature of the scenario, it affords an idea concerning what may be required to achieve economic recovery. The scenario makes explicit assumptions concerning the necessary performance of major macro-economic variables to attain an improvement. Even then, certain major problems remain, especially in the external sector and more specifically with the need to find additional external financing or to give an even greater stimulus to exports than that outlined in the scenario.

The most important assumptions embodied in the scenario presented in Tables III to X for the years 1985 to 1990 are (all these assumptions affect the general macroeconomic simulation of Table VII):

— Real GDP will grow modestly during the rest of this decade. It will remain stagnant in 1985, and then increase by 2.0% to 2.5% annually during 1986/1990. This is a result of the adjustments needed to pass from an inefficient import substitution orientation to an export led economy. Upon this basis, much higher growth rates are expected in the next decade (see Table III).

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a/ The latest Central Bank economic report based on January-June 1985 data estimates GDP growth at -0.7%, primarily due to the drought during May-July. However, heavy rains in August and September ameliorated this situation somewhat, and USAID maintains no GDP growth for 1985.

-- Exports are expected to increase by an annual average growth rate of 4.4% from 1985 to 1990 with non-traditional exports growing by 17.0% yearly (see Table V). Due to poor price prospects and generally unfavorable marketing conditions, traditional exports will lag far behind the non-traditional commodities. Exchange receipts for traditional agricultural exports will only increase by an average of 4.9% annually from very depressed levels, reflecting only slight improvements of generally low prices. Major mineral exports are expected to suffer declines in their yearly average foreign exchange revenues of 7.9% over the 1985 to 1990 period. No bauxite sales are projected, and gold alloy exports are expected to disappear. If current studies show that expanded gold mining operations are commercially viable, this could greatly affect the export earnings of the mineral sector; at present, this looks doubtful due to the $300 million capital investment and even more so when reserves of the State Mining Company were used to pay for a wage increase of public employees, thus reducing the possibility of obtaining counterpart funds for new investments.

-- Under these circumstances, non-traditional exports are projected to increase their participation in total export sales from 14.7% in 1985 to 26.0% in 1990. It is important to noten that, for purposes of the scenario, non-traditional exports are defined as those which exclude the agricultural and mineral exports listed in the first two commodity groups of Tables IV and V. This definition is somewhat different than that utilized by CEDOPEX, which includes certain processed agricultural products and minerals as "non-traditional" exports. These are considered as "traditional" in the scenario.

-- Imports are expected to remain depressed due to measures being taken to improve the balance of payments. Table VI shows that they declined, expressed at origin (FOB) as opposed to border (CIF) prices, from US$1,451.7 million in 1981 to US$1,255.0 million in 1984, which represents a fall in relation to GDP (using 1985 prices and an exchange rate of RD$3 = US$1) of 31.6% in 1981 to 25.1% in 1984 (see Table X). In subsequent years, it is assumed that debt service rescheduling and a gradual recuperation of exports will permit imports to rise from a low point in 1985 of US$1,190 million (see Table VII) or 21.3% of GDP (Table X) to US$1,556 million in 1990 which represents 28.2% of GDP.

-- ESF support is projected at US$60 million in 1986 and US$50 million annually from 1987 through 1990. As can be seen in Table VII, this is an important contribution to the balance of payments.

- An increase in the export of overall services, primarily of tourism, by an average of 6.8% per year over the 1985 to 1990 period (see Table VII). As is well known, increased revenues from tourism depend closely on the maintenance of political stability. This is assumed in the current scenario.

- Disbursements of medium- and long-term credits as shown in Table VIII. This table projects AID (non-ESF funded assistance since ESF funds are shown as grants in the current account) and PL-480 loans. The San José petroleum credits are assumed to continue to 1986.

- Amortizations of medium- and long-term credits are shown in Table IX. New borrowings do not have a great impact on amortizations since most are assumed to be accompanied by grace periods.

- The Central Bank is assumed to increase its gross reserves by US$100 million per year from 1987 to 1990, permitting a sounder financial position and a potential cushion against an unforeseen problem.

- IMF repurchases constitute an important drain from 1987 to 1990. Since all are "below the line", they are not depicted as capital flows.

- The effects of the Paris Club and commercial debt relief are shown in the next to last line. The relief becomes negative in 1988 due to new interest and repayments of capital. This net impact will even be more negative in the next decade, as amortization payments to commercial banks become greater.

Even with the debt relief of 1985, there are financing gaps in every year from 1985 to 1990, except 1987. The Central Bank has expressed its hope of receiving all of FY-1986 ESF support in November 1985, thus partially alleviating the US$67 million gap this year (but aggravating next year's problems). Another possibility of filling the gap may be through a continuation of large capital inflows by a return of funds which previously left the country.

The gaps from 1986 to 1990 can be covered by another Paris Club rescheduling in 1986 and possibly in other years, new credits, lower reserve accumulations from 1987 to 1990, and possibly by lower imports. The scenario poses a danger in that debt service will continue to be heavy through the next decade, especially to the commercial banks.

Key to the success of the scenario is the increase in non-traditional exports and service earnings from tourism development and free trade zone expansion. They must continue to grow into the next decade at high rates. If this does not occur, the external sector will show serious disequilibria, which will affect gravily the nation's productive abilities.

The scenario makes a fundamental assumption regarding USG assistance—that is, any decrease in this assistance, not compensated by other means, could have very serious consequences for the Dominican economy, as this support permits needed imports during the transition period. Not only is the magnitude of this assistance important, but the ability of US-sponsored programs to increase exports is crucial to the nation's recovery as presented in the scenario. Since it is generally expected that traditional exports will not show important gains, non-traditional exports are considered the major hope of generating growth in the rest of this decade and in the 1990s. Specific support to non-traditional exports is embodied in the Mission's private sector investment/export development program and its agricultural diversification program.

The FY-1986 ESF support, estimated at US$60 million, is considered crucial since, without it, the financing gap would be projected at US$145 million, an amount which would be difficult to finance without reducing imports to a level which might endanger the recovery plan. It is believed that the residual US$85 million gap could be financed through additional Paris Club relief, complemented by new credits. The GODR will be under severe balance of payments pressure in 1986.

If the export led strategy is successful, ESF support could be decreased and phased out in the early 1990s. A more rapid transition than presented in this scenario would permit the phasing out to begin toward the end of the 1980s, but this is not considered likely.

