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

January 14, 2005

The following item is a Letter of Intent of the government of Dominican Republic, which describes the policies that Dominican Republic intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Dominican Republic, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Santo Domingo, Dominican Republic
January 14, 2005

Dear Mr. De Rato:

The Dominican Republic has developed a strong and comprehensive program aimed at restoring fiscal discipline and financial stability, while creating the conditions for sustaining growth over the medium term. The government is well aware that the success of the program hinges on a substantial fiscal adjustment and the implementation of an ambitious structural agenda addressing a wide range of governance issues in the public sector and financial system. In this regard, in recent weeks the government has moved forward with policies essential to the success of the program, including ensuring the approval of the 2005 budget, strengthening bank supervision and regulation further, and securing the necessary financing. With these elements now in place, we ask that our program be submitted to the IMF Executive Board for its consideration.

The attached Memorandum of Economic and Financial Policies (MEFP) lays out in detail our economic program for 2005–06 and requests a new Stand-By Arrangement for a period of 28 months with the Fund in an amount equivalent to SDR 437.80 million (about US$670 million and 200 percent of quota or 86 percent of quota on an annual basis) in its support. Given the Dominican Republic's balance of payments need, we request that the repurchase expectations arising in 2005 be moved to an obligations basis. We further request the cancellation of the existing arrangement upon approval of the new arrangement.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but the Dominican Republic stands ready to take any further measures that may become appropriate for this purpose. The Dominican Republic 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 policy on such consultation.

The program will be monitored through regular reviews, which will be held quarterly for the duration of the arrangement. Quantitative performance criteria, and structural performance criteria and structural benchmarks have been set up for March and June, 2005, with indicative targets for September and December, 2005. The reviews will assess overall performance under the program and observance of the associated performance criteria and benchmarks (Tables 1 and 3). In addition, they will be associated with financing assurances reviews for the period while sovereign arrears to the private sector persist. The first review, scheduled to be completed no later than June 2005, is expected to focus on defining the content and timetable of the tax reform package, and ensuring that banks meet capitalization targets. The second review, scheduled to be completed no later than September 2005, will focus on progress in structural reforms in the areas of electricity, public expenditure and debt management, and accountability and independence of the central bank and bank superintendency.

In an effort to avoid the reoccurrence of significant revisions to the fiscal and external debt data, the government is committed to improve the monitoring and control of foreign-financed projects and external disbursements. To this end, we recently issued a series of decrees centralizing expenditure, debt contracting, and debt management operations. The program also envisages the development of an action plan, with multilateral technical assistance, for the introduction of a wider range of legislative and institutional reforms in this area.

Finally, the government is developing policies to mitigate the anticipated adverse impact of the expiry at end-2004 of the textile quotas under the WTO's Agreement on Textiles and Clothing (ATC). In view of the possible effect on the Dominican Republic of the end of these quotas we hereby request activation of the Fund's Trade Integration Mechanism (TIM). Should the impact of the end of these quotas be greater than currently anticipated before policy adjustment, we would request an augmentation of the stand-by arrangement by up to 10 percent of quota, or SDR 21.89 million, under the TIM's deviation feature.

We remain committed to implementing our new economic program which we trust will help to improve living standards for all Dominicans.

Sincerely yours,

/s/	/s/	/s/
Hector Valdez Albizu Governor Central Bank	Temístocles Montás Technical Secretary	Vicente Bengoa Secretary of Finance of the Presidency

Mr. Rodrigo De Rato y Figaredo
Managing Director
International Monetary Fund
Washington DC, USA

Attachments:
Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

DOMINICAN REPUBLIC—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. INTRODUCTION

1. The Dominican Republic is in the process of emerging from the economic crisis triggered by inadequate management of the public finances and the banking crisis of 2003, which led to high inflation, a sharp depreciation of the peso, a disproportionate growth of public debt, and massive capital flight. Unfortunately, the large public assistance to contain the banking crisis was not accompanied by the needed fiscal adjustment and institutional reforms to restore confidence in the economy and access to private capital markets.

2. The new government is well-aware of the need for a strong and coherent program to allow the Dominican Republic to entrench the nascent stability and establish the conditions for sustaining growth over the medium-term. To this end, it is determined to implement a new program which aims at restoring fiscal discipline and financial stability, with a strong institutional component that addresses a wide range of governance and transparency concerns. The key elements of the new program are as follows:

- Macroeconomic and structural policies aimed at solidifying price stability and ensuring the resumption of sustained growth;
- A fiscal policy adjustment to improve the public accounts and reduce public debt, guaranteeing its sustainability in the medium term.
- A financing strategy that will allow the public sector to overcome its short-term liquidity crunch, consistent with medium-term debt sustainability;
- A strategy of strengthening the financial system to establish sound financial intermediation;
- A plan to improve the efficiency of the electricity sector to ensure its financial viability;
- Reform of the institutions in the public finance area to improve the design and execution of fiscal policy and permit the achievement of the needed large fiscal adjustment; and
- Further strengthening of the central bank and banking supervisory agency, in order to improve the implementation of monetary policy and guarantee the stability of a well-functioning financial system.

II. MEDIUM-TERM MACROECONOMIC FRAMEWORK

3. Output growth is estimated at 2.0 percent in 2004 and is projected at 2½ percent for 2005 and 4.3 percent in 2006, as confidence builds and domestic demand recovers. Inflation

is targeted to drop sharply from 29 percent during 2004 to between 11 and 13 percent during 2005 and to the single digit range during 2006.

4. Given the expected economic recovery, the external current account surplus is projected to decline from 5.8 percent of GDP in 2004, to less than 1 percent of GDP in 2006. The strengthening in tourism receipts will be offset by an expected fall in textile exports as a consequence of the expiry of the textile quotas at end-2004 under the WTO's Agreement on Textiles and Clothing (ATC) and the recovery in imports, as private sector consumption and investment rise toward pre-crisis levels. In the capital account, private capital outflows are projected to decline, as confidence in the banking system and the economy recovers, and net international reserves are targeted to increase to more comfortable levels (by US$440 million over the program period).

5. The consolidation of public finances is central to the program. In this regard, the government is implementing the large fiscal adjustment needed to set the stage for a reduction in public debt and a recapitalization of the central bank. This adjustment reflects a significant improvement in the non-financial public sector (NFPS) balance, as well as a reduction in the quasi-fiscal deficit of the central bank. The government is committed to resolve the problem of the quasi-fiscal deficit through a program of capitalization and the transfer of assets to the central bank.

