Development Challenges in Dominican Republic

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Medium-Term Economic and Social Trends

During the last decade, Dominican Republic has been one of the more dynamic economies in the region. GDP growth has averaged 5%, above the Latin America and the Caribbean (henceforth LAC) average of 3% for the same period. Inflation has averaged 4.5%, with a sharp decrease from 2014 onwards, and external reserves have increased to around 11% of GDP. Among the factors that contributed to this strong performance are i) a beneficial external context that allowed the country to improve its terms of trade, and to access international markets under favorable conditions; ii) large and growing inflows of foreign currency, particularly from tourism and remittances; and iii) a constant stream of foreign direct investment, averaging 3.9% of GDP since 2010.

Rapid GDP growth has not led to a significant reduction of poverty and inequality, but in recent years some improvements have been seen. Despite growing faster than the region, the country lagged in poverty reduction. Between 2005 and 2014 the national poverty rate fell from 47.5% to 37.2%, a 21.7% reduction; in the same period, LAC managed to reduce average poverty by 29% (from 39.7% to 28.2%). The trend seems to have reversed after 2014, as poverty reduction in Dominican Republic accelerated while LAC reversed recent gains. The country's poverty rate in 2016 was 30.5%, a remarkable convergence to the regional average of 30.7% (ECLAC, 2018). Inequality remains high but with a general trend downwards, as can be observed in the trajectory of the GINI index, which went from 0.51 in 2005 to 0.46 in 2016, in line with the regional level.

Figure 1. GDP growth (%)

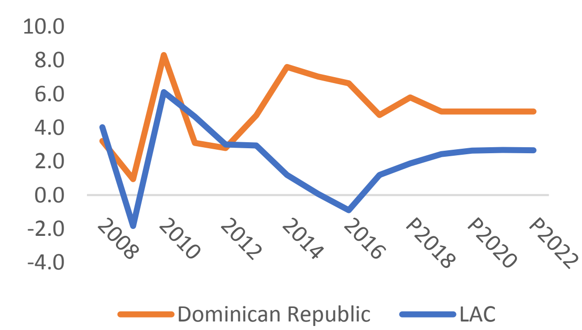
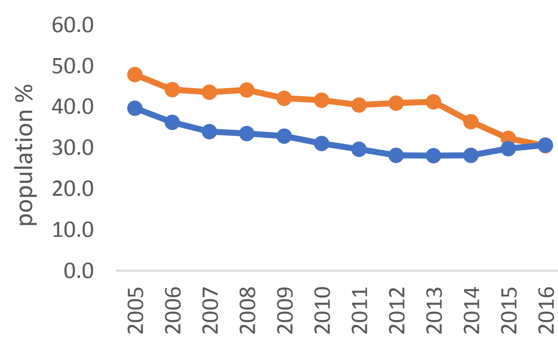


Figure 2. Poverty rate



Low international interest rates and the fall in crude prices provided a windfall that allowed the country to grow at rates above its long-term potential (5.5%) for several years. This favorable context had positive impacts on external sustainability, price stability and the fiscal deficit. In 2017 the non-financial public sector deficit was 3.2% of GDP (Banco Central de la República Dominicana, 2018), a reduction of 3.7 percentage points from the 2012 deficit; this fiscal consolidation was achieved mainly through reductions in public capital expenditure. It must also be noted that in the last two years the deficit has been above the levels set in the government's budget: while it originally planned for a deficit of 2.3%

of GDP in 2016 and 2017, the final balance was significantly higher in both years. The imbalances arose from higher-than-expected capital expenditures, mainly to supply funding for the Punta Catalina Thermoelectric project as the expected private financing did not materialize. The persistence of fiscal deficits has steadily pushed the country's debt into an upwards trend. Consolidated public sector debt was 50% of GDP by the end of 2017, nearly twice the level in 2012. Despite fast debt growth, sovereign risk perceptions remain low, as shown by an EMBIG spread of 278 in March 2018, 140 basis points below the 418-point average for LAC. Rating agencies have raised the governments credit rating to B+ (Fitch), BB- (S&P) based on the government's fiscal consolidation and prudent monetary policy.

Growth in 2017 slowed to 4.7% due to a worsening external outlook and slower internal performance. The main internal factor behind this result was a sharp slowdown in public and private investment and a restrictive monetary policy in the first semester, due to uncertainty and lack of significant policies to support productivity and export growth. Tourism and finance were the best-performing sectors, buoyed by the US recovery and an expansive monetary policy stance during the second semester. Additionally, growth was affected by Hurricanes Irma and Maria, which struck the country during September 2017.