TABLE III

DOMINICAN REPUBLIC: Gross Domestic Product
1981 to 1990
(In RD$ Millions)

Year	Current Prices	Constant Prices (1970)	Rate of Growth	
			Nominal	Real
1981	7,210.2	3,019.8	8.7	4.0
1982	7,917.5	3,070.9	9.8	1.7
1983	8,772.6	3,192.5	10.8	3.9
1984	10,965.8	3,211.5	25.0	0.6
1985	15,000.0	3,211.5	36.8	0.0
1986	16,500.0	3,280.0	10.1	2.0
1987	18,300.0	3,350.0	10.9	2.4
1988	20,100.0	3,420.0	9.9	2.1
1989	22,000.0	3,500.0	9.5	2.3
1990	24,100.0	3,590.0	9.3	2.5

SOURCE: GDP figures for 1981/1984 and growth rates for 1986/1990 are from the Central Bank of the Dominican Republic.

TABLE IV

DOMINICAN REPUBLIC: Exports by Principal Products
1980 to 1984
(In US$ Millions)

	1980	1981	1982	1983	1984
Traditional Agric. Exports	498.9	753.6	487.2	460.3	525.9
Raw Sugar	(290.2)	(513.2)	(265.5)	(263.6)	(275.5)
Refined Sugar & By-Products	(40.5)	(47.2)	(43.1)	(35.4)	(48.1)
Unprocessed Coffee	(51.8)	(62.2)	(90.6)	(76.3)	(95.1)
Processed Coffee	(25.0)	(13.6)	(5.0)	(0.1)	-
Raw Cocoa	(51.1)	(44.8)	(52.9)	(55.5)	(70.1)
Processed Cocoa	(4.7)	(5.3)	(6.1)	(5.4)	(6.7)
Tobacco Leaf	(34.8)	(65.6)	(21.4)	(21.8)	(24.2)
Tobacco Products	(0.8)	(1.7)	(2.6)	(2.2)	(6.2)
Major Mineral Products	379.4	334.1	193.0	248.0	240.3
Bauxite	(18.5)	(15.7)	(5.2)	-	-
Ferronickel	(101.3)	(110.5)	(24.2)	(83.5)	(108.5)
Gold Alloy	(225.5)	(186.4)	(146.6)	(149.5)	(122.1)
Silver Alloy	(34.0)	(21.5)	(17.0)	(15.0)	(9.7)
Other Exports (Non-Traditional)	83.7	100.3	87.3	76.9	105.5
TOTAL	961.9	1,188.0	767.5	785.2	871.7

SOURCE: Central Bank of the Dominican Republic.

TABLE V

DOMINICAN REPUBLIC: Projections of Exports
by Principal Products, 1985 to 1990
(In US$ Millions)

	1985	1986	1987	1988	1989	1990
Traditional Agric. Exports	454.2	476.2	503.9	528.3	552.0	576.0
Raw Sugar	(185.3)	(193.5)	(195.2)	(196.1)	(197.6)	(199.7)
Refined Sugar & By-Products	(66.3)	(72.9)	(80.2)	(88.2)	(97.1)	(106.8)
Unprocessed Coffee	(86.9)	(92.7)	(95.5)	(101.4)	(104.4)	(107.6)
Processed Coffee	(0.1)	(0.1)	(0.1)	(0.1)	(0.2)	(0.2)
Raw Cocoa	(64.6)	(60.2)	(67.8)	(71.8)	(76.0)	(78.3)
Processed Cocoa	(8.8)	(12.0)	(12.5)	(13.0)	(13.5)	(14.0)
Tobacco Leaf	(31.8)	(32.8)	(40.6)	(45.2)	(50.2)	(55.4)
Tobacco Products	(10.4)	(12.0)	(12.0)	(12.5)	(13.0)	(14.0)
Major Mineral Products	214.1	222.0	225.7	229.6	136.2	142.2
Bauxite	-	-	-	-	-	-
Ferronickel	(108.2)	(112.6)	(117.9)	(123.4)	(129.2)	(135.2)
Gold Alloy	(99.4)	(102.4)	(100.8)	(99.2)	-	-
Silver Alloy	(6.5)	(7.0)	(7.0)	(7.0)	(7.0)	(7.0)
Other Exports (Non-Traditional)	115.0	134.6	157.4	184.2	215.5	252.1
TOTAL	783.2	832.7	386.9	942.2	903.7	970.2

SOURCE: Central Bank of the Dominican Republic and IMF.

TABLE VI

DOMINICAN REPUBLIC: Balance of Payments
1981 to 1984
(In US$ Millions)

	1981	1982	1983	1984
Current Account	-405.9	-442.0	-421.1	-219.2
Trade Balance (Goods)	-263.7	-489.7	-497.0	-380.7
Exports, FOB	(1188.0)	(767.6)	(785.2)	(872.0)
Imports, FOB	(-1451.7)	(-1257.3)	(-1282.2)	(-1252.7)
Services (Net)	-335.2	-157.3	-139.1	-105.5
Interest Component	(-304.9)	(-285.5)	(-304.0)	(-269.0)
Transfers (Net)	193.0	205.0	215.0	267.0
Capital Account	296.3	85.7	68.4	89.0
Direct Investment	79.7	-1.4	22.0	68.0
Disbursements (Medium-/Long-Term)	320.2	355.8	248.7	324.0
Amortizations	-166.6	-205.3	-224.6	-290.0
Other 1/	63.0	-63.4	22.3	-13.0
Financing	109.6	356.3	352.7	130.2
Change in Central Bank Assets 2/	-8.3	111.1	-31.9	-92.0
Change in Central Bank Liabilities 3/	117.9	245.2	90.1	
Use of IMF Credit	(-25.5)	(48.6)	(174.6)	
Arrears	(166.8)	(119.9)	(-67.4)	
Other Liabilities	(-23.4)	(76.7)	(-17.1)	
Arrears Outside Central Bank	-	-	142.6	220.2
Debt Relief	-	-	151.9	-
Financing Gap	-	-	-	-

SOURCE: Central Bank of the Dominican Republic.

1/ Includes SDR allocation in 1981, short-term public and private capital (net), gold revaluation and monetization, and errors and omissions (net) through 1984.
2/ Increase (-).
3/ Decrease (-).