6. The government is committed to improving the overall balance of the NFPS in 2005 to -0.7 percent of GDP, compared to a projected deficit of 2.7 percent of GDP in 2004, and further to a surplus of 0.7 percent of GDP in 2006. To this end, the government has adopted measures (see following paragraphs) which will also allow for increased social spending and the partial recovery of some expenditures that had been reduced excessively over the past two years. After taking into account the projected decline in the quasi-fiscal deficit of the central bank (largely reflecting a drop in interest rates), the consolidated public sector balance is projected to improve by about 3 percentage points of GDP in 2005, to a deficit of 3.9 percent of GDP. The fiscal adjustment programmed over the two-year period would help reduce the consolidated public debt from 52 percent of GDP in 2004 to about 48 percent of GDP by end-2006.

Main Macroeconomic Assumptions and Targets

	2004	2005	2006
GDP growth (percent change)	2.0	2.5	4.3
Inflation (12-month percent change, eop)	28.7	11– 13	8.0
External current account balance (in percent of GDP)	5.8	2.0	0.5
Gross international reserves (in US$ millions)	825	1,257	1,844
Net international reserves (in US$ millions, program definition)	211	350	650

III. Economic and Financial Policies for 2004–06

A. Fiscal Policies

7. Shortly after assuming office, the new government implemented a set of adjustment measures—with an annual estimated yield of over 2.8 percent of GDP—aimed at correcting the inherited fiscal imbalance, significant arrears on public debt service, and liquidity problems more broadly. These measures included: (i) the enactment, effective October 1, of a tax reform that among other things increased the VAT (*ITBIS*) rate from 12 to 16 percent, and raised excise taxes on alcohol and tobacco products; (ii) a catch-up in the adjustment of fuel excises for inflation (in accordance with the law on fuel taxes); (iii) the targeting of liquefied gas (LPG) subsidies; and (iv) the reduction in the central government payroll.

Public Sector Summary Accounts
(in percent of GDP)

	2004	2005	2006
Nonfinancial public sector balance	-2.7	-0.7	0.7
Quasi-fiscal balance of the central bank	-4.0	-3.2	-2.5
Consolidated public sector balance	-6.7	-3.9	-1.8
Primary balance	-0.9	1.9	3.3
Interest payments	-5.8	-5.9	-5.1
Gross public sector debt	52.1	49.1	48.3
External	33.5	30.3	30.2
Domestic	18.6	18.8	18.2

8. On December 30, 2004, the congress approved the 2005 budget proposal (*Proyecto de Presupuesto de Ingresos y Ley de Gastos Públicos*). This budget is consistent with an overall balance for the NFPS of -0.7 percent of GDP. In addition to the recently adopted fiscal measures, the proposed budget assumes: (i) an increase of 3 percentage points in the exchange commission tax (which more than offsets the effect of eliminating the 2 percent tax on imports at end-2004); (ii) a further increase, of about 10 percent on average, on the excises applied to various fuels, to recover the revenues lost as the result of the delayed adjustment for inflation of that tax during 2003 and 2004; (iii) a freeze in the level of central government employment; (iv) the containment in the growth of non-priority recurrent spending; (v) the further retargeting of LPG subsidies; and (vi) the scaling-back of public investment projects. At the same time, the budget envisages a considerable increase in social expenditures and a reduction in payments arrears to avoid disruption in the provision of public services. The main policies underlying the budget follow:

- To partially reverse the recent compression in public sector real wages, the government plans to increase wages of central government employees by 30 percent (implemented in two equal installments on January 1 and July 1), while freezing employment at the level existing in October 2004. As a result, the central government wage bill is targeted to increase by RD$6.7 billion, to RD$35.8 billion in 2005.

- Spending on goods and services will be limited to RD$17.5 billion, mainly reflecting an increase in social spending in real terms. The government recently launched a new food assistance program (*Comer es Primero*), which is expected to benefit 125,000 families by end-2005, and this will be complemented by a strengthening in the flagship school breakfast program (*Desayuno Escolar*).

- Current transfers are projected at RD$ 43.0 billion, mainly reflecting an increase in: (i) transfers to the electricity sector (previously extrabudgetary) to cover the deficit estimated for that sector (see paragraph 38); (ii) pension payments in line with the increase in salaries; (iii) transfers to government agencies in line with the growth of fiscal revenues. These increases will be offset by the saving arising from the targeting of subsidies to users of energy. LPG subsidies will be limited to RD$ 2.8 billion through the implementation of a program involving the distribution of up to 500,000 magnetic cards to poor households effective April 2005 (following completion of a census aimed at identifying these households).

- Capital spending will be limited to RD$ 38.2 billion and will be directed to priority projects. The recent centralization of the management and control of investment projects financed from external sources (see paragraph 23) will assure that execution of such investment does not exceed RD$ 19.4 billion in 2005.

- The brackets used to determine individual income tax will not be adjusted for inflation (consistent with the recent modification of the law in this area)

- Budgeted expenditures are slightly lower than envisaged under the program for 2005, providing some room to deal with unexpected developments. Moreover, if necessary to protect the program's fiscal target from unexpected developments, the government will take additional measures. We will execute the budget prudently, in light of monthly reviews of the performance of tax collections, so as to ensure that any shortfall in revenue (for example, deriving from nominal GDP being lower than projected at the time the budget was formulated) would be offset by appropriate expenditure restraint. The evolution of the plan to reduce losses in the electricity sector (see paragraph 38) also will be closely monitored. In March 2005, we will analyze with World Bank and IMF staff the latest electricity sector developments and determine whether or not these imply a need to adopt an alternative electricity plan and/or compensatory fiscal measures, including the possibility of bringing forward elements of the planned tax reform (see paragraph 19).

B. Financing Policies

9. The government's financing strategy centers on solving its short-term liquidity problem in a manner consistent with debt sustainability, while fulfilling the country's recent commitment to Paris Club creditors to obtain comparable treatment of non-Paris Club debt. The success of the financing strategy hinges on the continued support from international financial institutions and official creditors, as well as the participation of private creditors, domestic and external. The government plans to address the projected financing gap for 2004-05 of roughly US$330 million through: (i) restructuring the payment profile of external bonds, (ii) the rescheduling of debts to external commercial banks and suppliers, (iii) the rescheduling of pre-cut off date obligations to Paris Club creditors falling due in 2005, and (iv) obtaining new financing from a pool of private domestic banks. The financing strategy also hinges on a recently-obtained credit from the government of Venezuela to finance a share of oil imports (about US$200 million), and on meeting conditionality to enable the disbursement of budget support loans from the IDB and World Bank (about US$260 million). The government has cleared most arrears with official creditors and will clear the remaining arrears in the coming days. The only remaining external arrears to private creditors are to a handful of foreign banks and suppliers, and amount to less than US$50 million. The government has developed and initiated a strategy for regularizing these arrears through a process of negotiated rescheduling (see paragraph 10).

