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Dominican Republic: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

October 6, 2009

LETTER OF INTENT

Banco Central de la República Dominicana
Secretaría de Estado de Hacienda
Secretaría de Estado de Economía, Planificación y Desarrollo

Istanbul, Turkey
October 6, 2009

Mr. Dominique Strauss Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

Like many economies around the world, the Dominican Republic has been adversely affected by the global economic crisis and the credit crunch in capital markets, with a deteriorating external outlook, falling aggregate demand, and lower tax revenues; while the limited financing for our budget is creating the conditions for a procyclical fiscal response, greatly constraining our ability to react to these shocks. This letter and the attached memorandum of economic and financial policies (MEFP) outline an economic program that the Government of the Dominican Republic intends to adopt to strengthen its capacity to respond to the crisis.

The main objective of this program is to boost economic recovery in an environment of macroeconomic stability and strengthen our growth prospects by conducting a counter-cyclical policy in the short-run while achieving sustainability over the medium-term. These efforts are being supported by the adoption of a reinvigorated structural reform agenda. To this end, we are requesting a 28-month Stand-By Arrangement (SBA) through February 2012 in an amount equivalent to SDR 1,094.5 million or 500 percent of quota (about US$1,700 million) which will support the program detailed in the attached MEFP.

The previous SBA (2004–07) was very successful and allowed us to recover from the domestic financial crisis of 2003 and paved the way to achieve high growth with low inflation in the period 2004–08. In fact, the Dominican Republic grew 40 percent in that period, equivalent to some 8 percent per annum and became one of the fastest growing economies in Latin America. In our view, the international outlook will remain unfavorable for some time. Thus, we would like to replicate the past experience of success with the Fund by designing a strong economic strategy to achieve the highest and most sustainable growth possible for our economy.

The government believes that the policies set forth in the MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. The government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will also provide Fund staff with all the relevant information required to complete program reviews and monitor performance.

The authorities will observe the standard performance criteria against imposing or intensifying exchange restrictions, introducing or modifying multiple currency practices, concluding bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, and imposing or intensifying import restrictions for balance of payments reasons.

During the period covered by the program, there will be quarterly quantitative performance criteria (Table 1) and structural benchmarks (Table 2). There will be eight quarterly reviews to be completed by mid-March, mid-June, mid-September, and mid-December of 2010 and 2011. These reviews will be associated with the observance of the relevant performance criteria.

We have authorized the Fund to publish this letter and the attached Memorandum of Economic and Financial Policies (MEFP), to facilitate a wider access and review of our policies to the international community and to economic agents within the Dominican Republic.

Sincerely yours,

_________/s/_________	_________/s/_________	_________/s/_________
Héctor Manuel Valdez	Vicente Bengoa	Temístocles Montás
Governor of the Central Bank	Minister of Finance	Minister of Economy

ATTACHMENT 1. MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE GOVERNMENT OF THE DOMINICAN REPUBLIC

I. Background

1. After emerging from the 2003 financial crisis as one of the fastest growing economies in Latin America, the Dominican Republic was hit by external shocks in 2008 that affected macroeconomic performance. In the first half of 2008, a sharp deterioration in the terms of trade due to falling nickel and rising food and energy prices led to sharp increases in the external current account deficit and an acceleration in inflation. The fiscal position deteriorated mostly as a result of measures to alleviate the effect of these shocks on vulnerable groups which generated higher energy and food subsidies, among others, while monetary policy was tightened to address emerging inflationary pressures. In the second half of 2008, as the economy was adjusting to the external supply shocks, it was further hit by the effects of the global financial crisis. Bank lending came to a halt and international trade slowed considerably reflecting increased risk aversion and the rapid weakening of external demand. As a result, growth slowed significantly to 5.3 percent for 2008 (compared to almost 9 percent for 2007), inflation fell to 4.5 percent, the lowest in Latin America (after reaching a high of 15 percent year-on-year in August 2008), and the exchange rate depreciated moderately by 3.5 percent against the US dollar.

II. 2009 Developments

2. During 2009, the economy has continued to feel the effects of the international crisis, although it has been one of the best performers in the region. Growth reached 1.4 percent in the first half of the year, compared to a fall of 1 percent in Latin America as a whole, mainly due to the expansion of agriculture. At the same time, inflation continued decelerating to –0.5 percent year-on-year in August, well below the average for the region, as commodity prices continued to fall while core inflation remained at around 5 percent.

3. This resilience of the Dominican Republic economy has in part been due to the timely and speedy loosening of monetary policy that was implemented since the beginning of 2009. Following the tightening in 2008, the policy interest rate (overnight) was lowered by 550 basis points to 4 percent in the first eight months of the year. In addition, reserve requirements were lowered to promote bank lending to priority sectors. While credit remained stagnant in the first quarter of the year, as banks preferred to absorb the additional liquidity in the system, there were signs that bank lending was beginning to recover in the second quarter of 2009, as lower interest rates stimulated demand for construction and mortgage lending.

4. Fiscal policy was tight in the first half of 2009 as the cyclical decline in tax revenue and restrictions in financing limited expenditure. Tax revenues fell by 11 percent in the first semester, due mainly to the decline in imports and the weakening of consumption. At the same time, primary expenditure fell by more than 10 percent compared to 2008, as electricity transfers fell (related to the lower cost of fuel) but also due to lower expenditures on goods and services, and capital spending related to the restrictions in financing. As a result, the consolidated public sector primary balance for the first half of the year was zero.

