DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

DOMINICAN REPUBLIC

FINANCIAL REFORM CONSOLIDATION PROGRAM

(DR-0151)

LOAN PROPOSAL

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ANNEXES

BASIC SOCIOECONOMIC DATA

For basic socioeconomic data, including public debt information, please refer to the following address:

http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata

INFORMATION AVAILABLE IN THE RE2/FI2 TECHNICAL FILES

Preparation:

Letter requesting technical cooperation

Reports by the joint mission of the International Monetary Fund, the World Bank and the IDB

Reports on execution of the MIF operation TC-98-02-44-9

Aide-memoire of the identification mission, 9 to 19 July 2003

Execution:

List of Central Bank professionals who will act as the counterparts of the consultants to be contracted

Timetable of activities and budget

Technical-cooperation matrix agreed on with the authorities, 18 July 2003

ABBREVIATIONS

BANINTER	Banco Intercontinental [private bank]
BCRD	Banco Central de República Dominicana [Central Bank of the Dominican Republic]
BNV	Banco Nacional de la Vivienda [National Housing Bank]
CFATF	Caribbean Finance Action Task Force
LMF	Ley Monetaria y Financiera [Monetary and Finance Act]
PATU	Program administration technical unit
PTU	Program technical unit
SB	Superintendencia Bancaria [Office of the Superintendent of Banks]

DOMINICAN REPUBLIC

IDB LOANS

APPROVED AS OF NOVEMBER 1, 2003

	US$Thousand	Percent
TOTAL APPROVED	2,280,352	
DISBURSED	1,891,523	82.94 %
UNDISBURSED BALANCE	388,829	17.05 %
CANCELATIONS	602,221	26.40 %
PRINCIPAL COLLECTED	766,911	33.63 %
APPROVED BY FUND		
ORDINARY CAPITAL	1,470,900	64.50 %
FUND FOR SPECIAL OPERATIONS	722,731	31.69 %
OTHER FUNDS	86,722	3.80 %
OUSTANDING DEBT BALANCE	1,124,611	
ORDINARY CAPITAL	696,209	61.90 %
FUND FOR SPECIAL OPERATIONS	421,821	37.50 %
OTHER FUNDS	6,582	0.58 %
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	521,063	22.85 %
INDUSTRY, TOURISM, SCIENCE AND TECHNOLOGY	133,836	5.86 %
ENERGY	348,610	15.28 %
TRANSPORTATION AND COMMUNICATIONS	234,484	10.28 %
EDUCATION	253,288	11.10 %
HEALTH AND SANITATION	147,805	6.48 %
ENVIRONMENT	0	0.00 %
URBAN DEVELOPMENT	33,693	1.47 %
SOCIAL INVESTMENT AND MICROENTERPRISE	330,860	14.50 %
REFORM AND PUBLIC SECTOR MODERNIZATION	201,510	8.83 %
EXPORT FINANCING	20,296	0.89 %
PREINVESTMENT AND OTHER	54,906	2.40 %

* Net of cancellations with monetary adjustments and export financing loan collections.

DOMINICAN REPUBLIC

STATUS OF LOANS IN EXECUTION

AS OF NOVEMBER 1, 2003

(Amount in US$ thousands)

APPROVAL PERIOD	NUMBER OF PROYECTS	AMOUNT APPROVED*	AMOUNT DISBURSED	% DISBURSED
<u>REGULAR PROGRAM</u>				
Before 1998	3	145,200	80,313	55.31 %
1998 - 1999	7	241,960	132,754	54.87 %
2000 - 2001	2	74,300	16,472	22.17 %
2002 - 2003	4	149,400	200	0.13 %
TOTAL	16	$610,860	$229,739	37.61 %

* Net of cancellations. Excludes export financing loans.

Inter-American Development Bank
Regional Operations Support Office
Operational Information Unit

Dominican Republic

Tentative Lending Program

2004

Project Number	Project Name	IDB US$ Millions	Status
DR0159	Sustainable and Protection of Social Reforms	200.0	
DR0151	Financial Reform Consolidation Sector Program	100.0	
DR0141	Housing Program	37.0	
DR0150	Social Reform Program	105.0	
	Total - A : 4 Projects	**442.0**	
DR0156	Public Investment Project strengthening Management	5.0	
DR0154	Enhancement of Superior Education, Science and Technology	34.0	
DR0157	Fiscal Modernization Program	5.0	
DR0143	Rehabilitation Historical Center Sto Domingo	10.0	
	Total - B : 4 Projects	**54.0**	
	TOTAL 2004 : 8 Projects	**496.0**	

2005

Project Number	Project Name	IDB US$ Millions	Status
DR0142	Credit Global Program	30.0	
DR0127	Municipal Governments Development	30.0	
	Total - A : 2 Projects	**60.0**	
	TOTAL - 2005 : 2 Projects	**60.0**	

Total Private Sector 2004 - 2005	**0.0**
Total Regular Program 2004 - 2005	**556.0**

*** Private Sector Project**

FINANCIAL REFORM CONSOLIDATION PROGRAM

(DR-0151)

EXECUTIVE SUMMARY

Borrower and guarantor:	The Dominican Republic	
Executing agency:	Banco Central de la República Dominicana (BCRD) [Central Bank], Superintendencia Bancaria (SB) [Office of the Superintendent of Banks], and Banco Nacional de la Vivienda (BNV) [National Housing Bank]	
Amount and source:	IDB:	US$100.0 million
	OC/FFI:	US$ 30.2 million
	OC:	US$ 69.8 million
	Total:	US$100.0 million
Financial terms and conditions:	Amortization period:	20 years
	Grace period:	5 years
	Disbursement period:	18 months
	Interest rate:	variable
	Inspection and supervision:	0%
	Credit fee:	0.25%
	Currency:	U.S. dollar Single Currency Facility

Objectives: The ultimate objective of the project is to strengthen the Dominican banking system by supporting the program that the authorities have proposed as a response to the recent financial crisis in the country. More specifically, the program will facilitate the development and full implementation of the new Monetary and Finance Act (LMF) and the institutional strengthening required to make the financial reform established in the act permanent. The financial reform consolidation program has three objectives that complement and reinforce each other: (i) to strengthen the public institutions that support the financial intermediation system, particularly the Central Bank; (ii) to strengthen the supervisory agencies in order to modernize the regulatory framework within which the banking system operates, improve its transparency, promote its competence and efficiency, protect its solvency and improve its ability to withstand internal and external shocks; and (iii) to lay the groundwork for restoring the solvency of the banking system and public confidence in it, while establishing

mechanisms for an adequate flow of medium- and long-term funds to finance productive investments.

Description: The financial reform consolidation program is a lending operation to support reforms in the financial sector, which seeks: (i) to strengthen the capital position and technical capacity of the Central Bank, the Office of the Superintendent of Banks and the National Housing Bank; and (ii) to set the stage for strengthening the commercial banks and reestablish their credibility and solvency. Given the need to ensure the viability of the program and its consistency with a sustainable macroeconomic context, approval of the proposed program will be conditional on the existence of a sustainable program for macroeconomic stabilization. The program has three specific components. Component A: regulation of the execution of monetary policy and adjustment of the structure of the Central Bank to comply with the objectives of the new Monetary Act. Component B: strengthening of bank supervision and development of the financial market. Component C: elimination of the credit functions of the Central Bank and creation of a replacement mechanism to provide development credit for the productive sector (second-tier bank).

The first component seeks to strengthen the capital position and technical capacity of the monetary authority, particularly the Central Bank, by developing the enabling regulations of the LMF and laying the groundwork to enable the Central Bank to operate efficiently and eliminate the quasi-fiscal deficit, thereby increasing its technical capacity.

The second component seeks to strengthen the financial position and technical capacity of the Office of the Superintendent of Banks. This component will support changes to the rules and prudential regulations to enable the Office of the Superintendent of Banks to carry out its functions independently, including operational independence and financial autonomy, and professionalization of the agency through the design and execution of a strategic plan, coupled with the adoption of adequate human resource management. It will support the adoption of international standards and practices in prudential regulation regarding the concentration and management of credit risk and modernization of auditing practices, as well as assisted inspections of all the banks, with the dual purpose of eliminating mismanagement by banks and determining the true level of solvency of the financial system.

The third component seeks to provide the productive sector with appropriate mechanisms for channeling medium- and long-term resources as a replacement for the development credit function that the Central Bank performed in the past. The Central Bank will

eliminate its functions of providing credit for the nonfinancial public sector and the productive sector, both directly and through rediscounts for the banking sector. The new Monetary and Finance Act calls for the establishment of a new second-tier bank, through the transformation of the National Housing Bank (BNV) which will lend and facilitate funds for the productive sectors and promote a secondary mortgage market.

The Bank's country and sector strategy: The Bank's updated strategy for the Dominican Republic, which was approved by the Board of Executive Directors in May 2002, is intended to support the country's efforts to reduce poverty through the following strategic vectors: (i) to overcome the persistent macroeconomic and financial weaknesses; (ii) to improve the provision of social services; (iii) to relieve bottlenecks that hamper the development of the productive sectors; (iv) to build capacity to protect the environment and to prevent, mitigate and respond to natural disasters; and (v) to build up the capacity of administrative and political institutions to respond to social demands. The proposed program is fully consistent with (i), (iii) and (v). The actions it includes will complement the process of implementing the new Monetary and Finance Act, with a guarantee of quality, so that the legal and institutional framework of the financial sector introduced in 1995 is effectively updated and the Dominican Republic is able to comply with internationally accepted standards.

Coordination with other multilateral development agencies: This year, the IDB has participated actively in joint missions with the IMF and the World Bank to examine and correct the problems in the Dominican banking sector. The three institutions are coordinating technical assistance for the country to support the recovery and strengthening of the sector. The possibility of participation by the United States Treasury Department in providing technical assistance is even being examined. The World Bank is planning a Technical Assistance Loan (TAL) for the financial sector, which could be concluded by the end of this year. The IMF negotiated a Stand-by Arrangement with the government to stabilize the macroeconomic balance and restore the solidity of the banking system, while reestablishing confidence in the Dominican economy.