10. The government is well-advanced in designing both a bond exchange offer and a rescheduling of commercial bank debt, with the objectives of providing cash flow relief during 2005-06 and ensuring a sustainable debt service profile over the medium term. In this regard, the government hired additional financial advisors in October 2004 and concluded a round of consultations with bondholders and commercial banks in mid-December. An additional round of discussions with commercial banks will be held in January and further consultations with bondholders will take place in February 2005. The restructuring will be voluntary and will aim at (i) a high-level of creditor participation; (ii) ensuring, as far as possible, equal treatment among creditors; and (iii) in the case of commercial banks and suppliers, will also ensure the elimination of all arrears to these creditors (mentioned in paragraph 9). The government fulfilled the expectations of the Paris Club on progress toward comparable treatment on January 12, 2005 and is aiming to launch the bond exchange offer during the first quarter of 2005 and complete the rescheduling of debt to commercial bank and suppliers by April 2005.

11. Negotiations with domestic suppliers and banks on refinancing of their claims are also well-advanced. In this regard, the government recently submitted to congress legislation allowing the refinancing of certain domestic obligations falling due in 2005, including the partial refinancing of bonds issued to domestic suppliers in 1999, and the issuance of bonds to cover arrears to domestic suppliers accumulated up to 2003. The financing legislation also allows the use of bonds for the recapitalization of the central bank and Banco de Reservas. Congressional approval of this legislation is expected in February 2005. In addition, the government intends to reach an agreement with local commercial banks for refinancing domestic loans, and for obtaining medium-term financing.

12. Finally, the government has identified possible measures to mitigate the effects of the expiry of the textile quotas under the ATC, primarily through the negotiation, ratification and implementation of CAFTA to secure continued market access. However, in parallel with the request for a new stand-by arrangement from the IMF, the government is requesting the activation of the IMF's Trade Integration Mechanism (TIM) in case the effect of the elimination of these quotas turns out to be greater than projected. In this regard, we plan to closely monitor the external trade balance to evaluate whether a request for an augmentation of access under the deviation feature of the TIM would be warranted. An augmentation will be based on a comparison of the TIM's baseline trade projections before any policy adjustment (Scenario B in Table 4) with the corresponding actual outcomes, before policy adjustment, for 2005 and beyond.

C. Monetary and Exchange Rate Policies

13. To stabilize prices, the central bank has maintained a tight monetary policy. As a result, inflation has declined sharply in recent months (from about 25 percent in the first quarter to less than 1 percent in the third quarter), and the peso has recovered strongly, reflecting also renewed confidence in the new government. In this context, the central bank has been able to increase the issuance of its certificates to mop-up any excess liquidity, while extending maturities and reducing interest rates (in line with the decline in inflation expectations), developments which are helping to reduce the central banks' quasi-fiscal deficit and rollover risk.

14. The central bank will continue to conduct monetary policy within a flexible exchange rate regime. The monetary program will be consistent with reducing inflation to a rate of 11-13 percent during 2005 and 8 percent during 2006 by observing strict limits on monetary aggregates while allowing for an increase in international reserves. The main instrument of monetary policy will continue to be auctions of central bank certificates. The central bank will set its policy interest rates according with its objectives for monetary growth and inflation and continue to use its standing facilities (Lombard window and overnight deposits) to signal the direction of its monetary policy.

15. The central bank remains committed to a unified and competitive foreign exchange market. Intervention in the market, to buy or to sell foreign exchange, will be limited, and geared mainly toward achieving the program's monetary targets as well as to avoid excessive volatility in the exchange rate. To foster competition and transparency in the foreign exchange market, the central bank will support adoption of an electronic trading platform by September 2005 providing firm quotes and public data on exchange transactions. In this regard, the central bank, in cooperation with the IDB, plans to tender the trading platform to an internationally recognized firm by March 2005. Closely linked to this project, the central bank intends to introduce further improvements in the payments system.

16. In an effort to lower the quasi-fiscal deficit of the central bank and the roll-over risks of its certificates, the Monetary Board recently approved the use of longer-term indexed certificates. The new instruments, with maturities ranging from 1 ½ years to 5 years, will be indexed to inflation or carry a floating rate linked to the banking deposit rates. Issuance of

these instruments will be mainly through public auction, and direct placement will be limited in size and referenced to the auction rate. The use of exchange rate-linked certificates is also contemplated, but will be limited to US$225 million in the first semester of 2005. In addition, the Monetary Board has authorized the creation of a new advisory unit that will be responsible for the oversight and development of the strategy for reducing the quasi-fiscal deficit of the central bank.

17. To strengthen the central bank's ability to pursue the inflation objectives, the government will develop by March 2005 a detailed plan to recapitalize the central bank and lower its quasi-fiscal deficit. As a first step, the government recently submitted to congress legislation to issue an interest-bearing bond equivalent to US$65 million, effective January 1, 2005. Congressional approval is expected in February 2005. Under the plan, an additional and significantly larger capital injection will be made in the first semester of 2006, once the central government's cash flow has improved as a result of further fiscal adjustment. In addition, the government is committed to fulfilling its obligation to transfer to the central bank a share (1.75 percentage points) of revenues from the exchange commission tax to help reduce the quasi-fiscal deficit. Finally, the sale of central bank assets, including those transferred from the government (see paragraph 30) will also play a role in reducing the central bank's debt burden and restoring its net worth.

IV. Structural Reforms

A. Structural Fiscal Reforms

18. The improvement in the fiscal position will be supported by reforms in tax policy, revenue administration, public expenditure management, and debt management. To strengthen policy formulation, the President recently established a high-level economic council (*Gabinete de Coordinación Económica*), headed by the Technical Secretary of the Presidency, with clear responsibility on all economic policy decisions.