5. Despite the rapid deterioration of the world economy, the exchange rate and international reserves have remained relatively stable. The external current account deficit narrowed to around 3.5 percent of GDP on an annual basis in the first half of 2009 (from a deficit of 10 percent of GDP in 2008), as the decline in exports, tourism and remittances was offset by an even larger decline in oil and non-oil imports. At the same time, inflows of foreign direct investment remained strong but lower than in previous years. International reserves fell by about $150 million (about 6 percent) in the first half of 2009, reflecting mainly lower disbursements of international financial institutions, while the nominal exchange rate depreciated by about 3 percent in line with the deteriorated fundamentals.

III. Medium-Term Macro-framework for 2009–12

6. The government's program for 2009–12 aims at implementing a counter-cyclical policy through an expansionary fiscal stance and an accommodative monetary position in the short-run, to counteract the effects of the global financial crisis on the economy, and a gradual fiscal consolidation effort over the medium-term (starting in mid-2010) to ensure fiscal sustainability and the return of the public debt-to-GDP ratio to a declining path. Monetary policy will continue to maintain in the short-term an accommodative stance to offset the effects of the global financial crisis in the economy. At the same time, recognizing the importance of increasing the potential for growth and sustaining a strong expansion in economic activity, the program will aim to implement structural reforms in key areas of the economy. Over the next few months, the government will produce detailed strategy papers in key areas outlining specific structural measures to be implemented during the course of the program. The main elements of the structural agenda include:

- Institutional reforms aimed at strengthening public financial management to allow the adoption of a medium-term expenditure framework to support fiscal consolidation. In addition, higher tax collections will be achieved by improving tax administration, strengthening enforcement of the legislation on fuel taxes, and limiting tax exemptions and incentives;

- A reform of the electricity sector to improve the efficiency of distribution, eliminate indiscriminate subsidies and ensure financial viability, reducing its burden on public finances;

- Monetary and financial sector reforms, including: (i) technical adjustments to the ongoing recapitalization of the central bank through amendments to the law while maintaining the spirit the original draft; (ii) enhancing banking supervision; and (iii) the implementation of an inflation targeting framework to help safeguard financial stability, control inflation, and anchor expectations;

- A strategy for the development of local debt markets and public debt management that will improve access to longer term financing and lower the cost of finance for the government and the Dominican private sector in domestic and international markets, with a view to improve the rating of the public debt.

7. The program aims to restore real GDP growth to the robust rates that prevailed before the external crisis. Output growth is estimated at 0.5 to 1.5 percent in 2009, but recovering to the 2.5–3.5 percent range in 2010 as the fiscal stimulus takes effect and the economy recovers. Going forward, real GDP growth is expected to recover to its potential of 6 percent in 2011 and beyond. Inflation pressures for 2009–10 are expected to remain subdued, well within the original target range that the central bank has established of 6–7 percent, and falling gradually to the level of main trading partners (3 percent) over the medium-term.

8. The external current account deficit is expected to fall to around 6 percent for 2009–10, as the recovery in exports and tourism receipts is partly matched by a recovery in oil imports and non-oil imports related to investment. In the capital account, flows of foreign direct investment to the mining sector are expected to continue, while other private financing flows will remain subdued. Over the medium-term, the external current account deficit is expected to fall gradually to around 4 percent of GDP, as exports recover with external demand and mining sector investments for export become operational.

9. Following the fiscal expansion in 2009-10, the program aims at achieving fiscal consolidation in the medium-term to bring the debt-to-GDP ratio back to its 2008 level. For 2009 the program aims at a primary fiscal deficit of the consolidated public sector of 0.8 percent of GDP, consistent with an overall deficit of 4.5 percent of GDP (significantly higher than the deficit of 3.3 percent of GDP which is consistent with the 2009 budget). For 2010 the program aims at a gradual consolidation, bringing the consolidated primary fiscal balance to zero, mainly through improvements in tax administration and recovery of tax revenues due to higher economic activity. Going forward, increasing revenue from the proposed structural reforms and a moderate containment in expenditure (especially energy subsidies) will lead to a gradual increase in the primary surplus of the combined public sector to 1 percent of GDP in 2011 and 2 percent of GDP in 2012 and beyond. Under these assumptions, the overall public debt is expected to increase from 35 percent of GDP in 2008

to 40 percent of GDP in 2011, only to fall to 35 percent of GDP by 2014, and continue declining in subsequent years.

IV. Macroeconomic Policies for 2009–10

10. In order to facilitate the monitoring of the program, the government will establish an inter-institutional task force with staff from the Central Bank, the Ministry of Finance, and the Ministry of Economy to monitor implementation and provide timely information to policy makers on program developments on a high frequency basis.