Environmental and social review: Owing to its nature, the project has a neutral environmental impact. It will have an indirect social impact by protecting small savers and minimizing the risk of a financial crisis that would impact all sectors of society equally, meaning that it would be regressive.

Benefits: The program will facilitate the institutional strengthening of the public institutions that support the financial intermediation system, particularly the Central Bank and the Office of the Superintendent of Banks, and will help to modernize the regulatory framework in which

the banking system operates, improve its transparency, promote its competence and efficiency, lay the groundwork for protecting its solvency and improve its ability to withstand internal and external shocks. The direct beneficiaries of this operation are the institutions responsible for defining and carrying out monetary, exchange and financial policies (the Monetary Board, the Central Bank, the Office of the Superintendent of Banks and the National Housing Bank), the commercial banks and the users of the banking system (depositors and borrowers). Indirectly, the program will help to maintain fiscal stability, which is a key element for the government and the Bank in the poverty-reduction strategy. Experience has shown that financial crises have an immediate impact on the country's economic development and increase its poverty levels.

Risks: The main risks of the operation are that it will be executed under unfavorable conditions, particularly on account of marked institutional weakness, serious fiscal difficulties, particularly in the electric power sector, and the political context (preelection year, presidential elections will be held in May 2004). The main lesson learned from operations to support financial sector reforms is that reforms are complex processes that demand a large formal commitment from the authorities and a political consensus for their effective materialization. Also, the capital position and technical capacity of all the institutions that participate in the design and implementation of policies affecting the financial sector needs to be permanently strengthened. Therefore, programs of this kind must be continually supported, ideally through successive operations in the sector, particularly technical-cooperation programs. This operation is part of a comprehensive package of government actions and financial and technical assistance from the multilateral institutions for the country, to address the problems in the banking sector and restore confidence in it.

Special contractual clauses: The program's conditions are reflected in the matrix presented in Annex I.

Poverty-targeting and social sector classification: This operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704). It will have an indirect social impact by protecting small savers and minimizing the risk of a financial crisis that would that would impact all sectors of society equally, meaning that it would be regressive (see paragraph 4.2).

Exceptions to Bank policy: None.

Procurement: The fast-disbursing program funds will be used to finance the total cost in foreign currency of eligible imports from Bank member countries. The Bank's procedures for sector loans established in document GN-2001-2 will be applied. The Program Administration Technical Unit, in coordination with the Office of the Comptroller General, is responsible for maintaining the financial and accounting records on sources and applications of program funds.

I. FRAME OF REFERENCE

A. Socioeconomic framework

1.1 Since 1990, the Dominican Republic has made a great effort to strengthen public finances, control the growth of credit and indiscriminate wage increases, reduce exchange, financial and price distortions, open up the economy and standardize its financial relations with foreign creditors. These stabilization and reform efforts, in the midst of a highly favorable external environment, led to high and uninterrupted economic growth. Between 1993 and 2000, the economy grew at an annual average rate of 6.2 percent and that growth was accompanied by relative monetary, exchange and price stability.

1.2 In 2001, the economy began to slow down on account of both external and internal factors.[1] To return to the high growth rates achieved at the end of the 1990s, the authorities began in that same year to relax monetary policy and promote an aggressive program of public investments to be financed with external resources, including US$500 million in sovereign bonds sold on international capital markets. This combination of policies was successful in reactivating the economy, which rebounded to 4.1 percent in 2002. However, given weak external demand, the government's expansive fiscal policy began to cause serious macroeconomic imbalances, including increased outflows of capital, a rapid loss of reserves, strong speculative pressure on the exchange market and a systematic increase in prices. Inevitably, in a context of this kind and faced with growing lack of confidence among the economic agents, the liquidity position of the banking system and the composition of its assets and liabilities deteriorated.

1.3 The Dominican peso lost almost one third of its value on the private market in 2002. The deficit in the balance of payments current account rose to US$875 million in 2002, US$134 million more than in 2001. As a percentage of GDP, the deficit rose from 3.5 percent in 2001 to 4.1 percent in 2002. These imbalances became more acute in the third quarter of the year, owing to the growing perception by economic agents that the government was not willing to cut back on its high level of spending, certain contradictory measures adopted by the monetary authority, the severe conflict that arose between the government and the electric power generators and distributors regarding the financial sustainability of the electricity sector, and the perception of serious financial difficulties in certain banks.

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1 The factors that have had the largest effect on good economic performance since 2001 include the gradual slowdown in the United States and European economies, appreciation of the dollar against the euro, the aftermath of the terrorist acts of September 11, the rises in international oil prices owing to the wars in the Middle and Far East and the recessive effect of the adjustment measures that the current government had to adopt in its first 180 days in office to rectify the fiscal and external imbalances that existed when it took power.

1.4 The restrictions on liquidity reached the point that in September 2002, eight of the country's 14 commercial banks were unable to comply with their legal reserve requirements. Just when signs began to appear of some recovery in external demand at the beginning of 2003,[2] fraud was discovered in the Banco Intercontinental (BANINTER). On 8 April when it was taken over by the government, BANINTER was the country's largest bank, with registered and unregistered deposits of RD$55.9 billion (equivalent to US$2,236 million or 14 percent of GDP). On 13 May, the authorities announced publicly that the financial imbalance in the bank was RD$55 billion (equivalent to US$2.1 billion, 13.2 percent of GDP or 67 percent of the government's budget for 2003). In the opinion of the authorities, the imbalance had been caused by fraudulent actions over the last 14 years that involved keeping two sets of books.

1.5 The government took over the bank, which was placed under the administration of a receivership panel appointed by the Monetary Board and provided with liquidity so that it could continue to honor its internal and external commitments.[3] Also, in order to send a clear signal to the market that fraud would not be tolerated, the government has acted to enforce the law, jailing BANINTER's principal shareholder and two senior executives and seizing their assets.

1.6 In accordance with the law, BANINTER's license has been revoked and the bank is being sold. Its foreign lines of credit and its assets in foreign currency for an equivalent amount have been transferred to other banks. Its legitimate deposits have been transferred to Scotiabank, which has bought some of BANINTER's branches and other assets. Under this arrangement, any shortfall in liquidity will be made up for by the Central Bank. All other deposits will be honored as part of the process of liquidating the bank.

1.7 The BANINTER case showed clearly that the mechanisms for bank control and supervision have not operated properly and that there is a serious institutional weakness in this field. Therefore, it is impossible to rule out that accounting and financial malpractices similar to those used by BANINTER's former management could be taking place in other banks. In fact, after BANINTER was taken over, it

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[2] In response to a recovery in external demand and the depreciation of the peso, exports of goods and nonfactor services in the first half of 2003 were 11.3% higher than in the same period in the previous year. Family remittances, for their part, grew by 6%. This growth in exports and remittances, coupled with shrinkage in imports in response to the lower peso, the drop in domestic demand, and the temporary surcharge of 10% on imports applied in the first five months of the year, permitted the balance of payments current account to move from a deficit of US$480 million in the first half of 2002 to a surplus of US$465 million in the first half of 2003.

[3] To date, Central Bank assistance for BANINTER is the equivalent of 12% of GDP but it could rise to 15% unless assets are recovered. To mitigate the monetary impact of this liquidity support, the Central Bank increased its sales of papers on the domestic market. Reflecting that increase and the impact of the depreciation in the exchange rate, the balance of the external public debt in mid-2003 rose to 45% of GDP, much higher than the 26.3% that applied at the end of 2002.

was found that two medium-sized banks had incurred excessive related-party debt and were beginning to have serious liquidity problems (Banco de Crédito and Banco Mercantil). The first of these institutions was placed on a recovery plan and was sold to a recognized domestic financial group. This bank will be kept under strict supervision until all the liquidity assistance provided by the Central Bank is repaid. The other bank was placed on a restructuring plan that includes replacement of its senior management, its recapitalization and a business plan that will allow the liquidity provided by the Central Bank to be repaid. To carry out the capitalization process, the bank was sold to the Republic Bank of Trinidad and Tobago.

1.8 In April, the authorities asked the multilateral agencies, particularly the IMF, to provide technical cooperation in this process and examine the situation in the banking system in greater detail.[4] Inevitably, the collapse of BANINTER heightened the mistrust of the economic agents, brought additional pressure to bear on the interest rates, the exchange rate and prices, and undermined public finances. The government, with support from the IMF and the development banks, has committed to addressing these problems through a comprehensive economic program intended to strengthen the banking system and create the macroeconomic conditions needed to return to high and sustained economic growth.

1.9 The program that the government presented to the IMF[5] and which resulted in a 24-month Stand-by Arrangement, contains measures to: (i) restore confidence in the banking system; (ii) strengthen public finances and guarantee the sustainability of the public debt; and (iii) establish a flexible exchange rate, supported by strict monetary discipline.

1.10 To reestablish depositor confidence in the banking system, the government's program includes actions to: (i) address and solve the problems of the three banking institutions mentioned, with a view to minimizing the possibilities of systemic risk and limiting the potential fiscal and monetary impact; (ii) strengthen corporate management and the management practices of financial institutions; (iii) consolidate the legal framework for resolving bank crises, thus protecting the stability of the system and minimizing the fiscal costs; (iv) undertake assisted inspections of all the banks, in cooperation with international experts; and (v) strengthen prudential regulations and bank supervision.

1.11 To strengthen public finances and ensure that the debt can be sustained, the government's program includes anti-cyclical and structural measures. The anti-cyclical measures include: (i) spending restrictions, including a wage freeze in 2003 and strict limits on procurements of goods and services, transfers and low priority

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[4] The IDB was invited to participate in the IMF missions carried out from 22 to 30 April, from 19 to 23 May and from 10 to 20 June.

[5] The Stand-by Arrangement with the IMF was signed by the government on 5 August, approved by IMF Management on 15 August, and was discussed and approved by its Executive Board on 29 August 2003.

capital expenditures during the program; and (ii) certain measures to boost revenue, such as doubling the departure tax, adjusting fuel prices, a surcharge of 2 percent on imports, a 0.15 percent tax on bank checks, and a temporary tax of 5 percent on windfall profits obtained by the tourism sector and free zones as a consequence of the depreciated peso. The structural measures include a tax reform, reform of the civil service and a comprehensive reform of the government's financial management. It is expected that the laws supporting these reforms will be passed by congress in the next 18 months. The actions envisaged in the program to strengthen public finances also include the sale of public assets.