19. In view of the need to offset the revenue losses associated with the eventual implementation of the CAFTA and the phased reduction of the foreign exchange commission and financial transactions tax that will begin in January 2006, the government is committed to a carefully sequenced tax reform aimed at simplifying the tax system and broadening the tax base, which will strengthen revenues over the medium term. In this regard, the government will develop, with IMF technical assistance, the details of a tax reform package by March 2005, and by June 2005 will agree to a strategy for its implementation, which could be advanced depending on the date of the approval of CAFTA. This implementation strategy will be consistent with our commitment to further consolidate the fiscal position in 2006. As a first step, the government issued, on January 6, 2005, a decree dismantling the existing tax and customs exemptions previously granted through administrative procedures, and plans to propose to congress the elimination of special tax regimes (border zones and tourism) by March 2005.

20. The government is committed to improve tax compliance. To this end, a detailed reform program will be developed with technical assistance from the IMF and other institutions by April 2005. The reform will include measures to strengthen the institutional capacity of the tax authority (including through improved headquarters planning and control capacities, and computerization of core procedures) while strengthening audit and enforcement procedures, and improving customs valuation and inspection. The government will submit draft legislation making tax fraud and evasion a criminal offense by March 2005.

21. To improve the efficiency, transparency and accountability of fiscal management, the government has developed, in collaboration with the IDB, legislation reforming existing budget, procurement, treasury, public debt and financial management system practices. We plan to finalize, in consultation with the IMF staff, this legislation package and submit it to congress by March 2005 and will seek its approval by June 2005. In addition, the government will develop before June 2005, with technical assistance from the IMF, an action plan to ensure that the legal reforms are accompanied by the necessary capacity building and institutional reforms. The main objectives of the reform agenda follow:

- The reform of the organic budget law will ensure that the responsibility for all aspects of budget management, including revenue, expenditure, and financing, are centralized in one cabinet post by December 2005. In particular, the new budget organic law will require that spending in excess of the established budget ceilings be approved by congress through a supplementary budget.

- The reform of the procurement law will subject all domestically- and externally-financed public purchases, contracts and other public procurement to strict public tender rules, based on international standards. The new norms will increase transparency, including through the introduction of an electronic procurement system.

- The objective of the reform of the Treasury is to improve, through the use of the single treasury account, cash-flow management, and the process of budget projection and execution.

- The reform of the public debt law (*crédito público*) seeks to improve the government's debt management practices by strengthening the Secretariat of Finance's capacity in the areas of management and registration of public debt.

- The reform of the internal controls law aims to gradually substitute the current mechanism of ex-ante controls with a more up-to-date system of internal controls.

- The reform of the financial management system aims to increase the speed and accuracy of information on budget execution (revenues and expenditures) in order to improve the government's decision making process.

22. During 2005, prior to the enactment of the above laws, the government will ensure compliance with the program's fiscal targets through enhanced expenditure monitoring and

control. In this regard, the President recently issued a series of decrees to: (i) guarantee that all central government payments are made with authorization of the Treasury and registered in the integrated financial management system (SIGEF); (ii) implement a monthly cash-based budget; (iii) regulate access to domestic credit to enforce adherence to the spending limits by line ministries and decentralized agencies. In addition, by March 2005 the government plans to complete an inventory and verification of domestic arrears outstanding as of end-December 2004, with a view to establishing a timetable to clear these arrears and to put in place a system to monitor and control domestic arrears by June 2005.

23. Special emphasis will be given to strengthening the management and control of externally-financed capital expenditure and domestic debt operations. In this regard, a special unit was created under the Technical Secretary of the Presidency (TSP) responsible for monitoring all new project-related external financing and debt management operations. In addition, the following actions have been taken:

- A database of existing projects has been recently created, with information on current and expected disbursements, execution status, and cash balances available for each project. In this regard, the government has identified approved projects that have not been initiated and that can be postponed without incurring significant penalties, and by March 2005 we will develop an action plan for each of these loans. This database has been integrated with the database on public external debt prepared by the *Crédito Público* Department of the Secretary of Finance.

- The President issued a decree (i) centralizing the process of authorization to contract and negotiate any new external financing, including a prior analysis of the operations on debt sustainability, under the guidelines set by the *Consejo de Gobierno*; (ii) reviewing all outstanding authorizations to contract new loans using the guidelines mentioned above; and (iii) requiring that all line ministries and decentralized public sector agencies report to the TSP and Secretary of Finance on project execution, new loans, disbursement and debt service. The National Planning Office (ONAPLAN) will make every effort to ensure that actual disbursements remain within amounts programmed in the budget.

B. Financial Sector Reform

24. The banking strategy aims to strengthen (i) the financial system, including through a well-structured bank recapitalization program; and (ii) the institutional framework as well as fostering better governance, including by granting the central bank and superintendency of banks greater independence and making them more accountable.

Strengthening the Financial System

25. The monetary and financial authorities have developed a strategy for the recapitalization of banks, on the basis of the current local asset evaluation regulation (in effect until December 31, 2004), without forbearance. In this regard, the superintendency of

banks recently issued a circular specifying the criteria that will be used to compute banks' regulatory net worth as of end-December 2004. This strategy, which is consistent with the legal framework, is based on the following key principles:

- For regulatory purposes, all losses determined on the basis of existing rules, without forbearance, have been booked up front. The elimination of forbearance will be reflected in the banks' published accounts by December 2004 pari-passu with the recapitalization calendar;

- Undercapitalized banks are to be brought, by shareholders, to a capital ratio of 10 percent of risk-weighted assets by December 2004. To this end, the superintendency recently completed its evaluation of progress made in bank recapitalization as of September 2004, aiming at ensuring the timely compliance of all banks with the agreed schedule. By April 2005 all banks will submit their 2004 audited financial statements showing their compliance with the agreed capital ratio of 10 percent;

- Capital contributions must fully meet international best practices, international accounting standards and local regulations, including the treatment of goodwill. Retained earnings will be allowed to count as tier 1 capital, subject to independent verification.

- Following the completion of the bank recapitalization calendar, any bank found to be undercapitalized will promptly submit and adhere to an acceptable rehabilitation plan. Any manager or director found at any time not to be fit and proper will be suspended immediately;

- If shareholders cannot recapitalize their institutions, and new investors cannot be found within the specified timeframe, the monetary authorities will adopt appropriate measures to strengthen banks within the framework set in the law.

- Public banks will be subject to quality of capital requirements identical to those for private banks. For this purpose, amendments to the relevant laws will be submitted to congress by April 2005 and approval will be sought by September 2005. In addition, profits of public sector banks will be used to increase their capital through end-2007.