TABLE VII

DOMINICAN REPUBLIC: Balance of Payments Projections 1985 to 1990 1/ (In US$ Millions)

	1985 5/	1986 5/	1987	1988	1989	1990
Current Account	- 107	- 34	- 20	- 5	- 86	- 80
Trade Balance (Goods)	- 407	- 419	- 436	- 455	- 571	- 586
Exports, FOB	(783)	(833)	(887)	(942)	(904)	(970)
Imports, FOB	(-1190)	(-1252)	(-1323)	(-1397)	(-1475)	(-1556)
Services (Net)	- 40	58	87	109	130	137
Of which Exports	(560)	(648)	(690)	(735)	(783)	(833)
Of which Interest	(- 255)	(- 239)	(- 233)	(- 237)	(- 250)	(- 272)
Transfers (Net)	340	327	329	341	355	369
ESF Component	(85)	(60)	(50)	(50)	(50)	(50)
Capital Account	- 117	- 75	39	110	220	283
Direct Investment	(42)	(50)	(60)	(65)	(70)	(75)
Disbursements(Medium/Long-Term)	(264)	(258)	(312)	(324)	(330)	(352)
Amortizations	(- 423)	(- 383)	(- 333)	(- 279)	(- 180)	(- 144)
Overall Balance	- 224	- 109	19	105	134	203
Net Change Central Bank Assets 2/	- 67	- 20	- 100 3/	- 100 3/	- 100 3/	- 100 3/
IMF Resources	(29)	(- 22)	(- 49)	(- 44)	(- 64)	(- 48)
Of which Purchases	(61)	(17)				
Of which Repurchases	(- 32)	(- 39)	(- 49)	(- 44)	(- 64)	(- 48)
Arrears (-Reduction)	- 108	- 100				
Financing Gap Before Debt Relief 4/	-399	- 229	- 81	5	34	103
Net Impact of 1985 Debt Relief	308	144	93	- 53	- 62	- 120
Financing Gap After Debt Relief 4/	- 91	- 85	12	- 48	- 28	- 17

SOURCE: Central Bank of the Dominican Republic, IMF, and AID.

1/ Includes estimations of debt relief in 1985.

2/ Increase (-).

3/ Assumes increase in gross reserves of US$100 million per annum.

4/ Surplus (+).

5/ These figures are based on the Mission estimates of BOP, reported in Santo Domingo 10884, and therefore differ slightly from the Central Bank BOP data.

TABLE VIII

DOMINICAN REPUBLIC: Disbursements of Medium- and Long-Term Loans, 1986 to 1990
(In US$ Millions)

	1985	1986	1987	1988	1989	1990
Bilateral	126.0	132.1	96.5	98.0	99.5	101.1
U.S.						
DA Loans	10.0	27.0	35.0	35.0	35.0	35.0
PL-480	38.0	30.0	30.0	30.0	30.0	30.0
San José						
México	27.0	20.1				
Venezuela	26.0	29.9				
Other	30.0	27.1	31.5	33.0	34.5	36.1
Multilateral	93.0	100.6	192.0	203.0	209.0	214.0
IDB	75.0	60.0	145.0	150.0	150.0	150.0
IBRD	15.0	34.0	40.0	45.0	50.0	55.0
FAO	3.0	6.6	7.0	8.0	9.0	9.0
Suppliers' Credits	40.0	23.0	23.0	23.0	22.0	37.0
TOTAL	264.0	257.7	311.5	324.0	330.5	352.1

SOURCE: IMF (preliminary figures) and AID projections.

TABLE IX

DOMINICAN REPUBLIC: Amortizations of Medium- and Long-Term Debt, 1985 to 1990 1/
(In US$ Millions)

	1985	1986	1987	1988	1989	1990
Bilateral	160	147	120	78	63	53
Commercial Banks	212	181	151	127	36	4
Multilateral	23	28	29	37	40	46
Other	28	14	10	10	9	9
Amortization New Borrowings	0	13	23	27	32	32
TOTAL	423	383	333	279	180	144

SOURCE: IMF (preliminary figures)

1/ Before debt relief in 1985.

TABLE X

DOMINICAN REPUBLIC: Basic Indicators of the Scenario 1981 to 1990 (Percentages)

Year	Debt Service / Exports	Imports / G D P
1981		31.6
1982		26.2
1983		25.8
1984		25.1
1985	34.3	21.8
1986	39.0	23.7
1987	30.0	24.6
1988	33.9	25.9
1989	29.2	27.0
1990	29.7	28.2

2. Developmental Constraints

This section of the paper discusses development constraints in seven broad policy areas. For each policy area, principal constraints are described, together with a summary of actions recently taken. Needed actions that remain to be taken are analyzed, and priorities for inclusion in AID's policy dialogue agenda are identified.

a. Exchange Rate Practices

Since exchange rate unification during January 1985, the main remaining multiple exchange rate practices are exchange taxes of 36% on traditional exports and some services, 5% on non-traditional exports, and a tax of 18% plus surtax of 3% on repatriation of earnings from foreign investments. The somewhat arbitrary imposition of these exchange rate taxes creates uncertainty in the business community, contributes to a lack of confidence in equitable government administration, creates economic distortions, and fosters inefficiency.

Removal of the exchange taxes should be a priority concern of the GODR. Removal should be phased according to determinations of the effect of these taxes on the international competitiveness of the country's exports, as well as overall fiscal requirements.

Revenue losses of some RD$15 million annually that would result from removal of the 5% exchange tax on non-traditional exports is minimal compared to the potential incentive impact that removal would have on the expansion of such exports. Even though the 5% tax may not have unduly affected profitability of existing enterprises during 1985, projections of its impact in future years have likely deterred the implementation of new projects, since it significantly lowers expected rates of return.

The GODR has an understanding with the IMF on the magnitude and timing of reductions of the 36% exchange tax on traditional exports, as public sector fiscal circumstances improve. Moreover, to the extent that the temporary application of these taxes to traditional exports, such as sugar, encourage diversification into more efficient non-traditional agricultural activities, complete removal of these taxes during 1986 may not be warranted, despite the fact that the Dominican Republic has a clear competitive advantage in the production of these crops were international markets not distorted by unrealistically high price support programs and quota systems practiced by the major industrial country purchasers.