1.12 To ensure that the debt can be sustained in the medium and long terms, the program calls for a primary fiscal surplus in the next five years equivalent to 3.5 percent of GDP which, together with the sale of public assets worth 6 percent of GDP in the same period, will make it possible to gradually reduce the ratio of the public debt to GDP. The total public debt is expected to rise from the equivalent of 26.2 percent of GDP in 2002 to an average of 47.4 percent in 2003-2004 and then to decline gradually to 33 percent in 2008. The burden of the debt on the public sector accounts is also expected to improve in the medium term. The total public debt as a percentage of public sector income is forecast to increase from 135 percent in 2002 to 245.4 percent in 2003 and then to fall gradually to 164 percent in 2008.[6]

1.13 In addition to unifying the exchange market before the end of 2003, the government has undertaken to introduce a free floating exchange rate. As part of this initiative, by the end of November, the Central Bank plans to set up a mechanism for auctioning foreign currency, which will give the private market access to foreign currency without creating major distortions.

1.14 To guarantee price stability and thus the stability of the exchange rate, the government has proposed to maintain strict monetary discipline, which will be exercised increasingly through market instruments. It plans to resume competitive auctions for the sale of Central Bank papers by the third quarter of this year and to establish a rediscount window in the bank for those papers, to promote liquidity in the system.

1.15 To implement the government's macroeconomic program, a package of financial assistance has been planned from international lending agencies of US$1.2 billion over a 24-month period, including US$300 million from the World Bank, US$300 million from the IDB (US$100 million in the present operation and US$200 million in an emergency loan to guarantee maintenance of the

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6 Apart from the goals of generating a primary surplus and selling assets mentioned earlier, these debt and debt service projections are based on the following additional assumptions: (i) that the economy will grow at an average of 4.6% a year in the period 2005-2008; (ii) that annual average inflation for the period will be 3.7%; and (iii) that annual average depreciation of the exchange rate will be 0.7%.

government's social programs) and US$600 million from the IMF.[7] This amount excludes potential debt management operations with multilateral agencies used in the buyback of Central Bank certificates. The funds envisaged in the proposed operation form an integral part of the financial assistance package agreed on by the authorities, the IMF and the IDB to back the government's comprehensive economic program and, in particular, to strengthen the balance of payments by recouping a large part of the country's international reserves.

1.16 It is expected that successful implementation of the Stand-by Arrangement will restore the confidence of the economic agents and reestablish economic stability and growth. Inflation is expected to peak at 35 percent in 2003, reflecting the sharp devaluation of the exchange rate, but will decline to single digit levels in 2004. Despite shrinkage of 3 percent in 2003,[8] real GDP is expected to grow slightly in 2004 and to recover strongly after that. In this scenario, the balance of payments current account will post a surplus during most of the program.

1.17 The Dominican economy will continue to be very vulnerable to the external environment in 2003, given that international reserves are already low. External vulnerability is compounded by internal vulnerabilities associated with the fragile situation in the electric power and financial sectors and the impact that a sharp slowdown in the economy could have on the levels of liquidity of commercial banks and the quality of their loan portfolios, in the presence of strong monetary restrictions, growing dollarization of the financial system, exchange instability and high nominal interest rates.

1.18 Different studies on the banking system since the late 1990s, in particular the Financial Sector Assessment Program (FSAP) prepared by the IMF and the World Bank at the end of 2001, have pointed repeatedly to the structural weakness of the financial sector, which is a product of inadequate regulation and supervision, high indexes of credit concentration and the widespread practice of operating with related parties. The new Monetary and Finance Act and its appropriate development and implementation could help to correct this situation.

B. The sector

1.19 The Central Bank and credit and exchange policies have generated large quasi-fiscal deficits and the consequent build-up of losses in the Central Bank. Also, the bank has been used by the government to carry out activities that are not typical of a bank of issue, such as acting as a development bank, administering hotels and being lender of last resort. This situation distorts the impact of fiscal policy and

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7 The funds from the IMF are equivalent to 100% of the country's annual access limit for two years.

8 Real GDP in the first half of this year shrank by 0.8% compared to the same period in the previous year, which is consistent with the current projection for the year (-3%).

undermines transparency in execution of the activities that are typical of a central bank.

1.20 In the last decade, the authorities carried out major reforms in the financial sector, freeing interest rates, eliminating subsidies and caps on credit and tying legal reserves to bank liabilities in domestic currency. The prudential regulations were also modernized. However, despite the increases in the assets of the banks, the system continues to be weak and is undercapitalized because of rapid growth in credit and reserves for bad debts. This situation can lead to the appearance of significant systemic risks coming from growth in the debt in foreign currency, high nominal interest rates and the considerable concentration of bank loans in a few clients and with related parties, coupled with almost zero development of a capital market that would reduce term risks and ensure an adequate flow of medium- and long-term resources to promote productive investment.

1.21 The Dominican Republic has an extensive and active network of financial intermediaries that are legal but unregulated and that may or may not be linked to formal financial entities. All the formal entities are probably linked through their shareholders to informal entities such as private finance companies, off-stock exchange sales, credit card companies and off-shore banks. Owing to the recent events in the banking sector, it is clear that neither the internal controls of the banks, their external auditors nor the supervisory and control agencies (Office of the Superintendent of Banks and Central Bank) operated properly. It is therefore necessary to: give the Office of the Superintendent of Banks more power and independence in its work; improve the quality and intensity of on-site and off-site supervision by training personnel in the regulation and supervision of financial conglomerates and by improving the technical, legal and investigative areas; establish prudential regulations for capital requirements in function of risks; revise, update and modernize the risk clearinghouse and introduce solvency indexes for all risks (market, liquidity and interest rates); make accounting standards converge with international standards for financial information; establish prudential limits on loans to related parties; evaluate the quality of management and internal risk management controls; and strengthen inspections of off-shore banks.

1.22 As a response to this situation and with steady support from the Bank, the government enacted the Monetary and Finance Act (Law No. 183-02) in December 2002. The content of the new act corrects the shortcomings in the drafts of the monetary code that the Bank analyzed in the past. With the new text, the law gains in coherence and consistency. It develops the concept of the independence and autonomy of the monetary authority, establishing its top priority as inflation control, and the stability of the country’s payment systems, in coordination with the government’s economic policy, while promoting the transparency and accountability of monetary policy, bringing it into line with best international practices. It limits virtually all primary financing to the government, strengthens the function of bank supervision and introduces the practice of consolidated

supervision. It spells out the concept of second-tier bank and lays the groundwork for creating a second-tier multisector bank through the transformation of the National Housing Bank.

C. The country's sector strategy

1.23 To address the bank crisis, the government took corrective actions to safeguard the payment system and protect all legitimate depositors. Today, with the cooperation of multilateral agencies, the government has designed a program to strengthen the banking sector. The strategy seeks to improve transparency and provide a legal framework for bank resolution that effectively protects all the deposits in the system. The government's program rests on four pillars: (1) addressing the problems of weak banks that have been identified; (2) ensuring good management of the banking system, including good safeguards against fraud; (3) applying an improved framework for banking resolution; and (4) strengthening prudential regulations and bank supervision. The government is also committed to following up on the recommendations of the Financial Sector Assessment Program (FSAP) of 2002.

D. The Bank's sector strategy

1.24 The Bank's updated strategy for the Dominican Republic, which was approved by the Board of Executive Directors in May 2002, is intended to support the country's efforts to reduce poverty through the following strategic vectors: (i) to overcome the persistent macroeconomic and financial weaknesses; (ii) to improve the provision of social services; (iii) to relieve bottlenecks that hamper the development of the productive sectors; (iv) to build capacity to protect the environment and to prevent, mitigate and respond to natural disasters; and (v) to build up the capacity of administrative and political institutions to respond to social demands. The proposed program is fully consistent with (i), (iii) and (v). The Bank has participated actively in reforming the country's financial system. Last December, it approved the third and final tranche of the financial sector loan (773/OC-DR). The loan contract was signed on 21 November 1995. Its objective was to support a start on the implementation and execution of measures to strengthen the country's financial sector, which is marked by very high concentration in the hands of persons who wield economic and political power. In that context, the adoption of a monetary code acceptable to the Bank and the international financial community took a long time to achieve. Passage of the new Monetary and Finance Act is the first step toward a true reform of the financial sector.

1.25 Since 2001, through a IDB/MIF technical-cooperation project (TC-99-01-01-9), the Bank has been financing the strengthening of the Office of the Superintendent of Banks. Execution of the project was a key element in the design and preparation of the new Monetary and Finance Act. The main weaknesses in bank supervision have

been identified and headway has been made in preparing some of the regulations necessary to implement the new act.

1.26 The main lessons learned from the operations in question are that programs for financial sector reform are complex processes that demand a large formal commitment from the authorities and a political consensus for their effective materialization. Also, the capital position and technical capacity of all the institutions that participate in the design and implementation of policies affecting the financial sector needs to be permanently strengthened. Therefore, programs of this kind must be continually supported, ideally through successive operations in the sector, particularly technical-cooperation programs. The development of new practices or instruments requires permanent monitoring to ensure they are standardized and effectively used. Also, effective supervision is a permanent process and not a one-time exercise. To maintain good supervisory standards requires a permanent commitment from the authorities, which is difficult given the turnover in the officials responsible for the design, management and execution of financial and supervisory policy. It is likely that the new sector operation can be completed on schedule, thanks to the new act produced as a result of the previous sector operation and the IDB/MIF operation under way, which has made significant progress in regulating prudential requirements. These operations have also permitted the Bank to maintain its leadership in the reforms being carried out in the country. The proposed operation incorporates these lessons by supporting the consolidation of past and future reforms.