26. From January 2005 to December 2007, the banking system will transition from local to international best practices for asset valuation. In this regard, the Monetary Board approved a resolution clarifying recent revisions to the asset valuation and provisioning rules requiring that banks gradually comply with stricter standards over a three-year period beginning January 1, 2005. The transition from local to international rules for asset valuation will require the adherence to the following timetable:

- By April 2005, all banks must submit their December 2004 financial statements (audited by an internationally-recognized accounting firm, with the participation of a partner from an investment grade country). The report must include a supplement showing the impact of adopting the new regulations on their financial statements.

- By May 2005, all banks must submit five-year business plans, on the basis of the supplement to the financial statements, demonstrating their solvency and viability over the three-year transition period. In this regard, the monetary and financial authorities have recently issued a resolution requiring banks to submit these five-year plans.

- By July 2005, the superintendency of banks will complete the assessment of the business plans (with help from internationally-recognized external advisors) and the negotiations of memoranda of understanding with the banks' senior managers, committing them to maintaining the required solvency ratio.

- Beginning December 2005, the banks' business plans will be updated twice a year, on the basis of June and December financial statements (audited by an internationally-recognized accounting firm with the participation of a partner from an investment grade country).

27. The monetary authorities will continue to strengthen the regulatory framework of the financial sector. Over the next few months, the Monetary Board is expected to approve a series of regulations, including on: (i) consolidated accounting by March 2005, requiring, inter alia*,* that capital of wholly or partially-owned subsidiaries be measured on a consolidated basis; (ii) consolidated supervision and the use of public funds under the systemic risk law, by April 2005. The latter will include a provision creating a high-level committee to coordinate bank resolution in case of need.

28. In addition, a regulation governing the treatment of market risk and liquidity will be approved by March 2005. Regarding liquidity risks, this regulation will specify additional actions to be taken by the superintendency should a bank request liquidity support. Should liquidity support exceed: (i) 20 percent of capital, lending activities will be suspended; (ii) 50 percent of capital, a plan to collect connected loans must be submitted within two weeks; and (iii) 100 percent of capital, shareholders must pledge their shares as collateral for additional liquidity assistance. Finally, in December 2004, the superintendency completed its assessment of the banks' progress in implementing the new regulations regarding offshore activities and related party lending.

29. By June 2005, the superintendency of banks will update the chart of accounts governing financial institutions following the new regulations and international accounting standards, as well as the IMF manual on monetary statistics. The new chart of accounts will become effective in January 2006.

30. The central bank is reorganizing the effort to manage and dispose of assets acquired primarily as a result of the resolution of the three problem banks. In this regard, we recently initiated the foreclosure of assets placed in guarantee by the former shareholders of resolved

banks. In addition, we are in the process of completing the design of the organizational structure for the management of assets placed in guarantee and developing a timetable for their disposal, through the creation of an investment trust. A timetable of actions follows:

- By February 2005, we plan to: (i) appoint key staff, approve budgets and prepare strict and transparent internal control procedures (including external audit); (ii) prepare a market-based methodology to determine the value of the transferred assets; and (iii) initiate an inventory identifying and classifying all assets and claims.

- By March 2005, we expect to: (i) complete the inventory identifying and classifying all assets, rights, and potential claims including through verification of documentation and establishing legal title; and (ii) initiate the transfer of the assets to the new organization at the value established by the market-based methodology.

31. The monetary and financial authorities have invited the independent panel of external experts that visited the country in mid-2004 to hold new discussions on the origins and handling of the banking crisis. The panel will visit Santo Domingo in January 2005 and their report will be published by March 2005.

Strengthening the Institutional Framework

32. In an effort to strengthen the Monetary Board and increase the independence and accountability of the central bank and the superintendency of banks, the government will submit to congress by July 2005 draft amendments to the Monetary and Financial Law aimed principally at: (i) lengthening the term of members of the Monetary Board, including the governor of the central bank and the superintendent of banks to at least five years; (ii) subjecting the appointment of the governor of the central bank and the superintendent of banks to Senate ratification; and (iii) seeking to harmonize the Monetary and Financial Law and the systemic risk law. The details of the draft legislation will be developed in consultation with IMF staff.

33. The superintendency recently established a system for monitoring bank liquidity consisting of daily reports showing changes in the cash and deposit positions of each bank, and comparing liquidity indicators with data from previous periods. This information will be used by the off-site supervision area to ensure the proper monitoring of banks. The superintendency will develop by January 2005, based on a diagnostic of problem areas, a plan to strengthen its supervisory capacity through: (i) an intensive capacity building program; (ii) specific actions to improve financial analysis and on-site inspection, (iii) improved technological support; and (iv) a reduction of administrative and bureaucratic procedures. By February 2005, the superintendency will appoint a senior director with strong supervisory experience in charge of implementing the plan. Finally, the superintendency will begin implementing a plan by March 2005 to bring the risk bureau (*central de riesgos*) to the highest regional standards by December 2005.

34. In January, the monetary and financial authorities will complete the restructuring of two banks resolved last year. In this regard, and consistent with the legal framework, the central bank will provide no further compensation to the resolved banks. By February 2005 the monetary and financial authorities plan to initiate assessments (with technical assistance from external advisors) of the use made of the liquidity support facilitated to the three failed banks, and of whether all protected offshore deposits were in fact legally binding liabilities for these banks. Finally, the Prosecutor General recently appointed a special prosecutor to conduct the defense of the State's interests in the judicial cases against the managers and directors of the three failed institutions, and ensure that all parties responsible for the banking crisis are brought to justice. The government will seek that beginning in January 2005 the Office of the Prosecutor General will publish periodic reports on the status of the civil and criminal cases related to the failed banks.

35. The monetary and financial authorities are also developing a plan to strengthen other financial intermediaries, including savings and loan associations, finance companies, and the two specialized public banks. This plan will be finalized by September 2005.

C. Energy Sector

36. Despite the recent considerable increases in tariffs, the finances of the electricity sector remain under stress due to high distribution losses, low collection rates on invoices, high oil import prices, and the government's financial difficulties in making transfers to the sector. As a result, the sector has been running large losses—which, in the absence of corrective measures, would exceed US$600 million annually—resulting in widespread blackouts and shortages of electricity that have imposed undue hardship on the population. Moreover, electricity subsidies have severely burdened the public finances, reducing the government's ability to provide for other important social needs.