A. Fiscal Policy

11. The government intends to implement a countercyclical fiscal policy for the rest of 2009 and the first half of 2010. This will lead to a loosening of expenditures (predominantly in capital and social expenditures), which have been constrained in the first half of the year by the fall in tax revenues and the lack of external financing. The program aims at increasing the fiscal deficit of the central government by about 1.2 percent of GDP (from the level of 1.9 percent of GDP in the original budget) to 3.1 percent of GDP in 2009. This is consistent with a loosening of the primary fiscal balance from a surplus of 0.6 percent of GDP in the 2009 budget to a primary deficit of about 1.1 percent of GDP in this program. Excluding interest payments and transfers related to the energy sector (which have little effect on final demand), it is estimated that this expansion would result in a fiscal impulse of about 0.9 percent of GDP for 2009 compared to the fiscal stance in 2008. In 2010 the program aims at a gradual consolidation that would begin in the second half of the year as the economy recovers, leading to an overall deficit of the central government of 2.6 percent of GDP (consistent with a primary deficit of 0.4 percent of GDP).

12. The government will implement a number of measures to improve tax administration and compliance in 2009–10. A central element of this strategy will be the rationalization and better implementation of Law 112-00 on hydrocarbon taxation and Law 557-05 (article 23), which creates the selective ad-valorem tax on fuels to improve tax collections, make more transparent price calculations, rationalize tax exemptions and transfer the administration of tax collection to the domestic tax directorate (DGII). It is expected that this change will produce higher tax collections of 0.2 percent of GDP. Additional revenue enhancing measures planned for 2009-10, which could yield 0.3 percent of GDP a year, include:

- Transfer to DGII collection of taxes under Law 112-00 on fossil fuels until the new hydrocarbon's law gets approved.

- Control underinvoicing and contraband of fuel products through the creation of an inter-institutional committee of public sector agencies related to the energy sector to oversee the functioning of the hydrocarbon sector (Decree 369-09), which will integrate information from different agencies;

- The introduction of an information system (impresoras fiscales) to register the value of cash transactions in commercial establishments such as supermarkets and other retail outlets, to improve the efficiency and efficacy of collections;

- Simplification of tax procedures for small and medium-sized enterprises to improve compliance and increase the tax base.

- Considering the high level of tax exemptions in the country, the government will review all the legislation that includes tax breaks and tax exemptions with a view to eliminating those that do not conform with the objective of the legislation.

13. On the expenditure side, the government will prioritize public investment and social spending, to maximize the effects of the fiscal expansion on economic activity. In particular, central government expenditure on wages and salaries will decline gradually after reaching about 4 percent of GDP in 2009, while current spending on goods and services will remain stable as a share of GDP. Transfers to the electricity company CDEEE will be limited in line with reform in the sector, bringing them down from 2.7 percent of GDP in 2008 to 1.1 percent of GDP in 2009 and no more than 0.8 percent of GDP in 2010. This will allow the government to increase capital spending to 4 percent of GDP in 2009 (from the depressed levels of the first half of the year) and 5 percent in 2010, with the aim of promoting important infrastructure projects, and to increase priority social spending. It will be particularly important for the inter-institutional task force on program implementation to closely monitor the level and composition of expenditures to ensure the greatest benefit from the fiscal loosening in 2009–10.

14. Implementing the fiscal expansion contemplated for 2009 will result in a gross public sector borrowing requirement of about US$2.8 billion, or around 6 percent of GDP, which is US$700 million higher than originally contemplated in the budget for 2009. The government's financing strategy seeks to secure the multilateral financing originally envisaged in the budget and gain access to additional multilateral financing through emergency loans and the use of IMF financing. The bulk of multilateral financing would be used in 2009, with about US$350 million coming from the World Bank, US$450 million from the IDB and US$300 million from the use of IMF resources for the budget. These resources would be complemented by some US$250 million from Petrocaribe and around US$550 million of project financing for public investment, with the remainder coming from domestic bank loans and the domestic bond market.

15. For 2010 the program envisages a gross public sector borrowing requirement of about US$2.6 billion, or around 5.5 percent of GDP, which would be secured through a mix of multilateral resources and private sector financing. As the program increases the level of

capital spending, the largest source of financing in 2010 will be project financing with US$700-800 million, followed by multilateral organizations with some US$550 million in budgetary support (US$250 million from the IDB, US$150 million from the World Bank, and US$150 million from the IMF). Petrocaribe will continue contributing with US$240 million and some US$100 million are expected from the sale of state assets. The government will complement its financing requirements through the placement of a bond in international capital markets for US$500–600 million once conditions improve and spreads fall. The remaining amounts will come from domestic bank loans and the domestic bond market.

B. Monetary and Exchange Rate Policy

16. After the loosening in the first eight months of the year, the central bank will continue to maintain an accommodative monetary policy stance to support the fiscal expansion, while at the same time safeguarding its inflation objective of 6–7 percent for 2009-10. Given the rapid reduction in interest rates over the last several months, there is limited scope for further monetary easing.

17. As the economy recovers in 2010, the central bank will be prepared to adapt its monetary and exchange rate policy to the new economic conditions with the objective of preserving macroeconomic stability, prevent capital outflows and safeguard their international reserves.

18. The central bank will continue to manage monetary policy within the framework of a managed floating exchange rate regime. Gross international reserves reached a record level in 2007 and fell significantly in 2008 and in the first months of 2009 due to the international financial crisis. In the short run, gross international reserves will be replenished gradually and by end-2010, they are expected to recover the level of 2007. While this level is low for an economy as open as the Dominican Republic, the authorities consider that, under the current circumstances, the programmed level of reserve accumulation is consistent with very limited intervention in the foreign exchange market to avoid undue pressures on the exchange rate as the economy recovers.