The taxes and surtaxes on repatriation of dividends deter foreign investment in the Dominican Republic, as compared to countries not imposing such taxes. Since legislation is required for removal, however, it is not very likely that serious consideration for removal is feasible at this time. The issue is an element of the U.S. country team's ongoing policy dialogue agenda, and will be included in the Economic Policy Analysis and

Training Project's program of analyses of needed reforms in the tax and industrial incentives systems.

b. Import Tariff Structure and Customs Administration

Import prohibitions and quantity restrictions, together with a system of high tariffs, have provided monopolistic protection to many inefficient import substitution industries. This has resulted in high prices for domestically produced consumer goods and the local inputs of exports. The tariff system is complex to administer, as it is based on a large number of cumulative laws dealing with specific and *ad-valorem* tariffs modified by special industrial incentive exonerations, draw-back schemes, and the like. The complexity of the set of laws that define the tariff structure is a major administrative problem at the Customs Offices, and results in arbitrary application of customs administration. The major tariff laws are: Main Tariff Law 170, Law 173, Law 361, Law 136, Law 346, Law 597, Law 48, Law 71, and Law 211.

Due to the complexity of the tariff structure, the process of customs classification, valuation, and assessment is often arbitrary. The tariff and customs regime should be consolidated into a single law, with a view to rationalizing the tariff structure and streamlining customs procedures. Past attempts to rationalize the import tariff structure and customs procedures by comprehensive legislation have failed.

To the extent that tariff rationalization and customs procedures can be accomplished by issuing appropriate regulations, pending comprehensive reform through legislation, such regulations should be issued. Some import prohibitions and quantity restrictions could be removed this way, and guidelines to reduce customs official's discretion in the way the existing laws are applied can be developed and enforced. A major goal should be to reduce the high level and variability in protection of inefficient productive activity.

A maximum *ad-valorem* duty of, say, 50%, could replace import quantity restrictions and higher existing tariffs. Moreover, a minimum *ad-valorem* tariff should be applied to all imports except the import content of exports. Specific duties could then be removed.

The complexity of the overall tariff and customs reform effort probably precludes substantive action until after the 1986 elections, at which time action should be considered in the context of comprehensive tax reform and over-haul of industrial incentives practices.

c. Industrial Incentives and Foreign Investment Regulations

The Industrial Incentives Law 299 grants large tax and tariff exonerations on the imported raw materials and intermediate inputs of import substitution activities. This has stimulated the use of imported inputs and discouraged the use of domestic inputs. The Law also grants long-term income tax exonerations which are almost always automatically extended upon their expiration. A major effect of Law 299 has been to make high cost import substitution activities relatively more profitable than export activities, while, at the same time, significantly eroding the country's tax base.

The administration unsuccessfully sought legislation for a reduction of 50% in exemptions from taxes under Law 299 during November 1984. The purpose of the legislation, however, was to raise needed tax revenues. The original discretionary character of granting exonerations to qualified companies has been criticized. This criticism was addressed in June 1983 by Law 145, that modified Law 299 by extending to all manufacturers within an industry the maximum level of import duty exoneration.

Except for the provisions relating to Category "A" Free Zone Operations, Law 299 should be modified substantially to reduce the benefits and exonerations extended to import substitution activities. Such modification will require legislative action. However, discretionary decisions on the extension of income tax exonerations after expiry of original contracts should generally not be considered in the future. The issue of industrial incentives is an appropriate topic for study in the Economic Analysis and Training Project, and should be evaluated in conjunction with tax and customs reform.

Under the Foreign Investment Law 861, foreign investors that registered investments in order to access foreign exchange at the official rate, were excluded from several key activities, reserved for national enterprises. Moreover, the law allowed annual repatriation of a maximum 25% of the registered investment amount and a maximum of 20% repatriation of capital gains. In May 1984, the Monetary Board approved resolutions requiring all foreign investors desiring access to foreign exchange to register. The extent to which registered investments are now governed by Law 861 and other regulations is not clear with respect to activities actually available to foreign investors, qualification for certain incentives, restrictions on remittances, and limits on local borrowing. The entire Law 861 should be carefully reviewed, particularly in relationship to the overall motivation for foreign investment and the need to increase non-traditional exports.

The main objective of the GODR, however, should be to implement policies to increase all investments, domestic and foreign. Policies that are good for local investors are good policies for foreign investors. In this context, there does not seem to be any particular rationale for either special incentives or restrictive regulations that either benefit or limit foreign investors vis-a-vis local investors. The emphasis should be on creating an appropriate macro-economic environment that encourages private initiative and entrepreneurship.

d. Export Restrictions and Product Price Controls

In addition to import quantity restrictions and prohibitions, first imposed on a large scale in 1979, export quantity restrictions and prohibitions are often imposed on products in short supply, or those subject to price controls. Export restrictions of this kind strongly discourage the development of non-traditional exports, particularly agricultural crops, including products not usually targeted for restriction, since objective rules for designating particular products for restriction have not been promulgated.

Removal of export quantity restrictions and prohibitions, together with official commitment not to impose them in the future, would remove a significant disincentive to agricultural diversification into non-traditional export crops. An appropriate intermediate action would be to clarify the rules regulating designation of products to be restricted, how the quantity and duration of restrictions are arrived at, and publication of the rules for qualifying products for export licensing.

The Office of Price Control publishes a list of product price controls affecting basic commodities, such as vegetable oil, sugar, salt, tomato paste, rice, flour, pasta, milk, bread, chicken, cooking gas, kerosene, eggs, beans, chocolate, coffee, sardines, butter, crackers, soap, toilet paper, tooth paste, and others. Although enforcement is perceived to be lax at the retail level, these controls are a disincentive to local production. Moreover, even efficient producers are deterred from marketing abroad, as export prohibitions are often imposed for commodities in scarce supply. Price controls are often a principal reason for scarcity.

A schedule for removal of price controls should be developed and implemented. An intermediate step could be removal of price controls on PL-480 commodities and products made with these commodities. This could be CP to programming FY-1986 PL-480 imports.

A commitment to eliminate the Office of Price Control may be appropriate conditionality for future PL-480 or ESF programs. PL-480 conditionality related to removal of product price controls could be combined with conditionality seeking removal of export prohibitions through the ESF cash transfer program.

e. Parastatal Subsidies

The combined overall deficit of the principal public enterprises this year may exceed RD$700 million. The CDE, INESPRE, CEA, and CORDE must improve their operational efficiencies and reduce subsidies and transfers from the central government.