1.27 The present operation is an integral part of the government's macroeconomic program which, as has been mentioned, will provide a package of financial assistance from international lending agencies of US$1.2 billion over 24 months, including US$600 million from the IMF,[9] US$300 million from the World Bank, US$300 million from the IDB (US$100 million in this operation and US$200 million in an emergency loan to maintain the government's social programs). This loan to support reforms in the financial sector is accompanied by a technical-cooperation loan for US$6 million, which forms an integral part of an ambitious technical-cooperation program agreed upon by the country and the multilateral agencies and approved by the Board on 19 November 2003, together with a nonreimbursable technical-cooperation funding project (FSO) in the amount of US$200,000 now in preparation and a technical-assistance loan of US$14 million being prepared by the World Bank.

E. Program strategy

1.28 Presentation of this operation to the Board of Executive Directors is contingent on two fundamental conditions. The first is the existence of a macroeconomic stabilization program and the second is the existence of a strategy to restore the

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[9] The funds from the IMF are equivalent to 100% of the country's annual access limit for two years.

solvency of the financial system. This way of proceeding has three main benefits: (i) it makes it explicit that macroeconomic balance is an indispensable condition for the success of financial reforms; (ii) it avoids financing existing macroeconomic imbalances; and (iii) it avoids sending a signal accepting short-term management of the crisis, which is haphazard and could take a negative turn. The first corresponds to the economic program adopted by the government, which has served as the foundation for the financial agreement with the multilateral agencies, particularly for the Stand-by Agreement with the IMF. The second condition includes a final resolution for BANINTER, the definition of mechanisms to resolve other financial institutions with problems and the contracting and initiation of assisted inspections for the entire banking system, including a forensic audit of BANINTER.[10]

1.29 Overall, the program design involves the execution of immediate actions to address the problems with the three weak banks so as to minimize the systemic risk and limit the fiscal and monetary impact. The resolution of BANINTER involved revoking its license, in accordance with the Monetary and Finance Act, and placing the bank in liquidation. Its foreign lines of credit have been transferred to other banks, together with equivalent assets in foreign currency. Its legitimate deposits—not related-party deposits—have been transferred to Scotiabank, which is buying branches and other assets, and any outstanding amount is being made up for by the Central Bank. All the other deposits will be settled during the liquidation process, which is expected to take some time.

1.30 Two other banks, Bancrédito and Mercantil, have suffered from administrative shortcomings and have granted excessive loans to related parties. The first has been subject to a restructuring plan and has been sold to a domestic financial group. The bank will be kept under strict supervision until the additional liquidity provided by the Central Bank is repaid. The second bank was placed on a restructuring plan that includes replacement of its senior management, recapitalization and a business plan that will allow the liquidity provided by the Central Bank to be repaid. It was sold to a foreign bank. In both cases, the government's potential liabilities have been limited and the banks' shareholders will not be bailed out.

1.31 To address other problems that could arise in future, rules have been established on the Central Bank's role as lender of last resort. When a bank's liquidity exceeds 75 percent of its capital, supervision will be stepped up, supervisory personnel will be placed in the bank to monitor operations and a short-term regularization plan will be established. Banks that do not comply with the plan will be taken over. In no event will the shareholders be bailed out. The regulations to the LMF on the dissolution and liquidation of financial institutions have been recently approved by the Monetary Board.

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[10] These conditions have been discussed by the authorities, the IMF, the World Bank and the IDB. They form an integral part of the program with the IMF.

1.32 In second place, the program seeks to strengthen good management in financial institutions. The authorities have taken immediate steps to ensure there are no problems with accounting regularities in other banks. If they find problems, they will immediately impose the maximum penalties provided for in the law, establish a regularization plan and require the immediate preparation of new and exact financial statements. The Office of the Superintendent of Banks is preparing, with international assistance, a far-reaching process of assisted inspections of all the banks, seeking to detect accounting malpractices and determine net worth. The inspection plan is being defined with the coordination and assistance of an international firm that has been contracted on the basis of terms of reference agreed upon with the IDB, the World Bank and the IMF. The inspections will be concluded before the end of 2003. Banks found to be in violation of the prudential regulations will be penalized, subjected to regularization plans and intensified supervision or dissolved, pursuant to the LMF and the legal framework for resolution in the banking system.

1.33 The government is dealing decisively with cases of fraud and mismanagement of financial institutions, based on the LFM and legislation to prevent money laundering. As mentioned earlier, the persons who committed the BANINTER fraud have been tried in the courts and their assets have been frozen. In other cases, senior management and directors have been replaced, control of the institution has been transferred to other shareholders, or the institution has been sold. Steps have also been taken to ensure that institutions affected by malpractice are duly compensated by the guilty parties, even from their personal assets, to limit the public costs. The supervisory authorities will refer all evidence of misappropriation of funds to the judicial authorities for prosecution. The government is drafting a law on financial crimes to be sent to The Congress at the end of September, which will strengthen restraints on shareholders and officials suspected of malpractice, including freezing their personal assets, which will limit their ability to transfer funds abroad, and preventing them from leaving the country.

1.34 A third element in the program is to strengthen the legal framework for bank resolution. A bill as been sent to congress that seeks to protect the stability of the system while minimizing the fiscal costs. It is expected to be passed in the coming weeks. The legislation applies to banks that are important in the system. The decision to apply this framework in specific cases will be proposed jointly by the Superintendent of Banks, the Governor of the Central Bank and the Minister of Finance and approved by the country's president. Offending banks will be dissolved, following procedures determined by the Monetary Board, after a feasibility study conducted by external experts, who will report to the Superintendent of Banks. If the bank is considered viable and its capital requirement coefficient exceeds 50 percent of the minimum, the private shareholders will retain their majority shares and a public fund will be used to recapitalize the bank to the minimum required by the regulations. Strict conditions will be established for recapitalization with public funds in a memorandum of

understanding that defines the exit procedures, with time limits, for the public sector.

1.35 If the bank is found to be viable but the private shareholders are unable to meet the requirement of capital that exceeds 50 percent of the minimum, the bank will be completely recapitalized with public finds. Unproductive assets and residual liabilities, including any remaining private capital, will be liquidated. The private shareholders will lose their voting rights, and will become the creditors with the lowest priority. A private firm will be contracted, with appropriate incentives, to administer the bank and prepare it for reprivatization. If it is found that the bank is not viable, it will be closed and dissolved under the procedures established in the LMF. Public funds will only be used to cover the gap between the value of first-ranked legitimate internal liabilities and the value of assets. By way of exception, when the liabilities cannot be transferred to other banks, an additional deposit guarantee fund will be used solely to pay all legitimate internal liabilities.

1.36 Last, the program will strengthen prudential regulations and bank supervision, with assistance from the IMF and other international organizations. All the regulations needed to fully implement the LMF will be prepared in the coming months, in a process that will conclude by the end of September 2004. Priority has been given to regulations bearing on access to lender of last resort mechanisms and a deposit guarantee fund. The prudential regulations will be strengthened and made to conform to best international practices, including the classification and establishment of loss reserves, capital adequacy, treatment of off-shore subsidiaries, concentration of market risk, risk management, policies to prevent money laundering, and good management. This process will concluded by the end of September 2004 at the latest. The government understands that supervisory practices need to be strengthened. Therefore, it is preparing strategic plans for the Central Bank and the Office of the Superintendent of Banks, to improve their human, technological and financial resources, which should be completed and launched at the end of 2003. The plans will first address critical areas, including training and the development of skills in data collection and analysis. As part of the effort to improve the quality of bank supervision, a panel of independent experts will be appointed by the end of 2003, which will report any failings by the monetary and supervisory authorities that could have contributed to the recent problems, particularly in BANINTER.

F. Coordination with other multilateral agencies

1.37 Since the beginning of this year, when the problems in the Dominican banking sector became patent, the government asked the multilateral agencies, particularly the IMF, for cooperation. This year, the IDB has participated actively in joint missions with the IMF and the World Bank to examine and correct the problems in the Dominican banking sector. The three agencies are also coordinating the provision of technical assistance to support the recovery and strengthening of the

Dominican banking sector. The possibility of participation by the United States Treasury Department in providing technical assistance is even being examined. The World Bank is planning a Technical Assistance Loan (TAL) for the financial sector, which could be concluded by the end of this year. The IMF negotiated a Stand-by Arrangement with the government to stabilize the macroeconomic balance and restore the solidity of the banking system, while reestablishing confidence in the Dominican economy.

II. THE PROGRAM

A. Objectives and description

2.1 The ultimate objective of the project is to strengthen the Dominican banking system by supporting the program that the authorities have proposed. More specifically, the program will facilitate the development and full implementation of the new Monetary and Finance Act (LMF) and the institutional strengthening required to make the financial reform established in the act permanent. The financial reform consolidation program has three objectives that complement and reinforce each other: (i) to strengthen the public institutions that support the financial intermediation system, particularly the Central Bank; (ii) to strengthen the supervisory agencies in order to modernize the regulatory framework within which the banking system operates, improve its transparency, promote its competence and efficiency, protect its solvency and improve its ability to withstand internal and external shocks; and (iii) to lay the groundwork for restoring the solvency of the banking system and public confidence in it, while establishing mechanisms for an adequate flow of medium- and long-term funds to finance productive investments.

B. Program structure

2.2 The financial reform consolidation program is a lending operation to support reforms in the financial sector, which seeks to strengthen the financial position and technical capacity of the Central Bank, the Office of the Superintendent of Banks and the National Housing Bank. It will set the stage for strengthening the commercial banks and reestablish their credibility and solvency. Given the need to ensure the viability of the program and its consistency with a sustainable macroeconomic context, presentation of the financial reform consolidation program to the Board of Executive Directors for approval will be conditional on the existence of a sustainable program for macroeconomic stabilization. The proposed program has three specific components. Component A: regulation of the execution of monetary policy and adjustment of the structure of the Central Bank to comply with the objectives of the new Monetary Act. Component B: strengthening of bank supervision and development of the financial market. Component C: elimination of the credit functions of the Central Bank and creation of a replacement mechanism to provide development credit for the productive sector (second-tier bank).