19. One of the principal objectives of the government's program is to support the recovery of domestic credit as economic growth accelerates. Under current circumstances, the short-term monetary program does not contemplate using the traditional limits on net domestic assets, to avoid unnecessarily restraining the policy space of the central bank to support the growth of bank credit. As the economic recovery takes hold in the second half of 2010, however, the traditional programming ceiling on net domestic assets will be reincorporated to ensure a growth of monetary aggregates consistent with the program's inflation objective. The monetary program envisions a relatively large growth of currency issue in 2009 despite low inflation and growth to satisfy bank's demand for additional

liquidity and to create the conditions for higher private credit. The demand for currency issue is expected to moderate in 2010 as conditions in credit markets normalizes. Private sector credit is expected to remain subdued, growing at around 5 percent per year for 2009–10, before recovering to its historical level in subsequent years.

V. Structural Reforms for 2009–10

20. The government's reform agenda aims to safeguard medium-term fiscal sustainability while strengthening the institutional framework for financial stability and rapid and sustainable growth. The government sees these as self-reinforcing objectives that will help lower the overall cost of finance and improve the growth potential for the economy.

A. Tax Administration Reform

21. The main focus of public sector reform will be to ensure a return to fiscal sustainability after the expansion in 2009–10. The government continues to be committed to an ambitious goal of reducing the debt-to-GDP ratio to the 25–30 percent of GDP range in the medium-term, considering this to be an optimal level given the vulnerabilities that the economy faces. To achieve this target, sustained primary surpluses on the order of 2 percent of GDP for the combined public sector are necessary.

22. On the revenue side, improvements in the fiscal position will be supported by reforms in tax administration and a strengthening of customs administration. There will be a higher level of integration between the two tax collection institutions (DGII and Customs) to exchange information and exploit synergies. The reform does not contemplate changes in tax rates to achieve this fiscal objective. The program will contain a structural benchmark on the design of a tax administration strategy, which will be developed with technical assistance from the IMF and other institutions by March 2010. The reform will include measures to strengthen the institutional capacity of the tax and customs authorities and audit and control procedures, as well as a plan to rationalize tax exemptions.

23. There is also a need to improve budgetary procedures and expenditure control at the commitment level for all levels of the government. The design and presentation of the budget will be enhanced by including the job structure and number of positions in each budgetary chapter, by better programming and executing expenditures and by developing and gradually implement procedures to monitor the budget of decentralized agencies, municipalities and public enterprises. While there is a single treasury account, some expenditure commitments continue to be unregistered and the treasury account does not cover all levels of the public sector. The government is committed to improve the coverage and implementation of the single treasury account and will develop a program for the improvement of public financial management practices. This program will include the consolidation of all receipts received

by all municipalities and other public institutions as well as international aid and domestic and external loans (the loans from multilateral financial institutions in foreign exchange will be exchanged for local currency at the central bank as a way to contribute to the strengthening of the international reserves and to meet the reserve objectives under the program). The practice of budgetary advances will be severely restricted.

B. Financial Sector Reform

24. Financial sector reform is essential to support the recovery of economic activity by facilitating the intermediation of credit, lowering risk and avoiding financial turbulence. The main elements of the financial sector reform effort will include:

- Preparation for the implementation of an inflation targeting framework by early 2012, to strengthen the credibility of monetary policy and anchor inflationary expectations in the context of a more flexible exchange rate. The particular elements of this strategy include, inter alia, the strengthening of an integrated process for macroeconomic monitoring, forecasting, and policy formulation to enable a shift in the basis for policy decisions to the medium-term outlook for inflation and growth, and a strengthened communication strategy to promote understanding of the new policy framework and the basis for policy decisions. The program will include a structural benchmark for June 2010 on the formulation of a plan detailing roll-out of these elements over the next two years.

- The government remains committed to the transfer of resources to recapitalize the central bank in line with the objectives of the BCRD Capitalization Law, recognizing that this is essential to enhance the credibility of monetary policy and the successful adoption of an inflation targeting framework while supporting the gradual reduction in reserve requirements and the build-up of international reserves. However, the government plans to submit to Congress a limited set of amendments to the law including technical adjustments and the lengthening of the period of recapitalization from 10 to 15 years, which will allow for a less onerous schedule of transfers in the context of an unexpected decline in economic activity in 2009 and 2010, while following the spirit of the original legislation.

- Building on the wide ranging legislative and regulatory reforms for the banking system of the last few years, the government is fully committed to support continued efforts to improve supervisory practices as recommended in the recent update to the Financial Sector Assessment Program (FSAP). In particular, the program will include a structural benchmark to develop a strategy to deepen and widen the implementation of risk-based supervision by March 2010. Such strategy will include plans for strengthening the capacity to asses the quality of banks' management and risk-management policies and practices, the development of comprehensive risk profiles of banks, and the introduction of supporting changes to the organizational structure of the Superintendence of Banks. Effective implementation of such a strategy will support ongoing efforts to preserve and strengthen financial sector resilience, improve compliance with the Basel Core Principles for Effective Banking Supervision, and help in the effective application of consolidated supervision.