CDE is implementing programs to improve efficiency and reduce cost in the following areas: (1) generation and distribution losses, and (2) lowering generation costs by substituting coal for oil and more use of hydro-power. In addition, the tariff structure has been substantially adjusted so that, together with improved collection and efficiency, CDE may eliminate the need for subsidies by the end of 1987.

CEA is implementing a program to modernize its sugar mills, its transportation system, and administration. The company is seeking ways to diversify out of sugar and into more profitable uses of some of its large land holdings. It has proposed to do this through joint ventures with private sector shareholders, whereby CEA land would be leased to the joint venture companies. The issue of management participation is unclear.

The principal issue with CEA is whether the joint venture leasing program now being implemented is the best way to exploit CEA lands as a means to diversifying out of sugar. The diversification program might proceed more rapidly and efficiently if leasing or sale of sugar lands were offered to the private sector without the requirements of a joint venture with CEA. This can be a policy level decision within CEA, as there are no legal requirements for joint ventures with CEA. Nevertheless, the existing system is a positive first step toward divestiture, and is efficient compared to continued use of CEA lands for sugar production. Simplified procedures for obtaining access to land should be developed, and the availability of these lands should be aggressively promoted and advertised, including a decision to permit the leasing of lands without CEA's direct participation.

INESPRE has raised prices on some products, and stopped selling others in order to limit its losses this year. Substantial problems remain, especially with respect to such commodities as rice. Originally structured as a price stabilization entity under AID auspices, INESPRE now effectively controls the purchase, processing, and final use and sale of basic commodities, such as rice. It is unlikely that the GODR and INESPRE will accede to complete privatization of INESPRE's food distribution programs. However, the reduction of INESPRE's role in these activities may be obtainable through the leverage of PL-480.

INESPRE should give up its monopsony purchasing practices at the farm-gate. This would save on transportation costs and reduce grain losses. Farmers should be free to sell to whoever they choose, and not be required to sell only to INESPRE or specified millers. The monopsonistic power confered on INESPRE and the regional millers creates a high potential to depress prices and reduce incentives to produce. In the short run, monopsonistic bias of this kind penalizes everyone, as scarce foreign exchange is used to import commodities that can be efficiently produced at home.

INESPRE should eventually divest its rice mills. Control of rice distribution and pricing does not require milling and packaging. Millers should be allowed to purchase rice at market prices, and be assured that their sales will be at market prices. INESPRE subsidization of consumers, if any, should be explicit and above board. A major goal should be reduction and eventual removal of all INESPRE subsidy programs.

PL-480 commodities, including rice, should be auctioned to the private sector. Should INESPRE desire to intervene for purposes of price stabilization or consumer subsidies, it should purchase or value products at market clearing prices.

The CORDE companies were reorganized during 1984, and the price structures of most companies were rationalized enough to eliminate overall net losses for the holding company. Highly profitable enterprises, such as the cigarette company, apparently make up for the losses of less efficient enterprises, such as the cement company. Even though the CORDE companies did not require net subsidies last year, and may not need any this year, now may be an appropriate time to evaluate the benefits that would accrue to the government were some or all of these companies to be divested. A study of divestiture feasibility and strategy should be initiated this year, which should include an evaluation of the sequencing and modalities of divestiture by means of management contracts, leasing arrangements, stock sales, etc.

f. Money and Credit

Unification of the exchange rate was essential to the goal of freeing up prices in order to facilitate more efficient use of resources and improve international competitiveness. Complementary fiscal and monetary policies have been implemented with a view to reducing the country's excess imports, and to contain inflation by limiting growth in the money supply and credit. The goal has been to obtain these objectives without unduly slowing economic growth, targeted for 1985 at minimum GDP growth of 2%. During June 1984-June 1985, money supply increased at 39%, but this money growth occurred before December 1984. There has been no growth since then. Commercial bank credit to the private sector has increased at only about one-half the expected rate during June 1984-June 1985. However, during the first six months of 1985, commercial bank credit to the private sector declined by 1%. Central Bank data show that only agriculture and manufacturing sectors had slight increases in commercial bank credits. There ave been no credit increases to commercial merchants and a 9.8% reduction to exporters during January-June 1985. Credit to manufacturers has been constrained to about 50% of the expected levels. Unfortunately, average inflation is now expected to be some 50% greater than originally forecast, and no GDP growth rate is likely this year.

g. Public Finance

The central government has had current account surpluses before transfers to parastatals since 1982. The main constraint is the need for large transfers to CDE, CEA, and INESPRE, which limits the amounts that can be programmed for important central government investment projects. Central government investment spending last year was less than 2% GDP, and is unlikely to exceed 3% GDP this year.

The tax base generates a relatively low level of revenues. Tax revenues last year amounted to less than 10% of the GDP. Excluding the export surcharges imposed at the time of exchange rate unification, tax revenues this year may be less than 9% of GDP. (The export taxes are expected to generate additional revenues equivalent to just under 5% of GDP.) A major problem with the tax system is its emphasis on taxing international transactions, and relatively light taxation of domestic transactions.

The new sales tax is helping to change this emphasis but taxes on international trade last year accounted for over 25% of total tax revenues. Taxes on international trade are expected to amount to some 52% of total tax revenues this year, largely due to the export taxes imposed in January. Income taxes will account for 12% of total revenues this year, and taxes on goods and services 31%. Property taxes will generate only about 1% of total tax revenues.

Comprehensive tax reform is urgently needed. Both the OAS and the IMF have recently (past three years) conducted studies of the tax system, with recommendations for tax reform. These studies could serve as a basis for an up-to-date study of the tax system, with a view to comprehensive tax reform needed to enhance tax equity, broaden the tax base, and stimulate productive activity. This study could be combined with evaluations of the tariff and customs system and the industrial incentive laws.

The central government investment budget has been reduced to very low levels in recent years. Timely funding has often not been available for counterpart to externally financed development projects. The public sector investment program should be updated and priorities set, in order to assure that funding is provided to those projects with the highest impact on the economic recovery and medium-term development prospects.

3. Political Constraints

Although the GODR should address urgently all of these development constraints, current political situation before the 1986 election limits the scope of reforms to those that do not require the ratification of the Dominican Congress. The FY-1986 ESF conditionality will therefore concentrate on policy reforms in exchange rate, export restrictions and price control, money and credit to exports and agricultural production, and reduction of subsidies. The ultimate goal of the FY-1986 ESF conditionality is to eliminate all multiple exchange rate practices, to eliminate all export restrictions and price controls, to make non-inflationary money and credit, particularly working capital, available to exporters of non-traditional goods and services, and to basic grain producers, and to eliminate public sector subsidies. For 1986, however, the U.S. Mission proposes a conditionality package (detailed in the following sections) that is in the realm of practicality.