2.3 The first component seeks to strengthen the capital position and technical capacity of the monetary authority, particularly the Central Bank, by developing the enabling regulations of the LMF and laying the groundwork to enable the Central Bank to operate efficiently and eliminate the quasi-fiscal deficit. This component will support reforms in the following specific area: (i) the new operating structure required for the Central Bank and its professionalization through the adoption of suitable human resource management; (ii) definition of a suitable plan to adjust the

capital position of the Central Bank (reduction of the quasi-fiscal deficit); (iii) preparation and approval of the internal regulations of the new Monetary Board; (iv) regulations to define the instruments for monetary policy execution, particularly open market operations, exchange policy and the system of payments; (v) definition and regulation of the lender-of-last-resort mechanism and deposit insurance (contingency fund): (vi) definition of the transition process for the banks to adjust to existing regulations and the regulations adopted under the proposed program, particularly to regain adequate solvency for normal operations; and (vii) publication and dissemination of information on the Central Bank (financial statements) and the monetary program (execution and results) with timetables for submission, to ensure the regular and timely presentation of information.

2.4 The second component seeks to strengthen the financial position and technical capacity of the Office of the Superintendent of Banks. It will support changes to the rules and prudential regulations to enable: (i) the Office of the Superintendent of Banks to act independently, including operational independence and financial autonomy, and professionalization of the agency through the design and execution of a strategic plan, coupled with the adoption of adequate human resource management; (ii) the adoption of international standards and practices in prudential regulation regarding the concentration and management of credit risk and modernization of auditing practices;[11] (iii) performance of assisted inspections of all the banks, with the dual purpose of eliminating mismanagement by banks and determining the true level of solvency of the financial system; (iv) establishment of a portfolio information clearinghouse for consultation and compulsory reporting; (v) adoption of a streamlined and effective system of penalties; (vi) achievement of greater transparency in the financial information provided by the banks and other financial institutions to the Office of the Superintendent of Banks and the public; and (vii) standardization of the banking market.

2.5 The third component seeks to provide the productive sector with appropriate mechanisms for channeling medium- and long-term resources as a replacement for the development credit function that the Central Bank performed in the past. The Central Bank will eliminate its functions of providing credit for the nonfinancial public sector and the productive sector, both directly and through rediscounts for the banking sector. The new Monetary and Finance Act calls for the establishment of a new second-tier bank, through the transformation of the National Housing Bank which will lend and facilitate funds for the productive sectors and promote a

[11] The aspects to be reviewed and regulated include: (i) general rules governing the opening and operation of financial institutions; (ii) updating the prudential and supervisory rules, particularly for financial groups; (iii) a mechanism to monitor lending and borrowing operations in foreign currency; (iv) a methodology for analyzing financial institutions, with early-warning indicators; (v) consolidated supervision; (vi) system of penalties; (vii) procedures for dissolving and liquidating institutions; (viii) operation of the contingency fund; (ix) public banks (Reserve and Agriculture Banks); (x) savings and loan associations; (xi) insurance for secured mortgages; and (xii) policies to prevent asset and capital laundering.

secondary mortgage market. The following aspects are fundamental: (i) review and reformulation of the bank's charter and its prudential rules; (ii) definition of strategies and instruments to carry out its new roles; (iii) readjustment and expansion of its operating structure and optimization of procedures in terms of risk management systems, costing policy and the mechanisms for allocating resources; and (iv) staff training so that the new second-tier bank can take operational responsibility for the credit programs of the IDB and other donors in the near future.

2.6 For the purposes of program monitoring and compliance, a matrix of conditions has been prepared, accompanied by performance indicators and benchmarks.

C. Cost and financing

2.7 The program will cost a total of US$100 million. The financial terms and conditions are presented in the following table:

Amount and source:	IDB:	US$100.0 million
	OC/FFI:	US$ 30.2 million
	(IFF):	US$ 69.8 million
	Total:	US$100.0 million
Financial terms and conditions:	Amortization period:	20 years
	Grace period:	5 years
	Disbursement period:	18 months
	Interest rate:	variable
	Inspection and supervision:	0%
	Credit fee:	0.25%
	Currency:	U.S. dollar. Single Currency Facility

III. PROGRAM EXECUTION

A. Borrower, guarantor and executing agency

3.1 The borrower will be the Dominican Republic. The executing agencies will be the Banco Central de la República Dominicana [Central Bank] (BCRD), the Superintendencia Bancaria [Office of the Superintendent of Banks] (SB), and Banco Nacional de la Vivienda [National Housing Bank] (BNV). Through the Technical Secretary of the Office of the President (STP), the borrower will sign an agreement with the BCRD, the SB and the BNV establishing the responsibilities of the executing agencies.

B. Program execution and administration

3.2 A program administration technical unit (PATU), reporting to the Secretary of the Monetary Board, will be established to coordinate and monitor program execution and compliance. PATU will also be responsible for overall monitoring of the technical-cooperation funds that support execution of the proposed program, which is the direct responsibility of senior management of the Central Bank, the Office of the Superintendent of Banks and the National Housing Bank, in their capacity as program executors.

3.3 However, all the executing agencies will receive technical and administrative support on the same level from PATU. Although the technical characteristics of the program and the nature of the executing agencies make it necessary for the program to be executed flexibly, a general program execution framework and a system of internal control will be designed to coordinate program follow-up and evaluation and allow for feedback for its continuous improvement.

3.4 The proposed decentralized management will make for effective control and follow up, concurrently and/or ex post, by the Central Bank, the Office of the Superintendent of Banks and the National Housing Bank, based on the following considerations:

(i) The activities included in the program correspond to legal mandates conferred on different entities that form an integral part of the financial system and each component will be executed by the competent entity.

(ii) The proposed design permits the results of international cooperation programs to be used and allows for greater flexibility in executing the different program components independently, so that delays in one of the agencies will not have a negative effect on execution of the rest of the program.

(iii) Equitable participation by the agencies will allow them to strengthen their institutional capacity, while maintaining their independence.

(iv) Each executing agency will establish a program technical unit (PTU), whose composition will be decided by the senior management of each of them.

3.5 PATU will have the following responsibilities:

(i) To process disbursement requests.

(ii) To verify and monitor compliance with the contractual conditions.

(iii) To centralize the program's technical information.

(iv) To coordinate and carry out monitoring, control and evaluation and to maintain a follow-up system to obtain feedback for continuous improvement.

3.6 PATU will have a permanent technical advisor, preferably an international expert with extensive experience in the design of financial policies, central banks and bank supervision. It will also have a local administrative advisor to take charge of program monitoring.

3.7 The PTU in each executing agency will act as liaison with PATU and will have the following responsibilities:

(i) To provide all the information required by PATU to process the program's disbursement requests.

(ii) To verify compliance with the contractual conditions.

(iii) To centralize the program's technical information and processing, ensuring that proper files are maintained.

(iv) To coordinate and carry out monitoring, control and evaluation and to maintain a follow-up system to obtain feedback for continuous improvement.

C. Procurement

3.8 The fast-disbursing program funds will be used to finance the total cost in foreign currency of eligible imports from Bank member countries. The Bank's procedures for sector loans established in document GN-2001-2 will be applied. PATU, in coordination with the Office of the Comptroller General, is responsible for

maintaining the financial and accounting records on sources and uses of program funds.

D. Execution period and disbursement schedule

3.9 The minimum disbursement period for the policy-based loan will be 18 months counting from the date it is declared eligible for the first disbursement. The loan will be disbursed in three tranches. A first tranche of US$40 million will be disbursed when congress ratifies the operation and all the conditions precedent thereto established in the matrix of conditions attached to this proposal have been fulfilled. The second tranche in the amount of US$20 million will be disbursed at least nine months after the first tranche, upon fulfillment of all of the corresponding conditions precedent. The third tranche of US$40 million will be disbursed not less than 18 months after the first tranche, upon fulfillment of all the conditions precedent to this final tranche. All of the special conditions specified in the matrix must be fulfilled as a condition precedent to presentation of the program to the Board of Executive Directors for consideration. The deadline for the last disbursement of the financing will be 30 months after the effective date of the loan contract.

E. Monitoring and evaluation

3.10 The Bank will supervise the operation through the project team, with the cooperation of its Country Office in Santo Domingo. PATU, with the cooperation of the PTUs, will remit an initial report to the Bank on compliance with the conditions precedent to the first disbursement, together with a timetable of activities for the first nine months of the project that correspond to the conditions precedent to the second disbursement. This report will be the model for the later reports to be remitted to the Bank requesting subsequent disbursements.

3.11 The second report will also include a detailed analysis of compliance with the project objectives, based on the project's activities and performance indicators. The main performance indicators to be included in program evaluation will be: (i) a report on the results of the on-site inspection of all the commercial banks; (ii) the regulations corrected and implemented by the Monetary Board, the Central Bank and the Office of the Superintendent of Banks; and (iii) evidence that the information systems are working properly.

3.12 The borrower agrees to assist with any evaluation of the program that the Bank may decide to conduct after completion in order to determine the extent to which the program objectives have been attained and to furnish the Bank with such information, data, and documentation as the latter may request for the purposes of the evaluation. The borrower further agrees to provide such technical, logistical, and administrative support that may be required for the ex post evaluation.

3.13 The following indicators will be used for monitoring and evaluation of the outcomes: (i) financial deepening—M2 (expanded money supply)/GDP ratio and M1 (means of payment)/GDP ratio; (ii) banking system solvency and soundness (for individual banks and for all banks on a consolidated basis)—capital/total assets, capital/risk-weighted assets, reserves/nonperforming loans, nonperforming loans/total portfolio; (iii) quality of supervision—accountants, financial officers, and economists in SB supervision and regulation department/total SB staff, number of SB professionals with bachelor's or master's degrees in accounting and/or finance/SB professionals receiving post-graduate training in accounting and/or finance.

IV. FEASIBILITY AND RISKS

A. Institutional feasibility

4.1 The problems in the banking system can be partly explained by the marked weakness of institutions in the sector. Therefore, the program includes institution-building activities that are absolutely necessary for the process of modernizing the financial intermediation system. Given the scant institutional capacity to implement the new Monetary and Finance Act, it is advisable to provide technical assistance funding to strengthen the Central Bank and the supervisory agencies and to create a second-tier bank (transformation of the National Housing Bank) and to improve the information systems and regulate the risk information clearinghouse. Given the urgency with which the government wishes to address the serious problems that exist in the Dominican banking sector and the pressing need to implement the act and continue with financial sector reforms, the authorities require technical support to complement the country's few human resources who are specialists in financial crises. In parallel to the program, the authorities have defined an ambitious technical-cooperation program with the participation of the multilateral lending agencies (IMF, World Bank and IDB) costing more than US$20 million (see paragraphs 4.5 and 4.6).