C. Recovery and Growth Enhancement

25. It will be important to adopt a number of additional measures to safeguard the economic recovery while strengthening the growth prospects of the economy. We believe that measures in the electricity sector as well as those directly aimed at reducing the cost of borrowing in the economy (other than through monetary policy), including by reducing the external perception of country risk, should be key to achieve a successful recovery from this crisis.

26. Improving the functioning of the electricity sector will enhance the prospects for high and sustainable growth in the economy by ensuring an adequate and stable supply of energy, while at the same time supporting the objective of fiscal sustainability by reducing its dependence on the public finances. The government has begun to develop a strategy for reform in the sector, in conjunction with the World Bank and the IDB, and will formalize a program of specific structural reforms by December 2009, which will constitute a structural benchmark under the program. The main elements of the strategy will include:

- Tariff adjustments and the implementation of a more flexible tariff system to cover the costs of generation and distribution;
- Gradually eliminating the generalized electricity subsidy by 2012 and focusing it on the poor;
- Reducing technical losses and improving metering to reduce electricity theft;
- Improving management of distribution companies;
- Creating a special account to implement government payments to generation and distribution companies;
- Implementing an external audit of the finances of the government distribution companies, and the corporate unit;
- Developing a plan to invest in new generation and distribution capacity.

27. All of the reforms mentioned above will lower borrowing costs and reduce country risk to the extent that they improve financial intermediation and reduce financial and fiscal risks. To complement these reforms the program will include a structural benchmark for September 2010 on the development of a strategy to strengthen public debt management and

the development of local debt markets to enhance access to longer term financing. In addition, the strategy will include an agenda of additional reforms aimed at improving the government's creditworthiness and the credit rating of Dominican Republic sovereign bonds in international markets, thus lowering the financing costs for domestic private sector which uses public debt as a benchmark.

D. Social Safety Net

28. As economic conditions deteriorated over the last several quarters, this has created pressures over the most vulnerable groups of society, especially the poor and the unemployed. The government intends to strengthen the social safety net by increasing social spending and prioritizing public investment. The government will increase the coverage of the conditional cash transfer program by 70,000 families living in extreme poverty and will increase the payment to over 45,000 families already covered by the program. The government will increase its spending in health and education by 0.75 percent of GDP a year in 2010–12 with a view to: (i) increase the coverage of the public health system to include unemployed and people living in extreme poverty as well as strengthen preventive medical care; and (ii) increase the number of classrooms and improve maintenance of existing schools.

VI. Other Issues

29. The government has no external arrears, and it will regularize all outstanding domestic arrears, including those with electricity generators, by using the available financial mechanisms before the end of the year.

Table 1. Dominican Republic: Quantitative Performance Criteria 2009-10 1/

	2009	2010			
	end-Dec	end-Mar	end-Jun	end-Sep	end-Dec
Fiscal Targets					
1. Overall balance of the central administration (floor) 2/ 3/	-51.5	-68.0	-83.0	-91.0	-98.5
2. Overall balance of the consolidated public sector (floor) 2/ 3/	-74.5	-97.5	-119.5	-133.0	-147.0
Monetary Targets					
3. Net international reserves (floor) 4/	1,815	1,715	1,665	1,715	1,815
4. Net domestic assets (ceiling) 3/	--	--	--	65.0	80.0
Debt Targets					
5. Accumulation of public arrears with electricity generators (ceiling) 2/ 4/	0.0	0.0	0.0	0.0	0.0
6. Accumulation of external public debt arrears 4/ 5/	0.0	0.0	0.0	0.0	0.0

1/ Targets defined in the Technical Memorandum of Understanding.
2/ Cumulative flows from December 2008.
3/ In billions of Dominican Republic pesos.
4/ In millions of U.S. dollars.
5/ Continuous target.

Table 2. Dominican Republic: Structural Benchmarks for 2009-10

Measure	Timing
Tax Administration Reform	
A. Design a strategy to rationalize and limit tax exemptions, strengthen tax administration, and continue modernizing customs to achieve the medium-term revenue objectives of the program	end-Mar 2010
Financial Sector Reform	
B. Design a plan to achieve compliance with all Basel core principles for effective bank supervision by 2012	end-Mar 2010
C. Design a plan to formally adopt a full-fledge inflation targeting framework by early 2012	end-Jun 2010
Recovery and Growth Enhancement	
D. Design a strategy to reform the electricity sector, including by eliminating indiscriminate electricity subsidies to achieve the medium-term budgetary expenditure objectives of the program	end-Dec 2009
E. Design a strategy to develop domestic capital markets and debt management including by lowering the country risk and the borrowing costs for the economy	end-Sep 2010
Social Safety Net	
F. Increase the permanent coverage of the conditional cash transfer program by 70,000 families living in extreme poverty	end-Dec 2009

ATTACHMENT 2. TECHNICAL MEMORANDUM OF UNDERSTANDING

This Technical Memorandum Understanding (TMU) presents the definitions of the variables included in the quantitative performance criteria annexed to the *Memorandum of Economic and Financial Policies (MEFP)*, and the information requirements needed to ensure adequate monitoring of economic and financial developments.

I. Quantitative Performance Criteria: Definition of Variables

A. Cumulative Floor on the Central Government Balance

The overall balance of the central government covers government activities as specified in the budget.

