

## Fitch Revises Dominican Republic's Rating Outlook to Stable

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Fitch Ratings-New York-25 September 2008: Fitch Ratings has affirmed the Dominican Republic's ratings as follows:

- Foreign currency IDR at 'B';
- Local currency IDR at 'B';
- Country ceiling at 'B+';
- Brady bonds at 'B+/RR3';
- Senior unsecured debt at 'B/RR4';
- Short-term foreign currency IDR at 'B'.

Fitch has also revised the Rating Outlook to Stable from Positive for both the Dominican Republic's foreign and local currency IDRs, reflecting increased concern that the Dominican Republic's comparatively weak liquidity position relative to 'B' peers will render the country more vulnerable to external shocks in an environment of lower global growth and tighter international liquidity conditions.

'In spite of the swift economic recovery since the Dominican financial crisis and progress on the structural reform front, a still fragile liquidity position combined with the recurrence of sizable twin fiscal and current account deficits this year constrain the ratings to current levels at this time,' said Theresa Paiz Fredel, Senior Director in Fitch's Sovereign Group.

The Dominican Republic's need for foreign financing has rapidly increased at a time of worsening global financial conditions. Fitch expects the current account deficit to continue to expand in 2008, reaching about 8% of GDP. Almost two-thirds of this increase reflects higher international commodity prices. The oil tab alone accounted for about 43% of the overall increase in imports during the first half of 2008. Although the country's external liquidity ratio has almost tripled since 2004, at 98% it is still substantially below the 'B' median of 250%, leaving the country with a relatively thin buffer against an external financing shock.

Capital inflows were not sufficient to finance the current account deficit through July as reserves declined by about US\$240 million since year-end 2007. However, foreign direct investment flows have held up thus far in 2008 and the government will increase borrowing from bilateral and multilateral lenders in the remaining months of the year. As the commodity price shock was the main contributing factor to higher financing needs, expectations for lower commodity prices will help reduce the country's external financing requirement over our forecast horizon.

In addition to the rapid expansion of the current account deficit, commodity price shocks along with aggregate demand pressures have also contributed to rising inflation, which peaked at 15% in the twelve months ending in August. Inflation averaged 10.1% over this same period. Similarly, the improvement in fiscal balances will be reversed this year, reflecting the increasing cost of large and poorly targeted energy subsidies, reconstruction costs and higher expenditure in the run-up to the elections. Fitch expects the fiscal deficit to reach 2.1% of GDP this year. Despite continued progress toward strengthening the policy framework, the authorities must manage these vulnerabilities carefully to ensure the maintenance of macroeconomic stability over the medium-term.

Looking ahead, the Dominican Republic's ratings would benefit from stronger external liquidity. Maintenance of an appropriate policy response which resolves near-term challenges such as increasing inflation, as well as fiscal and external financing pressures would be supportive of the sovereign's ratings to the extent that it bolsters confidence. Though not Fitch's base case scenario, marked downward pressure on the peso or an erosion of international reserves would be negative



for the ratings. These pressures could materialize from a continued widening of the current account deficit, as well as a sharp decline in non-debt creating capital inflows or a return of capital flight.

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