37. To address the electricity sector crisis, the government has developed a comprehensive electricity sector reform plan, in consultation with the World Bank, the IDB, and USAID. This plan aims at sharply reducing the deficit of the sector in the short-term and ensuring its financial viability in the medium-term. As a first step, on January 6, 2005 the President appointed a high-level commission to ensure the strict and timely implementation of the plan, and will soon launch a media campaign to explain the strategy to the population. The most pressing challenge lies in stabilizing the supply of electricity, a necessary condition to improve collection rates. To this end, and to avoid an excessive burden on the public finances, the government will aim to satisfy about 70 percent of the daily electricity demand. The short-term plan includes a timetable for:

- Improving the cash-recovery index of distribution companies, by reducing line losses to around 30 percent and improving collection rates to about 90 percent by end-2005. While achieving these levels will require improvements in the management of distribution companies and a decisive fight against fraud, these standards of performance were achieved by the sector as recently as the second half of 2002.

- Increasing the average revenue of distribution companies by about 30 percent (in U.S. dollar terms) relative to September 2004, to be achieved through a better targeting of subsidies, focusing on consumers who use less than 200KWh per month, and tariff adjustments for the rest of consumers. To this end, in October and November of 2004, tariff adjustments averaging 9.3 percent were implemented, and further adjustments will be considered, if necessary, to ensure meeting the objectives of the plan. In parallel, the government will evaluate the Program to Reduce Blackouts (*Programa para la Reducción de Apagones, PRA*), and following its recommendations, a new program to improve the targeting and efficiency of this subsidy will be implemented by September 2005.

- Improving the regulatory framework. By February 2005, tariff regulations will ensure that fluctuations in the exchange rate and crude oil prices will be passed-through automatically to the final consumer tariffs, with a lag of only one month. By March 2005, regulations will be issued to facilitate and expedite fraud detection and reduction.

- Rollover of arrears with private operators. The government will remain current on the payment of interest on its debt with private parties in the sector, while the principal is expected to be rolled over. In addition, the government will remain current on the payment of its own electricity consumption.

- Managing the rationing of power supply. Power rationing will be handled by rewarding areas where distribution losses are lower and collections are higher, with a view to induce a better payment culture. As the deficit of the sector declines, average supply could increase above the 70 percent of demand target.

- Reduce the cost of electricity generation. The government plans to renegotiate some power supply contracts, which could result in potential price reduction of about US1 cent per KWh. A study will be conducted to review the terms of the *Acuerdo de Madrid*, to explore options to introduce more competition in the generation market.

38. A successful implementation of this program will reduce the need for public sector support to US$350 million during 2005. Starting in January, high-level commission will issue a public report on a monthly basis, comparing actual performance with the objectives of the plan, in particular regarding the evolution of the cash-recovery index and public transfers to the sector. In case of inadequate performance, the commission will decide on the implementation of a contingency plan, in consultation with the World Bank. The main element of this contingency plan, which is being developed, will include private sector participation in the management of the state-owned distribution companies. The government will finalize the financial audits of these companies by September 2005.

V. Improving Timeliness and Accuracy of Economic Information

39. We are committed to strengthen our internal data preparation and reconciliation, and review systems to improve the quality of economic data and to broaden the scope of information currently available. In this regard, the government plans to (i) publish by June 2005 detailed statistics for public corporations, municipalities and decentralized institutions, including the social security system, and (ii) establish by March 2005 a centralized database on public and publicly-guaranteed external debt, including external project financing. In addition, the monetary authorities are well-advanced in implementing the recommendations of IMF safeguards assessment mission. Remaining actions include:

- The central bank's internal audit committee will develop by March 2005 an audit plan with the advice of a tendered international auditor. To this end, earlier this year, the central bank established an independent committee, directly accountable to the Monetary Board, to oversee the bank's external and internal audit functions.

- The central bank established in December 2004 an interdepartmental committee in charge of reviewing and analyzing the composition of international reserves and other program data.

- An independent audit of the central bank's accounting records, internal control system and risk evaluation process was recently finalized. The report was presented to the Monetary Board in December 2004 and will be shared with IMF staff shortly.

- The central bank will publish, by January 2005, its audited financial statements for 2003. The audited statements for 2004 will be published by April 2005

40. To improve transparency and make information easily available to the general public, the central bank will update regularly the information disseminated through its web page, including external arrears, net international reserves, and the saving-investment account of the central government. In addition, the authorities will participate in a Data ROSC, for which an IMF mission is planned for May 2005, and the report will be published by end-2005.

Table 1. Dominican Republic: Quantitative Performance Criteria and Indicative Targets for 2005–06

	Estimate	Performance criteria		Indicative targets		
	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Dec-06
I. Quantitative Performance Criteria 1/						
(In billions of Dominican Republic pesos)						
A. Nonfinancial public sector (NFPS) balance (cumulative floor) 2/	-2.7	-6.0	-6.6	-7.3	-9.1	7.1
B. Central Bank net domestic assets (ceiling) 3/	25.1	26.0	24.5	22.5	26.5	21.3
(In millions of U.S. dollars)						
C. Gross accumulation of public sector external arrears (continuous ceiling)	0	0	0	0	0	0
D. Contracting of external debt by the public sector (cumulative ceiling) 2/ 4/	200	380	655	855	1,105	950
E. Central Bank NIR, excluding bank's foreign currency deposits (floor)	211	150	200	225	350	650
II. Indicative Targets						
(In billions of Dominican Republic pesos)						
A. Change in NFPS net credit from the domestic banking system (cumulative ceiling) 2/ 5/	4.8	6.5	5.0	3.0	1.0	-7.5
B. Monetary base, excluding reserves on foreign currency deposits (ceiling) 6/	91.1	89.4	91.8	93.0	104.0	117.4

1/ As defined in the Technical Memorandum of Understanding. Performance criteria are proposed for March and June 2005. At the time of the first review, performance criteria will be set for September and December 2005.

2/ For 2005, cumulative from end-September 2004. For 2006, cumulative from the beginning of the year.

3/ Defined as currency in circulation less NIR (program definition) valued at the accounting exchange rate of DR$35 per US$.

4/ Ceilings exclude any new debt instruments issued as part of the process of debt restructuring and rescheduling.

5/ Credit is defined on a net (of deposits) basis, and includes the central bank.

6/ Includes reserve requirements in the form of investment certificates.