B. Socioeconomic feasibility

4.2 This operation does not qualify as a poverty-targeted investment. It does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704). It does not contain explicit performance indicators to measure poverty reduction or improvements in social equity. It will have an indirect social impact by protecting small savers and minimizing the risk of a financial crisis that would that would impact all sectors of society equally, meaning that it would be regressive.

C. Financial feasibility

4.3 This program will help to restore macroeconomic stability. In 2003, it is expected that inflation will peak at 35 percent, reflecting the impact of the exchange rate, and will drop to the single-digit level in 2004. After falling in 2003, real GDP will grow slightly in 2004 and recover strongly after that. Consistent with these assumptions, the current account balance should show a surplus during most of the program and net international reserves should also recover. Given the increase in the public debt caused by recent problems in the banking sector, the government is determined to strengthen public finances. Traditionally, the Dominican Republic has been known for its solid fiscal policies and low levels of public debt. In this context, stabilizing and reducing the public debt in the medium term is a key objective. The debt coefficient is projected to rise to close to 49 percent of GDP in 2004. However it

will decline steadily after that to about 35 percent by the end of this decade. This will mainly be achieved through a gradual increase in the primary surplus to 3.5 percent of GDP (close to twice the average in the 1990s), facilitated by a series of fiscal structural reforms and the sale of public assets worth close to 6 percent of GDP over the next three years (2 percent of GDP during the program). These assets include land, mining projects and real estate.

D. Environmental impact

4.4 Owing to its nature, the project will have a neutral environmental impact

E. Benefits

4.5 The program will facilitate the institutional strengthening of the public institutions that support the financial intermediation system, particularly the Central Bank and the Office of the Superintendent of Banks, and will help to modernize the regulatory framework in which the banking system operates, improve its transparency, promote its competence and efficiency, lay the groundwork for protecting its solvency and improve its ability to withstand internal and external shocks. The direct beneficiaries of this operation are the institutions responsible for defining and implementing monetary, exchange and financial policies (the Monetary Board, the Central Bank, the Office of the Superintendent of Banks and the National Housing Bank), the commercial banks and the users of the banking system (depositors and borrowers). Indirectly, the program will help to maintain fiscal stability, which is a key element for the government and the Bank in the poverty-reduction strategy. Experience has shown that financial crises have an immediate impact on the country's economic development and increase its poverty levels.

F. Risks

4.6 The main risks of the operation are that it will be executed under unfavorable conditions, particularly on account of marked institutional weakness, serious fiscal difficulties, particularly in the electric power sector, and the political context (preelection year, presidential elections will be held in May 2004). The main lesson learned from operations to support financial sector reforms is that reforms are complex processes that demand a large formal commitment from the authorities and a political consensus for their effective materialization. Therefore, programs of this kind must be continually supported, ideally through successive operations in the sector. The development of new practices or instruments requires permanent monitoring to ensure they are standardized and effectively used. Also, effective supervision is a permanent process and not a one-time exercise. To maintain good supervisory standards requires a permanent commitment from the authorities, which is difficult given the turnover in the officials responsible for the design, management and execution of financial and supervisory policy. This operation is an

integral part of a package of actions and financial assistance from the multilateral agencies for the country so that it can address the problems in the banking sector and restore confidence. But as has been mentioned, it will be executed under adverse conditions caused by the fiscal difficulties, the political context and institutional weaknesses. It is likely that the new sector operation can be completed on schedule, thanks to the new act produced as a result of the previous sector operation and the IDB/MIF operation under way, which has made significant progress in regulating prudential requirements. The proposed operation incorporates these lessons by supporting the consolidation of past and future reforms.

4.7 Together, the IDB, the IMF and the World Bank have worked with the authorities to design a technical-assistance matrix which, in addition to the IDB operations mentioned below, includes a technical assistance loan that the World Bank is currently preparing for US$14 million. The IMF has focused its assistance on very short-term aspects and matters related to the design and execution of monetary and exchange policy, while the World Bank is focusing its technical assistance on the normal operation of the system of payments, development of the capital market and of the financial system in general. For its part the IDB has focused on supporting the regulation of the new Monetary and Finance Act, the strengthening of bank supervision and the recovery of solvency in the banking system. However, it should be noted that the government's program is a whole, whose different parts are being supported by the multilateral agencies.

4.8 As mentioned, the government, together with the multilateral agencies, has prepared a comprehensive technical-assistance plan and the formal request to the Bank includes the use of undisbursed funds from the IDB/MIF operation (US$700,000), the design of a parallel technical-cooperation program with FSO resources (TC-02-10-04-5 for US$200,000) and the reimbursable technical-cooperation loan (TC-L1001) approved by the Board on 19 November 2003, together with a technical-assistance loan from the World Bank. The detailed description of the technical-cooperation loan linked to the development of the financial sector is given in this document's matrix of conditions. The project team will recommend the actions necessary to ensure that activities under the technical-assistance package are consistent with the objectives of stage II of the financial sector loan and support its effective execution.

POLICY MATRIX

Policy	Precedent to submission to Bd. of Exec. Directors	Precedent to first disbursement	Precedent to second disbursement	Precedent to third disbursement
Macroeconomic situation	The economic policy framework is consistent with program objectives.	The economic policy framework is consistent with program objectives.	The economic policy framework is consistent with program objectives.	The economic policy framework is consistent with program objectives.
Component 1				
Monetary and Finance Act (LMF) Regulations				
Approval and implementation of the regulations envisaged in the LMF		Presentation of a timetable for drafting and approving the regulations.	At least the regulations envisaged in the LMF have been approved by the Monetary Board. 1. Regulations for opening and functioning of financial intermediaries 2. Foreign exchange regulations 3. Regulations for monetary operations 4. Regulations for monetary and financial program 5. Regulations on capital adequacy 6. Regulations on sanctions and penalties 7. Regulations governing the Contingency Fund 8. Regulations governing the lender of last resort 9. Regulations governing related parties 10. Regulations on off-shore operations	

Policy	Precedent to submission to Bd. of Exec. Directors	Precedent to first disbursement	Precedent to second disbursement	Precedent to third disbursement
Monetary policy				
Open market operations	Reintroduction of market mechanisms for BC intervention in the money market.	Maintenance of market mechanisms for BC intervention in the money market as the main instrument for monetary control.	Maintenance of market mechanisms for BC intervention in the money market as the main instrument for monetary control.	Maintenance of market mechanisms for BC intervention in the money market as the main instrument for monetary control.
Liquidity instruments for the financial sector		Development of an overnight window and a Lombard-type window.	Implementation of a mechanism for publishing the BC's interest rates on its liquidity instruments for the financial sector.	Maintenance of the liquidity instruments and the mechanisms for publishing the interest rates.
Regulations for implementation and dissemination of the monetary program		Presentation to the Bank of the timetable for preparing the regulations.	Approval of the regulations. Presentation to Congress of the monetary program for 2004.	Presentation to Congress of the monetary program for 2005.
Monetary and financial transparency of the Monetary and Financial Authority		Presentation to the Bank of the timetable for preparing the regulations.	Approval of the regulations governing the operation of the new Monetary Board.	Disclosure of monetary and financial information based on best international practices.
Exchange policy				
Coverage in foreign currency of deposits in foreign currency	Maintenance of reserves on deposits in foreign currency in the BC.	Regulations governing reserves on deposits in foreign currency are maintained. The BC intervenes in the exchange market through procedures that do not introduce distortions in determination of the price of foreign currency.	Regulations governing reserves on deposits in foreign currency are maintained. The BC intervenes in the exchange market through procedures that do not introduce distortions in determination of the price of foreign currency.	Regulations governing reserves on deposits in foreign currency are maintained. The BC intervenes in the exchange market through procedures that do not introduce distortions in determination of the price of foreign currency.
Lender of last resort				
Contingency Fund (CF) (deposit insurance)		Preparation of operating regulations for the CF.	The CF is operating in accordance with the rules.	The CF is operating in accordance with the rules.

Policy	Precedent to submission to Bd. of Exec. Directors	Precedent to first disbursement	Precedent to second disbursement	Precedent to third disbursement
Adjustment of the BC's capital position				
Definition of the quasi-fiscal debt and a plan for solving it			Presentation of a study quantifying the government's debt to the BC (Art. 82 LMF).	Approval by the government of the plan.
Capitalization of the BC			Since 13 November 2003, the BC has been capitalized in an amount of not less than US$40 million equivalent.	Since 13 November 2003, the BC has been capitalized in an amount of not less than US$65 million equivalent.
Definition of a new accounting plan for the BC			Approval of the new accounting system for the BC.	The BC's financial statements for 2004 have been published and reflect the new accounting system.
Internal regulations				
BC		Presentation of the timetable for drafting and approving the BC's internal regulations.	Approval and introduction of the regulations.	The regulations are maintained.
Organizational structure of the BC			Approval by the Monetary Board of the BC's new organizational structure.	Approval by the Monetary Board of the BC's new organizational structure. Adoption of a human resources policy.
Transition process – Strengthening of the banking system				
Systemic risk Transition mechanisms to ensure the recovery of the banking system	Presentation and passage of a bill entitled "Special risk prevention program for financial intermediaries".	Presentation of a timetable for regulating the law.	The Monetary Board has approved the regulations to the law.	
Mechanisms for capitalizing the banking system			The programs to capitalize entities with solvency problems have been approved by the Monetary Board. The Superintendent of Banks has verified compliance with the programs and in the event of noncompliance has applied the regulations.	The SB has verified compliance with the programs and in the event of noncompliance has applied the regulations.