As for the politically sensitive constraints, however, USG is laying a groundwork for future actions. To improve efficiency and productivity of CDE, we are undertaking a revenue collection assistance project. USAID also has encouraged the STP to undertake a comprehensive study analysis of CORDE's public enterprise system ranging from legal to management efficiency problems. If the STP chooses not to undertake such a study for political reasons, USAID is prepared to conduct its own study in order to present to the new government updated facts information and alternatives. With INESPRE, we are requiring a reduction of rice subsidies through PL-480 conditionality and within the ESF program. A covenant will be sought to encourage CEA to promote private sector leasing of State sugar lands. Although problems associated with customs regulations and tax reform will need the congressional action, the Mission is in the process of raising consciousness of Dominican authorities of the serious impediments they are creating for agribusiness development, export promotion and foreign investment, through the agriculture policy and economic analysis projects.

D. Mission Policy Dialogue Agenda and ESF Objectives

1. Basic Goals

The overall policy dialogue agenda is structured around the Mission's strategy to consolidate the benefits intended from the ongoing economic stabilization program, encourage private sector investment and the development of new exports, encourage agricultural diversification and expansion, and assure supporting infrastructure for these activities. The Mission will seek these goals through all aspects of the policy dialogue process, including routine day-to-day contacts, the programming of development assistance and local currency resources from PL-480 and ESF, the timing and conditionality of PL-480 and ESF resources, and direct policy action projects.

The proposed covenants directly parallel and complement the recommended conditionality for tranched disbursement of the FY-1986 ESF resources. These covenants seek to modify restrictions and prohibitions on exports, reducing the number of products subject to export restriction. They also seek to simplify generic export procedures and to establish simplified conditions for facilitating private sector access and productive utilization of State Sugar Company (CEA) lands.

Consistent with the U.S. Mission's policy concerns in such areas as private sector-led agricultural diversification and the development of more efficient markets in the agricultural sector, AID also will seek to negotiate covenants related to this year's programming of PL-480 Title I local currency proceeds. We will seek the removal of all price controls and subsidies on PL-480 commodities and their derivatives, request the distribution of PL-480 commodities through commercial channels beginning with implementation of an auction system for sale of rice to private distributors, and support the removal of regulations that restrict rice growers and millers in the transportation or sale of rice.

2. ESF Conditionality: Structure, Goals, and Benchmarks

The proposed conditionality for the FY-1986 ESF cash transfer is designed to build on the policy actions to which the GODR agreed in the December 1984 agreement. These indicate measures and actions essential to achieve longer term goals, as well as adherence to the short-term financial stabilization measures which have been implemented. The proposed 1986 conditionality consists of two Conditions Precedent, each respectively applied to the first and second tranches of ESF disbursements, four ESF Covenants, and three Covenants related to PL-480 Title I.

a. Conditions Precedent to Tranched ESF Disbursements

The program anticipates tranching $60 million of ESF resources in two separate disbursements, with benchmark dates of December 15, 1985 and March 15, 1986. There are strong indications, however, that this balance of payments support may be needed much earlier than December 15. Accordingly, the Mission intends to negotiate a PAAD during mid-October, and be prepared to disburse a $40 million first tranche in early November should circumstances indicate a compelling need. Any disbursement, however, is dependent upon compliance of the conditions precedent. A similar time-period flexibility is intended for disbursement of the second tranche with $10 million, plus $10 million supplemental. Should the additional $10 million supplemental support not be available at the time of a second disbursement, it is intended that this disbursement be made if and when such resources become available, presuming the satisfactory GODR compliance with all conditions for a second disbursement. (Immediately below are the proposed CPs, followed by Covenants I through IV.)

A. CONDITION PRECEDENT TO FIRST DISBURSEMENT

— $40 Million ESF
— Benchmark Date: December 15, 1985

The defacto removal, or an agreed upon effective firm date for the removal, of the 5% exchange tax on non-traditional exports.

COVENANTS

(I) The GODR agrees to continue to adhere to the major previous economic adjustment commitments contained in the FY-1984/1985 ESF agreement, e.g.:

(a) A single, unified market-determined exchange rate system.

(b) Increased petroleum prices and electricity rates.

(c) Liberalized interest rates.

(d) Limited reserve deficiencies in the Reserve Bank.

(e) GODR budgets prepared and presented in terms of the parallel exchange rate.

(II) The GODR agrees to jointly program with AID the use of local currency proceeds from both ESF and PL-480 Title I and make no third party agreements or understandings which would restrict either the use or disbursement of such local currencies without the prior consultation and written concurrence of the Mission.

(III) The GODR agrees to develop and publish objective regulations for designating export products for restriction, providing the justifications for determining the quantity and duration of the export restrictions.

(IV) The GODR agrees to provide increased access to State Sugar Company (CEA) lands, and to establish and promote the conditions and procedures for facilitating productive private sector access to these lands.

(V) GODR agrees to undertake a comprehensive study which will recommend a national sugar policy and plan for diversification.

B. CONDITIONS PRECEDENT TO THE SECOND DISBURSEMENT

-- $10 Million ESF (and $10 Million Supplemental ESF when/if Available)
-- Benchmark Date: March 15, 1986

1. U.S. Mission determination that satisfactory progress has been made relative to Covenants I through IV, and that Benchmark targets are being achieved.

2. U.S. Mission determination that a significant reduction in the 36% exchange tax-surcharge on traditional exports has been made.

C. PROPOSED COVENANTS TO THE FY-1986 PL-480 TITLE I AGREEMENT

1. The GODR will covenant to remove all price controls and subsidies on commodities and their derivatives of the grade and quality imported through the PL-480 Title I program.

2. The GODR will covenant to develop an auction system acceptable to USAID for the direct sale of PL-480 Title I rice to private distributors.

3. The GODR will covenant to remove all regulations that restrict rice growers and millers in any way relative to the transportation or sale of rice, and will publicize the removal of these restrictions.