Revenues are recorded when the funds are deposited in the Treasury account. Revenues will also include grants. Central government expenditures are recorded on an accrual basis and will include transfers to other government units as well as all transfers to the electricity sector. Interest payments, however, will be recorded on a due basis. Capital expenditure will include any in-kind capital expenditures defined as the externally financed investment projects (through loans and grants) in case they are not included in the execution of the budget.

The balance of the central government will be measured from "below the line" as the change in the central government's net financial position (assets minus liabilities). The net financial position of the central government includes: (a) non-bank central government debt, external and domestic, including debt with the IMF for budgetary support and short-term debt approved by the Ministry of Finance; (b) external and domestic bank borrowing (net of deposits), including deposits in the central bank; and (c) any other nonbank financing, domestic or external, including the sale of public assets and the net change in the stock of domestic and external arrears, including arrears to electricity distributors. Domestic arrears of the nonfinancial public sector are defined as delays in the payment of contractual obligations beyond the grace period set in the respective loan or debt contract or 30 days in case the grace period is not specified. Capitalizations or purchases of equity in public companies will be treated as an above-the-line expenditure transaction. External debt flows (i.e., disbursements and debt service), will be converted to Dominican Republic pesos at the exchange rate of the day in which the transaction takes place.

The following uses of funds will not affect the deficit and will be recorded below the line in 2009: (i) clearance of central government domestic arrears incurred before end-December 2008; (ii) amortization of loans and bonds; (iii) bonds issued for the recapitalization of the Central Bank and Banco de Reservas; and (iv) other arrears with suppliers incurred by end-December 2008. A memorandum line in the information reporting the Central Government fiscal operations will report items (i) to (iv) in this paragraph.

1. Targets on the Overall Balance of the Central Government

Cumulative Balance from December 31, 2008	Floor (In billions of RD$)
End-October 2009 (program projection)	-18.3
End-November 2009 (program projection)	-35.0
End-December 2009 (performance criterion)	-51.5
End-January 2010 (program projection)	-53.0
End-February 2010 (program projection)	-58.0
End-March 2010 (performance criterion)	-68.0
End-April 2010 (program projection)	-70.4
End-May 2010 (program projection)	-75.8
End-June 2010 (performance criterion)	-83.0
End-July 2010 (program projection)	-85.1
End-August 2010 (program projection)	-85.8
End-September 2010 (performance criterion)	-91.0
End-October 2010 (program projection)	-90.4
End-November 2010 (program projection)	-88.8
End-December 2010 (performance criterion)	-98.5

B. Cumulative Floor on the Consolidated Public Sector Balance

The consolidated public sector comprises: (i) the operations of the nonfinancial public sector; and (ii) the quasi-fiscal operations of the central bank. The balance of the nonfinancial public sector comprises the overall balances of the central government (as defined before) and the rest of the nonfinancial public sector (municipalities, decentralized entities, social security entities, and public enterprises).

The rest of the nonfinancial public sector includes the following non financial public enterprises: Corporación Dominicana de Empresas Eléctricas Estatales (CDEEE, including Empresa de Generación Hidroeléctrica Dominicana), Empresas Distribuidoras de Electricidad del Norte (EDENORTE), Empresas Distribuidoras de Electricidad del Sur (EDESUR), Empresas Distribuidoras de Electricidad del Este (EDESTE) , Consejo Estatal del Azúcar, Corporación de Fomento Hotelero y Desarrollo Turístico, Corporación de Acueducto y Alcantarillado de Santo Domingo, Acueducto y Alcantarillado de Santiago, Acueducto y Alcantarillado de Moca, Acueducto y Alcantarillado de la Romana, Instituto Nacional de Aguas Potables y Alcantarillados, Corporación de Acueducto y Alcantarillado de Puerto Plata, Proyecto de la Cruz de Manzanillo, Instituto Postal Dominicano, Corporación Estatal de Radio y Televisión, Instituto Nacional de la Vivienda, Lotería Nacional, Autoridad Portuaria Dominicana, Refinería Dominicana de Petróleo.

The overall balance of the rest of the nonfinancial public sector will be measured from "below the line" as the change in the net financial position (assets minus liabilities) on the basis of changes in: (i) domestic bank credit and deposits; (ii) domestic and external arrears, and (iii) external disbursements less amortizations.

The quasi-fiscal balance of the central bank included in the consolidated public sector balance is measured as all the administrative and financial revenues minus costs (including costs of monetary policy and interest on the central bank debt and operational expenditures). Given uncertainties on interest payments of the central bank by the end of 2009, the cumulative floor on the consolidated public sector will be adjusted downward by up to a limit of RD$0.5 billion for interest payments in excess of RD$27.5 billion for 2009. No adjustments will be applied for 2010 unless agreed between the authorities and the Fund staff in case there is a change in the recapitalization plan of the central bank.

Profits and losses arising from valuation changes of foreign currency denominated assets and liabilities will not be considered to determine the balance of the nonfinancial public sector.

Fiscal targets for 2009 and 2010 will be measured as a cumulative floor measured from end-December 2008.