Policy	Precedent to submission to Bd. of Exec. Directors	Precedent to first disbursement	Precedent to second disbursement	Precedent to third disbursement
Component 2				
Bank supervision				
Institutional strengthening		Approval of the strategic plan. Approval of the internal regulations of the SB.	Definition and introduction of the SB's operating structure.	The SB is implementing the strategic plan and new operating structure, including a human resources management office.
Adjustment of prudential and banking regulations, administration and management of credit risk		The Monetary Board has approved the regulations on the control of operations with related parties.	The rules governing related parties continue to be enforced. The Monetary Board has approved the regulations on consolidated supervision.	The rules governing related parties continue to be enforced. The rules governing consolidated supervision continue to be enforced.
Rules on opening and operation		Adoption of fit and proper principles.	Fit and proper principles continue to be enforced.	Fit and proper principles continue to be enforced.
Methodology for financial monitoring of financial intermediaries		Application of the new methodology.	The SB uses early-warning indicators.	The SB uses early-warning indicators.
System of sanctions		Approval of the regulations on sanctions.	The regulations on sanctions continue to be enforced.	The regulations on sanctions continue to be enforced.
Portfolio information clearinghouse			Definition of compulsory reporting and consultation systems.	All banks report to the portfolio information clearinghouse and in the event of noncompliance they will be subject to the actions established in the regulations.
Protection for users of the financial system		Creation of a structure for user protection.	Approval of the regulations.	
Standardization of the market			Publication of the financial statements of financial intermediaries under the new accounting system.	Introduction of a system for the publication of financial information (financial indicators and interest rates)

Policy	Precedent to submission to Bd. of Exec. Directors	Precedent to first disbursement	Precedent to second disbursement	Precedent to third disbursement
				by banks for the general public.
Money laundering		Evaluation of compliance with CFATF regulations.		Presentation of a report on compliance with the CFATF regulations.
Recovery of the banking system				
Assisted inspections with the participation of international experts	Contracting of international consultants and preparation of procedures for performing assisted inspections.	Assisted inspections under way.	All banks have been subject to assisted inspections. The SB and the Monetary Board have approved the solution plans to ensure the solvency of the banking system and remedy all the shortcomings detected by the assisted inspections.	The SB verifies that all banks are complying with all the regulations and in the event of noncompliance, it applies the sanctions established in the regulations.
Problem banks	BANINTER Resolution BanCrédito Resolution Banco Mercantil Resolution			
Preventive analysis	Selective cash audits for all banks Consistency analysis of changes in bank compensation			
On-site inspections				The SB has performed on-site inspections of at least 10 full-service banks.
Component 3				
Elimination of the Central Bank's credit functions and creation of a substitute credit mechanism to promote the productive sector (second-tier bank)				
Credit for the nonfinancial public sector (NFPS)	As of September 2003, the BC no longer grants loans directly or through rediscounts to the NFPS.	As of September 2003 the BC no longer grants loans directly or through rediscounts to the NFPS.	As of September 2003 the BC no longer grants loans directly or through rediscounts to the NFPS.	As of September 2003 the BC no longer grants loans directly or through rediscounts to the NFPS.
Credit to the productive sector	As of September 2003 the BC no longer grants loans directly or through rediscounts to commercial banks for the	As of September 2003 the BC no longer grants loans directly or through rediscounts to commercial banks for the	As of September 2003 the BC no longer grants loans directly or through rediscounts to commercial banks for the	As of September 2003 the BC no longer grants loans directly or through rediscounts to commercial

Policy	Precedent to submission to Bd. of Exec. Directors	Precedent to first disbursement	Precedent to second disbursement	Precedent to third disbursement
	productive sector. The BNV does not engage in new rediscount operations for commercial banks until its new operating structure has been approved and its business plan has been defined.	productive sector.	productive sector.	banks for the productive sector.
Definition of the new operating structure for the BNV	Transfer of development funds from the BC to the BNV.		Approval by the board of directors of the new operating structure.	Credit regulations approved.
Definition of a business plan for the BNV			Approval by the board of directors of the business plan.	Regulations for the classification and definition of entities eligible for portfolio rediscounts approved.

Secretariado Técnico de la Presidencia

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[TECHNICAL SECRETARIAT FOR THE PRESIDENT]

Dominican Republic
Financial Reform Consolidation Program

Policy Letter

Santo Domingo, Dominican Republic, 12 February 2004

Mr. Enrique Iglesias
President
Inter-American Development Bank (IDB)
Washington, D.C., USA

Dear Mr. Iglesias:

Deterioration in the external environment coupled with the failure of a large private bank have undermined the confidence of economic agents, exerting pressure on the Dominican peso and weakening public finances. The Dominican government has undertaken to address these problems through a comprehensive economic program to strengthen the banking system and macroeconomic conditions, thereby laying the groundwork for the reactivation of vigorous and sustainable growth.

The program rests on three pillars: (1) measures to boost confidence in the banking system and particularly in the institutions that guide the country's financial policies; (2) actions to strengthen public finances and ensure the sustainability of the debt; and (3) a flexible exchange rate coupled with strict monetary discipline.

To assist in these efforts, the government has asked the Bank to approve a loan equivalent to US$100 million for an operation to support policy reforms.

We believe that the policies established in this document are appropriate for achieving the program's objectives.

MACROECONOMIC FRAMEWORK

Although economic activity is expected to begin recovering in the second half of 2004, real GDP is projected to decline by around 1 percent in 2004 on an annualized basis, but to grow strongly thereafter. As confidence builds and domestic demand picks up, the external current account surplus should moderate. Inflation, after peaking at 43 percent in 2003, is targeted to decline to less than 14 percent in 2004 and to the single digit range in 2005. A moderate recovery of net international reserves (NIR) is projected during the remainder of the program, with NIR moving from negative territory (-US$95 million) to zero by late 2004, and then rising to US$300 million in 2005.

Macroeconomic Projections

	2002	2003	2004	2005
Real GDP (percentage change)	4.1	-1.3	-1.0	4.0-5.0
CPI (12-month percentage change)	10.5	42.7	14.0	9.5
External balance on current account (as a percentage of GDP)	-3.8	5.6	4.5	2.9
Total international reserves (in US$ millions)	630	279	725	1,243
Net international reserves (in US$ millions, as defined in the program)	356	-95	0	300

Fiscal policy, reform, and sustainability of debt

Fiscal objectives. The key objective of fiscal policy is to bring about a reduction in the consolidated public sector debt, which soared to 57 percent of GDP in 2003 as a result of central bank assistance to commercial banks, government support of the electricity sector, and the real depreciation of the peso. To this end, steps have already been taken to narrow the combined public sector deficit to 3.75 percent of GDP in 2004, with a further reduction to 1.8 percent of GDP the following year on the strength of a comprehensive tax reform in 2004.

This fiscal outlook, together with a resurgence in economic growth and the sale of government-owned assets (real estate, mines, government stakes in certain firms, and bank collateral) in an amount equivalent to 6 percent of GDP envisaged in the original program, will go a long way towards steadily reducing the public debt to around 40 percent of GDP by 2008.

**Breakdown of Public Sector Accounts
(as a percentage of GDP)**

	2002	2003	2004	2005
Nonfinancial public sector balance	-2.3	-2.7	0.2	1.3
Of which: Central government revenue	16.9	15.7	16.6	17.3
Central government expenditure	19.1	18.1	15.9	16.0
Quasi-fiscal balance of the Central Bank	-0.3	-2.5	-3.9	-3.1
Combined public-sector balance	-2.6	-5.2	-3.8	-1.8
Primary balance	-1.4	-0.9	2.5	3.5
Interest	-1.2	-4.3	-6.2	-5.3
Gross public-sector debt	27.0	56.8	54.4	52.0
External	22.3	37.9	35.5	33.7
Domestic (including Central Bank and electricity sector)	4.7	18.9	18.9	18.3

Adjustment measures in 2004. To achieve the fiscal targets set for 2004, the government has introduced an economic policy package amounting to 2.5% of GDP. Of this amount, fiscal measures account for approximately 0.5% of GDP and retrenchment for around 2%. The package, which was approved by the Congress in January 2004, consists of the following measures:

- ***Tax measures***. These measures encompass (i) increases in excise taxes on alcohol, tobacco, and other products; (ii) removal of exemptions on taxes on interest income received by companies on Central Bank certificates and on the income received by savings and loans associations; and (iii) standardization of the tax measures set by decree in 2003, including a 5% tax on exports of goods and services for a period of six months, a 2% surcharge on imports, and an increase in the airport departure tax. If the government's deficit widens further during the year, additional tax policy measures will be taken in consultation with the IMF, to offset the imbalance.

- ***Retrenchment measures***. Given the problems encountered in introducing a more ambitious tax package in the short term, the 2004 Budget contains cutbacks in capital spending as a percentage of GDP and a reduction in discretionary spending. In light of the 9% ceiling placed on public sector wages and salaries, the Budget passed by the Congress limits total public spending to a level below 16% of GDP. This would be its lowest level in five years, and the government acknowledges the need to prepare for a possible increase in the medium term. Meanwhile, we will make every effort to ensure that the specified spending limits are strictly adhered to, including the functions of a new coordinating committee set up to supervise and monitor externally-financed capital spending.

- ***Protection of social spending***. Appropriate steps have been taken to protect priority social programs from the retrenchment envisaged under the 2004 Budget. Such programs have to do mainly with staples for the poor, health care, and education,

and are backed by IDB social sector programs. Consequently, social spending is expected to remain around 7% of GDP, much the same as in 2002 and 2003.

Electric power subsidies. The Budget also provides for an electric power subsidy amounting to 0.9% of GDP based on a broader strategy to improve the financial condition of this critical sector and the need to protect the poor from the impact of higher rates (see paragraph 9 below). Despite these efforts, however, the deficit corresponding to State power distribution companies will continue around 0.6% of GDP, to be factored into the overall public sector deficit target.

Fiscal reform. The government has implemented a number of fiscal measures that could be sustained into the long term, such as the elimination of subsidies on gas and electricity for businesses and large users; increases in excise taxes and the elimination of certain income tax exemptions. A number of temporary measures, however, have had to be adopted, such as export and import taxes, and certain cuts in spending. It is our intention to introduce a tax reform in 2004 that will focus on widening the domestic tax base and on adjusting tax rates, in order to replace highly distorting taxes and offset the reduction in customs tariffs stipulated under forthcoming bilateral trade agreements, including with the one negotiated with the United States. The changes envisaged include specifically an across-the-board elimination of ITBIS (value-added tax) exemptions and all other income tax exemptions, and a review of tax rates including ITBIS and excise rates. A proposal is being drafted with the help of international experts for technical review by late March 2004. This proposal will go before the Congress by July 2004, as envisaged in the original program, in close consultation with the IMF.