D. BENCHMARK TARGETS TO BE MET

(Relative to the Conditions Precedent and the Covenants):

1. Indicative Benchmark Targets to First Condition Precedent

-- Provided that the 5% exchange tax is removed by early 1986, non-traditional exports will increase by 17% in 1986, compared to 9% in 1985.

2. Indicative Benchmark Targets to Second Condition Precedent

-- Traditional exports will increase at an annual average of 4% during 1985-1990, as compared to -3% during 1980-1984.

-- Provided that the reduction in the 36% exchange tax takes place in early 1986 and is no less than 16 percentage points, current account deficits will improve by more than US$70 million in 1986.

3. Benchmark Targets to ESF Covenants

a. Covenant I

(1) GDP growth of no less than 0% in 1985 and 2% in 1986.

(2) Annual inflation will decline to 15% in 1986, as compared to 35% in 1985.

(3) Overall balance of payments deficits will be reduced by more than US$100 million in 1986 from the $224 million deficit in 1985.

(4) The consolidated public sector enterprise deficit will decline by no less than 10% to RD$280 million in 1986, as compared to RD$350 million in 1985.

b. Covenant II

(1) The total local currency proceeds under the FY-1986 ESF will be deposited in special accounts in the Central Bank, and agreement to the programming of these funds will be completed by January 31, 1986.

(2) No less than 90% of all programmed ESF and PL-480 Title I funds will be assigned to activities which will have a direct or indirect impact on private sector development. Special emphasis will be given to providing credit for non-traditional export development and investment, diversified agricultural development, and supporting productive infrastructure.

c. Covenant III

(1) Non-traditional exports should increase by 17% in 1986, compared to 9% in 1985 (same as benchmark targets under conditions precedent for first disbursement).

(2) The total number of commodities under export restriction will not increase during 1986.

d. Covenant IV

(1) By the end of 1986, approximately 15% of CEA land will be under diversified production either in joint ventures or direct lease arrangements to private sector entities, either domestic or foreign.

(2) Of the 15%, no less than 40% will be under direct lease arrangements.

e. Covenant V

The National Sugar Policy and Diversification Plan will be completed not later than June 1, 1986.

f. Summary Conclusion

The Mission has informally discussed all of the above conditionalities with the GODR. Generally speaking, we believe that the ESF conditionalities are acceptable to the government, and that they conscienciously will seek to implement the Conditions and Covenants. Acceptance of the PL-480 Title I conditionality related to rice subsidies will, nevertheless, require a major concession on the part of the GODR, and some flexibility in negotiating this condition will be necessary.

3. Transfer Modality and Local Currency Programming

In general, similar mechanisms and procedures as utilized in the past in the transfer of dollar resources and programming of local currency under both the ESF and PL-480 Title I programs will be employed in the FY 86 programs.

a. Transfer Modality

(1) ESF Program

As in the FY 84/85 program, the FY-1986 PAAD will require the GODR to agree that the country will make available an equivalent amount of dollars to the private sector for the importation of raw materials, spare parts, machinery and equipment from the U.S. These dollars will be made available over the course of one year from the date of the first disbursement of the grant to the Central Bank. Documentation will be required from the GODR to verify that eligible imports for the private sector were actually received. This verification takes the form of customs receipts, bills of lading and other standard banking documents which identify the type of goods imported, the source and origin and U.S. dollar value. The U.S. Mission has been satisfied with these procedures in the past and will therefore employ similar procedures in the FY-1986 program.

As in the past, a Memorandum of Understanding (MOU) will be signed by the GODR and the Mission to define the basis for disbursement of the ESF resources. This MOU will provide that the US Dollar grant funds will be disbursed to the Central Bank in two tranches in GODR compliance of covenants and conditions. As this is a cash transfer, the method of payment for the ESF assistance is dollar payment through electronic fund transfer.

The cash transfer will also be conditioned upon the provision of an equivalent amount of counterpart funds by the GODR. The GODR will be required to provide and deposit the peso equivalent of the cash transfer into a special account in the Central Bank no later than 30 days after the dollar deposit is made. The amount of counterpart to be provided will be calculated using the average market rate as determined by the Central Bank for the previous thirty day period.

(2) PL-480

Before signing the Agreement, the GODR, through the Technical Secretariat of the Presidency (STP), will open an irrevocable peso denominated letter of credit (ILC) in an amount equivalent in value to the U.S. dollar value of the Agreement. The ILC will be drawn on a local bank and provide USAID with a guarantee that the timely deposit of LC occurs. Once the Agreement is signed and ratified by the Dominican Congress, the commodities will be allocated (possibly through auction) by STP to the local purchasers, which, in turn, will open Letter of Credit (L/Cr) in favor of GODR for the full purchase price of commodities, transportation, and insurance. When the commodities arrive in the country, the purchasers will receive the goods and the amount fixed in the L/Cr will be paid to the account of STP in the Reserve Bank from which it will ultimately be transferred into the Special Account in the Central Bank. Thus, the GODR's ILC serves principally as a formal guarantee that timely deposit will be made into the Special Account in the Central Bank. In the case that the sales proceeds from local purchasers are not deposited, the amount of the GODR ILC will be paid into the Special Account on the due date(s) set forth in the ILC.

b. Local Currency Programming

The counterpart funds under both ESF and PL-480 will be programmed jointly by the GODR and the Mission. The National Planning Office (ONAPLAN) will coordinate the GODR planning and programming of the specific uses of the LC proceeds. Prior to the disbursement of the proceeds for projects or activities, ONAPLAN will submit for U.S. Mission approval, a description and detailed implementation plan for each project and/or activity.

The counterpart resources will be programmed in support of the USG's strategy which is designed to achieve the objectives of economic adjustment and stabilization, private sector investment and export promotion; agriculture diversification; and development of supporting physical, social and institutional infrastructure. Specific allocations will be the subject of further negotiations. Illustrative allocations are as follows:

TABLE XI

Illustrative Local Currency Allocation

Purpose	Millions of RD Pesos ESF	PL-480
I. Economic Stabilization	100	-
A. GODR Economic Analysis Efforts		
B. Private Sector Working Capital		
C. Small Farmer Agricultural Credit		
D. Feasibility Studies		
II. Investment Promotion/Export Development	50	40
A. Small Scale Business Credit		
B. Agribusiness Credit		
C. Export Credit		
D. Export Market Promotion		
E. Free Zone Expansion		
F. Industrial Zones Rehabilitation		
III. Agricultural Diversification	-	20
A. Non-Traditional Agricultural Research		
B. Technology Transfer Support		
C. Agricultural Credit		
IV. Supporting Infrastructure	30	30
A. Public Works--Rural Roads & Irrigation		
B. Commercial Agricultural Training		
C. Support to Agricultural Cooperatives and Associations		
D. PVO Support		
E. Institutional Development		
F. Resource Coordination/Planning		
TOTAL	180*	90*

* The exchange rate of R.D. Pesos 3.00 to U.S. 1.00 dollars was used for the calculation Illustrative allocation programs total amounts of local currency for a year; however, actual disbursements may be on a multi-year basis.