2. Targets on the Overall Balance of the Consolidated Public Sector

Cumulative Balance from December 31, 2008	Floor (In billions of RD$)
End-October 2009 (program projection)	-40.1
End-November 2009 (program projection)	-56.4
End-December 2009 (performance criterion)	-74.5
End-January 2010 (program projection)	-78.2
End-February 2010 (program projection)	-85.4
End-March 2010 (performance criterion)	-97.5
End-April 2010 (program projection)	-102.2
End-May 2010 (program projection)	-110.0
End-June 2010 (performance criterion)	-119.5
End-July 2010 (program projection)	-123.4
End-August 2010 (program projection)	-125.9
End-September 2010 (performance criterion)	-133.0
End-October 2010 (program projection)	-134.6
End-November 2010 (program projection)	-135.1
End-December 2010 (performance criterion)	-147.0

The information to compute the overall balance of the nonfinancial public sector will be provided to the Fund by the central bank, based on information provided by the government's accounting office (expenditure) and various units of the Secretaría de Hacienda (revenue, nonbank domestic debt and arrears, external debt and arrears, and externally financed capital expenditure).

C. Floor on Central Bank Consolidated Net International Reserves (NIR)

For program monitoring purposes, the consolidated NIR is defined as the difference between gross international reserves of the central bank and reserve liabilities, including debt of the Ministry of Finance with the IMF as follows:

Gross international reserves include claims against non-residents, denominated in foreign convertible currencies that are in the direct effective control of the central bank and are readily available for such purposes as foreign exchange market intervention. Such assets include gold (valued in dollars at end-2008 prices), cash, deposits abroad (excluding funds used as collateral for central bank or other nonfinancial public sector liabilities), holdings of SDRs, and the IMF reserve position.

Reserve liabilities include debt with the IMF, including that of the Ministry of Finance, and short-term (up to one year) foreign-currency-denominated liabilities, including commitments to sell foreign exchange from derivatives or other contracts, and other guarantees or contingent liabilities.

The consolidated NIR definition does not modify the central bank balance sheet accounting rules. The consolidated NIR as defined above differs from the NIR definition included in the previous 2005 Stand-By Arrangement that excluded reserve requirements on foreign currency deposits, and government and bank deposits in foreign currency as they were considered part of the reserve liabilities.

To meet this performance criterion at each relevant date, the 5-day average of daily consolidated NIR values must be above the floor. The 5-day average will be calculated on the basis of the last five working days of each relevant month.

3. Targets on the Consolidated Net international Reserves

Outstanding stock	Floor (In millions of US$)
End-October 2009 (program projection)	2125
End-November 2009 (program projection)	2010
End-December 2009 (performance criterion)	1815
End-January 2010 (program projection)	1780
End-February 2010 (program projection)	1750
End-March 2010 (performance criterion)	1715
End-April 2010 (program projection)	1700
End-May 2010 (program projection)	1680
End-June 2010 (performance criterion)	1665
End-July 2010 (program projection)	1680
End-August 2010 (program projection)	1700
End-September 2010 (performance criterion)	1715
End-October 2010 (program projection)	1750
End-November 2010 (program projection)	1780
End-December 2010 (performance criterion)	1815

Consolidated NIR targets will also be adjusted upward *(downward*) by the surplus (*shortfall*) in program disbursements up to US$300 million. Program disbursements are defined as uncommitted external disbursements that are usable for the financing of the overall central government budget.

4. External Program Disbursements
(program projections)

Cumulative flows from December 2008	(In million US$)
End-October 2009	80
End-November 2009	519
End-December 2009	819
End-January 2010	819
End-February 2010	864
End-March 2010	864
End-April 2010	864
End-May 2010	1079
End-June 2010	1079
End-July 2010	1229
End-August 2010	1229
End-September 2010	1229
End-October 2010	1229
End-November 2010	1244
End-December 2010	1244

D. Ceiling on Central Bank Net Domestic Assets (NDA)

Central Bank net domestic assets (NDA) are defined as the difference between the monetary base and Consolidated NIR, as defined above. For the purposes of the program the monetary base is defined as equivalent to *emisión monetaria* , which includes currency issue (currency in circulation plus cash in vault) plus peso reserve requirements held by financial institutions at the central bank.

To meet this performance criterion at each relevant date, the 5-day average of daily NDA values must be below the ceiling. The 5-day average will be calculated on the basis of the last working days of each relevant month.

For accounting purposes, dollar accounts will be converted to *pesos* at the accounting exchange rate of RD$36.5 per dollar.

5. Targets on the Net Domestic Assets

Outstanding stock	Ceiling (In billions of RD$)
End-October 2009 (program projection)	48
End-November 2009 (program projection)	58
End-December 2009 (program projection)	68
End-January 2010 (program projection)	67
End-February 2010 (program projection)	66
End-March 2010 (program projection)	64
End-April 2010 (program projection)	65
End-May 2010 (program projection)	66
End-June 2010 (program projection)	67
End-July 2010 (program projection)	66
End-August 2010 (program projection)	67
End-September 2010 (performance criterion)	65
End-October 2010 (program projection)	70
End-November 2010 (program projection)	75
End-December 2010 (performance criterion)	80

NDA targets will be adjusted upward *(downward)* for any *increase (decrease)* in reserve requirement deposits *(encaje)* associated with peso deposits at the central bank. NDA targets will be adjusted downward *(upward)* by the surplus *(shortfall)* in program disbursements up to US$300 million.