Table 2. Dominican Republic: Prior Actions

Fiscal policy

Congressional approval of 2005 budget in line with the macroeconomic framework agreed with the IMF (MEFP, ¶8)

Implementation of fiscal measures needed to achieve 2005 targets: (i) adjustment of oil excises and (ii) increase in foreign exchange commission (MEFP, ¶8).

Issuance of decrees, establishing: (i) the administrative process to authorize contracting of external debt, including that associated with investment projects (MEFP ¶23); (ii) revision of all outstanding authorizations to contract new loans (MEFP ¶23); and (iii) strengthening of budget execution procedures, including registration of all central government expenditure in the SIGEF, and management of all public funds through the Treasury (MEFP, ¶22).

Implementation of information systems to permit adequate monitoring of execution of external debt disbursements and investment projects, including: (i) full centralization of external and domestic debt management in a single office, with a full reconciliation of data; and (ii) specific monitoring and control systems on the largest investment projects.

Issuance of legal instruments to eliminate custom and tax exemptions granted administratively (MEFP ¶19).

External financing

Completion of consultative phase of rescheduling/restructuring with private sector creditors (bondholders and commercial banks) (MEFP ¶10).

Obtain financing assurances from external official creditors (MEFP ¶9).

Clearance of all arrears to external official creditors (MEFP ¶9).

Initiation of restructuring negotiations with private external creditors on debt still in arrears, consistent with Fund's LIA policy (MEFP ¶10).

Banking sector

Issue clarifications to the asset valuation regulation (MEFP ¶26).

Issue a bank superintendency circular specifying procedures for bank recapitalization (MEFP ¶25).

Complete evaluation of progress made in bank recapitalization as of September, 2004 (MEFP ¶25).

Issue a Monetary Board resolution requesting that banks submit business plans based on the revised asset valuation regulation and audited 2004 financial statements (MEFP ¶26).

Completion of the restructuring of two banks resolved in 2003 (MEFP ¶34).

Initiate foreclosure of assets placed in guarantee by former shareholders of the resolved banks (MEFP ¶30).

Electricity Sector

Issuance of presidential decree establishing high-level commission to ensure timely implementation of the electricity plan (MEFP ¶37).

Table 3. Dominican Republic: Structural Performance Criteria and Structural Benchmarks

	Date
A. Structural performance criteria	
Fiscal policy	
Congressional approval of domestic debt issuance to pay debts to suppliers, maturing bonds, and recapitalize the Central Bank and Banco Reservas (MEFP, ¶11).	February 2005
Submission to congress of draft financial administration laws (budget, public credit, treasury, procurement, internal control), including centralization of fiscal policy management (revenue, expenditure, and financing) in one Ministry (MEFP ¶21).	March 2005
Verification and quantification of central government's domestic arrears as of December 2004 (MEFP ¶22).	March 2005
Banking sector	
Receive 2004 audited financial statements of commercial banks (including a supplementary report on the impact of the new asset valuation regulation), reflecting elimination of forbearance and compliance with the 10 percent minimum capital adequacy requirement (MEFP ¶25).	April 2005
Submit to Congress legislation requiring public banks to meet the same regulatory and capital quality requirements as private banks (MEFP ¶25).	April 2005
Receive five-year business plans submitted by the commercial banks (MEFP ¶26).	May 2005
Submit to Congress legislation to increase the independence and accountability of the central bank and bank superintendency (MEFP ¶32).	July 2005
Complete evaluation of the banks' business plans, and finalize negotiation on memoranda of understanding (MEFP ¶26).	July 2005
B. Structural Benchmarks	
Fiscal policy	
Submission to congress of draft law eliminating tax benefits to border zones and tourism (MEFP ¶19).	March 2005
Design of structural tax reform (MEFP ¶19).	March 2005
Banking sector	
Approve a prudential regulation on consolidated accounting, treatment of market risk and liquidty assistance (MEFP ¶27 and 28).	March 2005
Complete the inventory of central bank assets, and start transfer to the asset disposal unit using the market-based methodology to determine transfer prices (MEFP ¶30).	March 2005
Publish the report of the independent panel on the banking crisis (MEFP ¶31).	March 2005
Internal and external controls of the central bank are strengthened, in line with the recommendations of the Safeguards Assessment of 2003 (MEFP ¶39).	March 2005
Approve prudential regulations on consolidated supervision and rules governing use of public funds under the systemic risk law (MEFP ¶27).	April 2005
Issue a report on the verification by the Superintendency of the quality of capital increases made by commercial banks (MEFP ¶25).	July 2005
Develop plan to strengthen nonbank financial intermediaries (MEFP ¶35).	September 2005
Require commercial banks to submit the first update of their business plans on the basis of audited financial statements (MEFP ¶26).	December 2005
Make effective revised chart of accounts for financial institutions (MEFP ¶29).	December 2005
Complete implementation of a plan to bring the bank superintendency credit risk bureau to the highest regional standards (MEFP ¶33).	December 2005
Electricity sector	
Finalize audit of state-owned electricity distribution companies Edenorte and Edesur (MEFP ¶38).	September 2005

Table 4. Dominican Republic: Balance of Payments Impact of the Expiry of the ATC 1/

(In millions of U.S. dollars, unless otherwise indicated)