Under the economic stabilization category, a local currency resources will be to finance short-term credit requirements for the private sector. The credit will be provided both through the FIDE mechanism in the Central Bank and directly through private commercial and development banks. The credit will be made available for production credits, in particular short term working capital for agro-industry and basic food production.

In the investment promotion and export development category, credit will also be made available through a variety of sources (FIDE, Private Banks, Financieras) for medium-term capital investment for non-traditional agroindustry and small business development investment. Also, funds will be programmed for the construction and expansion of free trade zones and industrial parks. These resources will finance feasibility studies, construction, installation and/or improvements for sites and services. Finally, private sector entities which are directly involved in investment promotion and export development activities will be supported.

In the area of agricultural diversification LC resources will support research and technology transfer in the production and cultivation of non-traditional agricultural crops. Training for farmers and managers will be provided through extension activities and more formal programs. Emphasis will be placed on utilizing the private sector entities such as farmer associations, cooperatives, and educational institutions.

Under the supporting infrastructure category, local currency resources will finance projects in the areas of productive infrastructure and social and institutional development. This could include activities such as improvements in roads, highways, ports and airpots; electrical plant maintenance and rehabilitation; and irrigation and water systems improvement.

Program resources will also be used to finance projects and activities of US and Dominican private voluntary organizations. Emphasis will be given to those activities and projects which lead to self-sufficiency for the PVO and its program or income-generating activities.

SUMMARY OF PROPOSED FY-1986 ESF
AND PL-480 TITLE I CONDITIONALITY

(Conditions Precedent and Covenants
To Be Included Within Agreement)

A. CONDITION PRECEDENT TO FIRST DISBURSEMENT

-- $40 Million ESF
-- Benchmark Date: December 15, 1985

The defacto removal, or an agreed upon effective firm date for the removal, of the 5% exchange tax on non-traditional exports.

COVENANTS

(I) The GODR agrees to continue to adhere to the major previous economic adjustment commitments contained in the FY-1984/1985 ESF agreement, e.g.:

(a) A single, unified market-determined exchange rate system.

(b) Increased petroleum prices and electricity rates.

(c) Liberalized interest rates.

(d) Limited reserve deficiencies in the Reserve Bank.

(e) GODR budgets prepared and presented in terms of the parallel exchange rate.

(II) The GODR agrees to jointly program with AID the use of local currency proceeds from both ESF and PL-480 Title I and make no third party agreements or understandings which would restrict either the use or disbursement of such local currencies without the prior consultation and written concurrence of AID.

(III) The GODR agrees to develop and publish objective regulations for designating export products for restriction, providing the justifications for determining the quantity and duration of the export restrictions.

(IV) The GODR agrees to provide increased access to State Sugar Company (CEA) lands, and to establish and promote the conditions and procedures for facilitating productive private sector access to these lands.

(V) GODR agrees to undertake a comprehensive study which will recommend a national sugar policy and plan for diversification.

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B. CONDITIONS PRECEDENT TO THE SECOND DISBURSEMENT

-- $10 Million ESF (and $10 Million Supplemental ESF when/if Available)
-- Benchmark Date: March 15, 1986

1. USAID determination that satisfactory progress has been made relative to Covenants I through IV, and that Benchmark targets are being achieved.

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C. PROPOSED COVENANTS TO THE FY-1986 PL-480 TITLE I AGREEMENT

1. The GODR will covenant to remove all price controls and subsidies on commodities and their derivatives of the grade and quality imported through the PL-480 Title I program.

2. The GODR will covenant to develop an auction system acceptable to USAID for the direct sale of PL-480 Title I rice to private distributors.

3. The GODR will covenant to remove all regulations that restrict rice growers and millers in any way relative to the transportation or sale of rice, and will publicize the removal of these restrictions.

D. BENCHMARK TARGETS TO BE MET

(Relative to the Conditions Precedent and the Covenants):

1. Condition Precedent Benchmarks to First Disbursement

-- Provided that the 5% exchange tax is removed by early 1986, non-traditional exports will increase by 17% in 1986, compared to 9% in 1985.

2. Conditions Precedent Benchmarks to Second Disbursement

-- Traditional exports will increase at an annual average of 4% during 1985-1990, as compared to -3% during 1980-1984.

-- Provided that the reduction in the 36% exchange tax takes place in early 1986 and is no less than 16 percentage points, current account deficits will improve by more than US$70 million in 1986.

3. ESF Covenant Benchmark Targets

a. Covenant I

(1) GDP growth of no less than 0% in 1985 and 2% in 1986.

(2) Annual inflation will decline to 15% in 1986, as compared to 35% in 1985.

(3) Overall balance of payments deficits will be reduced by more than US$100 million in 1986 from the $224 million deficit in 1985.

(4) The consolidated public sector enterprise deficit will decline by no less than 20% to RD$280 million in 1986, as compared to RD$350 million in 1985.

b. Covenant II

(1) The total local currency proceeds under the FY-1986 ESF will be deposited in special accounts in the Central Bank, and agreement to the programming of these funds will be completed by January 31, 1986.

(2) No less than 90% of all programmed ESF and PL-480 Title I funds will be assigned to activities which will have a direct or indirect impact on private sector development. Special emphasis will be given to providing credit for non-traditional export development and investment, diversified agricultural development, and supporting productive infrastructure.

c. Covenant III

(1) Non-traditional exports should increase by 17% in 1986, compared to 9% in 1985 (same as benchmark targets under conditions precedent for first disbursement).

(2) The total number of commodities under export restriction will not increase during 1986.

d. Covenant IV

(1) By the end of 1986, approximately 20% of CEA land will be under diversified production either in joint ventures or direct lease arrangements to private sector entities, either domestic or foreign.

(2) Of the 20%, no less than 40% will be under direct lease arrangements.