E. Ceiling on the Accumulation of Arrears of Public Electricity Distributors with Generators

The government will regularize all outstanding domestic arrears (as defined in section IA above) with electricity generators using the available financial mechanisms before the end of the year. Arrears to private energy generating companies are defined as the balance of current invoices for energy sales to electricity distribution companies for which no payment has been made within 45 days following the contractual due date.

F. Continuous Ceiling on the Gross Accumulation of Public Sector External Arrears

The central government and any other entity of the nonfinancial public sector, as defined above, as well as the central bank, will not incur new arrears in the payment of their external obligations at any time during the program. Arrears are defined as a delay in the payment of contractual obligations beyond the grace period set in the respective loan or debt contracts or 30 days in case the grace period is not specified.

II. Information Requirements

To ensure adequate monitoring of economic variables and reforms, the authorities will provide the following information:

A. Daily

- Deposits in the banking system, exchange rate in the official and free markets, interest rates on bank loans and deposits, Consolidated NIR, currency in circulation, deposits held by financial institutions at the central bank, excess reserves of the banking sector in local and foreign currency, liquidity assistance to banks, central bank certificates, and all other remunerated liabilities of the central bank.
- Deposit of, and liquidity assistance to, troubled institutions, by institution.
- Central bank purchases and sales of foreign currency.
- Central bank intervention operations in domestic currency, including results of auctions of central bank paper (interest rates, details of bids, including minimum and maximum rates, volumes, and maturities).

B. Monthly

- Tax collection and expenditure of the central government, with a lag of no more than two weeks after the closing of each month.
- Starting in September 2009, revenue, expenditure, and financing of the nonfinancial public sector, including decentralized agencies and public enterprises of the previous month.
- Saving-investment account of the central government.
- Net financial position of the central government (as defined in section I.A.) with a lag of no more than two weeks after the end of each month.
- Central government's domestic interest, contractually due in the period and effectively paid, with a lag of no more than two weeks after the end of each month.
- Authorizations and stock of administrative debt, including the economic classification of the expenditure that has been financed with such debt, with a lag of no more than two weeks after the end of each month.

- Value of outstanding checks issued by the Treasury with a lag of no more than two weeks after the end of each month, starting in September 2009.
- Legal measures that affect the revenue of the central government (tax rates, import tariffs, exemptions, etc).
- In-kind capital expenditure statistics.
- Balance sheet of the central bank, *Banco de Reservas*, and deposit money banks (cable file).
- Balance sheet of the central bank excluding operations related to the recapitalization of the central bank and quasi fiscal.
- Quasi-fiscal balance of the central bank.
- Stock of central bank certificates, notes and bills each by type of holder.
- Maturity of certificates, detailing amortizations in the following 12 months (i.e., following the end of the current month).
- Public external debt service for the preceding month and revised monthly projections for the forthcoming year, with a lag of no more than two weeks.
- Monthly external public disbursements and revised monthly projections for the forthcoming year, with a lag of no more than two weeks.
- Monthly contracting of external public debt and monthly stock of contracted, but not disbursed external public debt, with projections of the stock of debt contracted, but not disbursed for the forthcoming year.
- Foreign exchange cash flow of the central bank (la balanza cambiaria).
- Electricity sector collections, losses, cash recovery index and central government transfers to the electricity sector, according to the following definitions: Collection rate: is defined as the ratio between the electricity invoices effectively paid (collected) and electricity invoices issued by electricity distributors in any given period. Loss rate: is defined as the ratio between electricity lost and electricity purchased by electricity distributors in any given period. Electricity lost is the difference between electricity invoiced and electricity purchased. Central government transfers to the electricity sector: is the sum of all transfers to the sector from the central government, including remaining PRA subsidies, FETE (*Fondo de Estabilización de la Tarifa Eléctrica*) and transfers to electricity companies, and all payments related to Bono Luz. The CDEEE will provide on a monthly basis (with a maximum 21-day lag) information on the arrears the generation companies accumulate with the CDEEE on energy purchases and transmission fees.
- Price of each fuel as set in the contracts for the purchase of electricity by each distributor and CDEEE from each producer for the next 6 months for coal and 3 months for other fuels.

- Purchases of electricity by each of the three distibutors and CDEEE from each generator. This includes quantity of electricity purchased (in KWh) and the unit price of each fuel charged by type of fuel and the quantity used in electricity generation. In addition report the quantity and unit price of electricity purchased by each distributor and CDEEE in the spot market.

C. Quarterly

- Revised balance of payments outturn for the preceding quarter and quarterly projections for the forthcoming year, with a lag of no more than four weeks.
- Revised estimates of the stock of short-term and medium- and long-term public external debt, by creditor, at the end of quarter, with a lag of no more than four weeks.
- Stock of public sector domestic debt, including public sector debt in the electricity sector.
- Stock of *avales* and any other guarantees or contingent liabilities of the public sector.
- Revised estimates of the quarterly disbursements, debt service and stocks of short-term and medium- and long-term private external debt, by debtor, at the end of quarter, with a lag of no more than two weeks.
- Stock of public external late payments and arrears (program definition), by debtor and creditor, with details on new arrears incurred in the last month and clearance of old arrears, with a lag of no more than 5 working days.
- Stock of domestic arrears, starting with figures for December 2008, with details on new arrears incurred in the period and clearance of old arrears.