Medium-Term Economic and Social Outlook

A slowdown is expected over the medium term. The IMF projects annual growth will hover around 5% for the 2018-2022 period. A less favorable external context of higher oil prices and global interest rates will affect the economy via increases in both the fiscal deficit and inflation, and through costlier financing of future deficits. Structural and institutional limitations, and the absence of significant pro-productivity reforms, will reduce the dynamism of investment, industrial output and exports, so more moderate performance is expected. Because 2020 will be an election year, and fiscal policy historically has been susceptible to political cycles, it is likely that government spending will increase without an offsetting increase in revenues (in the absence of fiscal reform), thus pushing the fiscal deficit above current levels in 2020. Unemployment will remain relatively high and real wage growth slow, given the economy's difficulties in producing jobs in the formal sector, whereas poverty and inequality will be somewhat mitigated by improvements in social services and cash transfer programs.

Risk Factors

In the medium term, the Dominican economy remains vulnerable to external shocks and highly dependent on the US economy. Sharp increases in oil prices or a slowing US economy would negatively impact public finances and affect the competitiveness of productive enterprises. Oil price increases beyond the range of US$65 to US$80 per barrel can notably affect public finances and generate inflationary pressures. There is additional risk arising from the recent fiscal reform in the United States, as it could create enough incentives for a reversal in the flow of foreign direct investment (FDI), although the Dominican Central Bank has deemed this unlikely.[1] Nonetheless, extreme weather events such as Hurricanes Irma and Maria in September 2017 do represent a significant risk.

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[1] The Central Bank's argument hinges on the competitive advantage of Dominican Republic in the areas where FDI from the United States is concentrated, which are free trade zones and tourism; these sectors already have generous tax exemptions locally.

Development Challenges

The main development challenges facing the Dominican Republic are how to increase productivity and the quality of public services in a context of weak institutions. The contribution of total factor productivity to GDP growth has historically been low. Poor productivity relates to low human capital accumulation, infrastructure deficiencies, the size of the informal sector and lack of depth in the financial sector. Human capital accumulation is affected by bad outcomes in health and education, sectors in which Dominican Republic consistently lags other countries with similar incomes. Long-term underfunding of health and education services has resulted in i) high maternal and infant mortality, and poor access to water, sanitation and quality healthcare; and ii) very poor learning outcomes, with relatively low access to pre-school and secondary school, the latter afflicted by high repetition, over-age and drop-out rates.

The most pressing infrastructure deficiencies lie in the electricity sector, transport and logistics. The costly and inefficient electricity sector has a high negative impact on productive activity, and this impact is compounded by the expensive transport and logistics sector; both have contributed to the stagnation of export-oriented sectors of the economy. The electricity sector requires improvements in the distribution network and in the management of distribution companies in order to reduce their high energy loss levels (around 30% as of December 2017), as well as adjustments of tariffs and subsidies. To reduce costs and increase access to transportation and logistics, the country's legal framework must be adapted to emphasize the promotion of competition among actors in those sectors. More investment in primary and secondary road networks is also needed. Although important reforms have been undertaken in recent years regarding education, health and, more recently, the electrical and transportation sectors, they have required large and sustained investments such that positive results will be observable in the medium term.

The institutions and legal frameworks needed to overcome these challenges face structural weaknesses. Solid and accountable fiscal institutions, as well as transparency and justice, are crucial to meeting the challenges mentioned above. However, the Dominican taxation system is complex, regressive, and incapable of raising enough revenue for current needs, while government expenses are rigid, opaque and generally considered to be of low quality and effectiveness. The IMF has emphasized the need for a fiscal reform that increases efficiency and equality in tax collection, reduces the number of exemptions and increases pressure to pay taxes. Regarding expenses, the introduction of a fiscal framework would provide a medium-term plan that rationalizes government expenditure, increasing transparency and the quality of information available.

Conclusion

Dominican Republic enjoys several advantages which have supported growth in recent decades. The degree of openness, coupled with proximity to the United States, provides advantages for export-oriented businesses and therefore make the country attractive to foreign direct investment. The external sector, particularly tourism and free trade zones, while highly dependent on the United States, has proven to be one of the stronger areas in the economy and could potentially be bolstered by further integration into global value chains, especially with the European Union and other Latin American countries. Mineral exports have also gained importance and have a positive outlook in the medium term. The population is younger than the LAC average and will not face significant constraints due to ageing in the foreseeable future.

Despite its vulnerabilities, the country has weathered recent international volatility without major disruptions. The 2008 financial crisis and recent global market uncertainty were overcome rather painlessly, meanwhile prudent macroeconomic management has ensured price stability and a steady

accumulation of international reserves. Sovereign risk shows a prolonged downward trend, thus permitting the government access to international markets in favorable conditions. The need for profound reforms in all sectors of the economy is widely recognized, and important steps have been taken in education and health, and electrical and transport sectors; the effects of these reforms are expected to materialize over the medium term and beyond.

References

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