Strengthening tax administration. In parallel with fiscal reform, the government will be taking steps to enhance tax administration. A plan will be introduced by March 2004 to boost internal revenue and customs service capacity to deal with tax evasion, through more effective information systems and staff training. In anticipation of the tax reform, the government is considering (i) creating an independent revenue authority for both customs and domestic revenue collection, and (ii) criminalizing tax evasion.

Energy sector

Near-term strategy. The finances of the electricity sector have been adversely affected by the deterioration in collection rates, the sharp depreciation of the peso, higher oil import prices, and the difficulty of raising tariffs to the levels needed to maintain the viability of the system. As a result, there have been widespread blackouts and shortages of electricity, which have inflicted hardship on the population. In recent months, the government has increased its responsibilities in this area, purchasing two ailing electricity distribution companies. In order to stabilize sector finances, we have put in place an emergency plan to deal with the most pressing problems over the next six months and to keep potential power disruptions to a minimum. This plan includes the phasing-in of tariff adjustments, thus eliminating costly and unnecessary subsidies to non-residential and large consumers and reducing subsidies for more affluent consumers, together with fuel and budgetary subsidies and the use of World Bank and IDB financing, as well as measures to maintain collection

rates. Poorer households will continue to be protected by the continuation of the PRA program of electricity subsidies to low-income neighborhoods and the retargeted price subsidy. Further details of the strategy, agreed with the World Bank, are contained in our Letter of Development Policy to the World Bank of 23 December 2003.

Long-term reform. We intend to prepare by September 2004 a comprehensive electricity sector reform to be agreed with the World Bank, which will take into account the recommendations of the international commission of experts that looked into the recent acquisition of the electricity distribution companies, Edenorte and Edesur. This reform will seek to bring about a rapid recovery in the electricity distribution companies' operating cash flow and putting in place a more efficiently functioning system that includes the distribution companies recently bought by the government. It will also include a plan for the full regularization of arrears in the system. As recommended by the international commission of experts, an independent international valuation of the recently purchased distribution companies will be completed by 15 May 2004, as a first step toward their eventual reprivatization. The terms of reference for such an audit have been developed.

Monetary policy

Monetary stabilization. The overriding objective of monetary policy is to return inflation to the single-digit range within the program period. The central bank has taken decisive action to slow the growth of base money, which is now moving back toward the original program path by which monetary policy will continue to be guided in 2004. To this end, in mid-January 2004, the Central Bank instituted a number of increases that included raising its overnight rate to 45 percent and its Lombard lending rate to 55 percent. These short-term rates are being set with a view to establishing immediately clear expectations of positive returns on peso-denominated assets and to attaining the monetary base target. If necessary, additional monetary tightening may be implemented in the near term. Looking further ahead, however, we expect nominal interest rates to decline, as actual and expected inflation come down.

Control of base money and central bank debt. For the near-term, the control of base money will still have to rely substantially on the issuance of short-term Central Bank CDs. However, in order to reduce the cost of monetary sterilization, and the rollover risk associated with the Central Bank CDs, the 2004 monetary program envisages a build-up of government deposits at the Central Bank, as a means of limiting the money supply.

Money market development. To develop a domestic yield curve, improve liquidity management, and reduce maturity risk, the Central Bank will aim to lengthen the maturity of its certificates through market-based operations. To facilitate this process, the Central Bank introduced an overnight deposit window and a Lombard facility in mid-January 2004. The Lombard rate and the rate at the deposit window are already serving as signals of the overall monetary policy stance, as discussed above. To enhance the transparency of its operations, the Central Bank will provide on a monthly basis information on the amortization profile of its certificates.

Foreign exchange market

Unification of the market. The government remains committed to a unified foreign exchange market. The exchange rate in the official market has been set to track that of the private market since July 2003, and most foreign exchange transactions remaining in the official market were transferred to the private market in October, with the exception of government debt service operations. Mechanisms and foreign exchange resources were put in place at the Ministry of Finance by the end of December 2003 to ensure a smooth transfer of such transactions to the private market, in line with commitments under the original program.

Freely floating exchange rate. We remain committed to a flexible exchange rate regime. While we are convinced that the exchange rate has overshot and will revert to a more normal level once confidence is restored, there is no official target for the exchange rate, which is free to move in both directions.

Exchange market by-law. To enhance the transparency and efficiency of the exchange market, and increase competition, the Central Bank Monetary Board recently approved an exchange market by-law.

Banking reform

Recent progress. We continue to implement the ambitious agenda of reforms designed with assistance from the IMF that aims at ensuring confidence in the system. Since the program was approved, the government has made significant progress to resolve the three problem banks (Baninter, Bancrédito, and Banco Mercantil); has launched an internationally-assisted inspection of all banks, which is to be completed shortly; and approved in January 2004 regulations for the Monetary and Financial Act in the areas of sanctions, the contingency fund for bank resolution, and lender-of-last resort status. In addition, a law governing bank resolution in conditions of systemic risk has been approved and passed into law. As required by law, the government has referred to the courts the cases of alleged fraud by the former owners of Baninter and Bancrédito and is actively engaged in prosecuting these individuals. In addition, a forensic and legal audit has been initiated for Banco Mercantil; if necessary based on the findings of that audit, appropriate legal action will be taken.

Strategy to recapitalize banks. The government has prepared a broad strategy for the recapitalization of private banks, if necessary. The full details of this strategy will be finalized after reviewing the findings of the internationally-assisted inspections. A high-level committee will be appointed to approve and coordinate the strategy, which we have charted with assistance from the IMF. This strategy is in line with the Monetary and Act and the soon to be approved law on bank resolution in conditions of systemic risk, and is based on the following principles:

- For regulatory purposes, all losses determined on the basis of existing rules, without exception, will be booked up front;

- Any bank with negative statutory capital will be returned to solvency, through cash injections by existing or new shareholders, promptly following the completion of the assisted-inspections;

- Undercapitalized banks will need to have their capital replenished, by new or existing shareholders, to the full statutory requirement, at a pace to be determined once the assisted-inspection results have been completed;

- If shareholders are unable to recapitalize their institutions, and new investors cannot be found within the specified timeframe, the government will adopt, in consultation with IMF staff, measures to strengthen banks in accordance with statutory requirements. Such measures may include financial assistance to facilitate the transfer of assets and liabilities to another private institution, or to a new institution capitalized by the government;

- Following the completion of the bank inspections, procedures will be promptly initiated to resolve or restructure any bank found to be insolvent. Any manager found to be unfit and unable to perform his duties will be suspended immediately;

- All banks will be required to submit business plans by April 2004, establishing their future solvency and viability on the basis of international best practices;

- All banks will be expected to be fully compliant with minimum solvency ratios based on international best practices within a timeframe to be decided after the assisted inspections are completed; and

- State-owned banks will be subjected to quality of capital requirements identical to those for private banks, if they are found to be undercapitalized in the assisted-inspections. To this end, the necessary legal instruments will be approved by June 2004.

Strengthening regulations. The government is continuing to strengthen the regulatory framework of the financial sector and will approve a number of regulations for the MFL in the coming six months, in consultation with the IMF. The government is amending legislation in order to deal more effectively with financial crime. The legislative amendments will be submitted to Congress in late March 2004, following the resolution of some constitutional issues.

Strengthening asset management. We will establish, by the end of February 2004, a unit under the Monetary Board to manage and dispose of assets acquired as a result of the resolution of the three problem banks, in order to maximize their recovery value. Proceeds of asset recovery will be used to reduce the debt of the Central Bank. Also by late February

2004, we will form an additional unit within the Superintendency of Banks to coordinate forensic and legal audits of failed banks.

Strengthening the Superintendency of Banks. In addition to the recent adoption in December 2003 of procedures to monitor bank liquidity on a day-to-day basis, this will include: (i) required submission of weekly cash flow projections for all banks commencing in February 2004, and (ii) improvements in critical areas, particularly on-site and ministerial supervision, by July 2004.

Lessons learned from the recent crisis. As envisioned in the original program, an independent assessment will be conducted to draw lessons from the monetary and supervisory lapses contributing to the banking problems. The scope of this assessment covers the procedures used to resolve Baninter, Bancrédito, and Banco Mercantil. A panel of international experts will be appointed for this purpose shortly. The panel is expected to complete its work by late April 2004.

Strengthening other financial intermediaries. Plans will be devised to strengthen savings and loan associations by the end of June 2004.

Balance of payments and financing guarantees

Balance of payments. The Dominican Republic has undergone sweeping external adjustment, on the heels of a 9 percent improvement in GDP from 2002 to 2003. The downside to such an improvement has been an abrupt rise in private capital outflows, as a loss of confidence spurred the private sector to accumulate assets outside the country, thus destabilizing the peso. The government considers that the confidence-building effects of the policies outlined in this memorandum, and the reduction of political uncertainty following the May presidential election, will set the stage for staunching the outflow of private capital in 2004.

External financing gap 2004. The external current account is projected to remain in surplus in 2004, but a sizable financing requirement of more than US$1 billion is projected for the year. After factoring in projected disbursements from the World Bank, the IDB, and bilateral sources, there would still be a residual financing gap of some US$300 million. To cover this gap, the government is approaching its creditors for a rescheduling of debt service obligations to finance the program. In this context, Paris Club creditors have agreed to consider such a request in due course.

External arrears. The treatment of debt is expected to provide for regularization of reschedulable arrears. The government will clear all non-reschedulable external arrears before the revised program is presented to the IMF Board, while continuing to remain current on all non-reschedulable debt service.

PRESIDENCIA DE LA REPUBLICA
SECRETARIADO TECNICO

los Despradel
residencia

Yours sincerely,

José Lois Malkun
Governor
Central Bank

Carlos Despradel
Technical Secretary
Office of the President