	2003 Est.	2004 Est.	2005 Prog.	2006 Prog.	2007 Prog.
Counterfactual projection assuming that the ATC were to be extended for another three years (A)					
Total affected current account entries	98	78	-314	-541	-841
Exports	5,471	5,710	5,640	5,962	6,172
(in percent change)		4	-1	6	4
Of which: Textiles and clothing exports	2,196	2,035	2,107	2,184	2,266
(in percent change)		-7	4	4	4
Imports (fob)	-7,627	-7,954	-8,301	-8,966	-9,605
Of which: Textiles and clothing imports	-1,261	-1,168	-1,209	-1,254	-1,300
(in percent change)		-7	4	4	4
Services (net)	2,254	2,322	2,346	2,463	2,592
Overall balance	-262	422	-52	220	715
NIR accumulation (increase, -)	252	-479	-143	-320	-204
Financing gap, before possible additional financing	0	0	251	400	-511
Financing gap, after possible additional financing	0	0	-77	-237	-327
Projection assuming no policy adjustment (B)					
Total affected current account entries	98	78	-496	-881	-1,281
Exports	5,471	5,710	5,200	5,129	5,087
(in percent change)		4	-9	-1	-1
Of which: Textiles and clothing exports	2,196	2,035	1,666	1,352	1,180
(in percent change)		-7	-18	-19	-13
Imports (fob)	-7,627	-7,954	-8,025	-8,456	-8,942
Of which: Textiles and clothing imports	-1,261	-1,168	-933	-743	-637
(in percent change)		-7	-20	-20	-14
Services (net)	2,254	2,322	2,329	2,445	2,574
Overall balance	-262	422	-233	-120	274
NIR accumulation (increase, -)	252	-479	-143	-320	-204
Financing gap, before possible additional financing	0	0	432	740	-70
Financing gap, after possible additional financing	0	0	105	103	114
Projection assuming policy adjustment (C) 2/					
Total affected current account entries	98	78	-391	-778	-1,168
Exports	5,471	5,710	5,384	5,314	5,290
(in percent change)		4	-6	-1	0
Of which: Textiles and clothing exports	2,196	2,035	1,851	1,536	1,384
(in percent change)		-7	-9	-17	-10
Imports (fob)	-7,627	-7,954	-8,128	-8,557	-9,052
Of which: Textiles and clothing imports	-1,261	-1,168	-1,036	-845	-747
(in percent change)		-7	-11	-18	-12
Services (net)	2,254	2,322	2,353	2,466	2,594
Overall balance	-262	422	-129	-17	388
NIR accumulation (increase, -)	252	-479	-143	-320	-204
Financing gap, before possible additional financing	0	0	327	637	-184
Financing gap, after possible additional financing	0	0	0	0	0
Impact of expiry of the ATC expiry before policy adjustment (A less B)					
Total affected current account entries	0	0	181	340	441
Exports	0	0	440	833	1,086
(change in percentage points)	0	0	8	7	4
Of which: Textiles and clothing exports	0	0	440	833	1,086
(change in percentage points)	0	0	22	23	16
Imports (fob)	0	0	-276	-510	-663
Of which: Textiles and clothing imports	0	0	-276	-510	-663
(change in percentage points)	0	0	24	24	18
Services (net)	0	0	17	18	19
Overall balance	0	0	181	340	441
NIR accumulation (increase, -)	0	0	0	0	0
Financing gap	0	0	-181	-340	-441
Impact of expiry of the ATC after policy adjustment (A less C)					
Total affected current account entries	0	0	77	237	327
Exports	0	0	256	648	882
(change in percentage points)	0	0	4	7	4
Of which: Textiles and clothing exports	0	0	256	648	882
(change in percentage points)	0	0	13	21	14
Imports (fob)	0	0	-173	-409	-553
Of which: Textiles and clothing imports	0	0	-173	-409	-553
(change in percentage points)	0	0	15	22	15
Services (net)	0	0	-6	-2	-2
Overall balance	0	0	77	237	327
NIR accumulation (increase, -)	0	0	0	0	0
Financing gap	0	0	-77	-237	-327

Sources: Central Bank of the Dominican Republic; Secretariat of Finance; and staff estimates and projections

1/ The expiry of the ATC is not expected to affect materially balance of payments entries not explicitly included in the table.

2/ This projection is dentical to the program's standard balance of payments projection. Assumes policy adjustment (i.e., implementation of DR-CAFTA) takes effect from 2005 onward.

DOMINICAN REPUBLIC—TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum presents the definitions of the variables included in the quantitative performance criteria and indicative targets annexed to the *Memorandum of Economic and Financial Policies*, and the information requirements needed to ensure adequate monitoring of the economic and financial developments.

I. QUANTITATIVE PERFORMANCE CRITERIA: DEFINITION OF VARIABLES

A. Cumulative Floor on the Nonfinancial Public Sector (NFPS) Balance

The balance of the nonfinancial public sector comprises the overall balances of the central government and the rest of the nonfinancial public sector (decentralized entities and the public enterprises, including the recently-acquired electricity distribution companies Edenorte and Edesur).

The overall balance of the central government covers government activities as specified in the budget. Revenue (recorded when the funds are transferred to the national consolidated fund) includes part of the *comision cambiaria* (11.25 percentage points, corresponding to the total rate of 13 percent, less the 1.75 percentage points that will be received by the central bank) and will not include proceeds from the sale of public assets, which will be considered as financing, below the line. Revenue will also include grants. Central government expenditure (recorded when checks are issued) will include transfers to noncentral 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 in-kind capital expenditure 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 central government's net financial position (assets minus liabilities). The net financial position of the central government includes: (a) non-bank central government debt, domestic and external, including short-term debt and administrative debt approved by the Secretary of Finance according to Decree #1523-04; (b) external and domestic bank borrowing and 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 external arrears. 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 average exchange rate of the month in which the transaction takes place.

The following uses of funds will be recorded below the line in 2005, and hence will not affect the deficit: (i) clearance of central government domestic arrears incurred before end-December 2004, to be settled in cash for a maximumDR$4.1 billion, and with a limit of DR$3,050 million in the first quarter of 2005 and DR$350 million per quarter in the rest of the year; (ii) amortization of bonds issued under Law 104-99; (iii) recapitalization Central

Bank and Banco de Reservas; and (iv); other arrears with suppliers incurred by end-December 2004 and to be paid with the issuance of domestic bonds, with a limit of DR$2.5 billion.

The overall balance of the rest of the nonfinancial public sector will be measured from below the line on the basis of changes in: i) domestic bank credit and deposits; ii) domestic and external arrears, and iii) external disbursements less amortizations. It will also include the authorizations to contract administrative debt approved by the Secretary of Finance according to Decree #1523-04.

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.

For end-December 2004, and end-March, end-June, end-September, and end-December of 2005, the cumulative floor will be measured from end-September 2004.

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 Secretaria de Finanzas (revenue, nonbank domestic debt and arrears, external debt and arrears, and externally financed capital expenditure). The *Credito Publico* unit of the *Secretaria de Finanzas* will ensure that its data on external debt, external arrears and externally-financed capital expenditure are fully reconciled with those of the *Secretariado Técnico de la Presidencia* and the central bank.

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

Central Bank net domestic assets (NDA) are defined as the difference between currency in circulation, that is currency issue minus cash-in-vault, and Net International Reserves (NIR), as defined below.

To meet this performance criterion at each relevant date, the 10-day average of daily NDA values must be below the ceiling. The 10-day average will be calculated on the basis of the last ten working days of each relevant month.

For accounting purposes, dollar figures will be converted to *pesos* at the exchange rate of September 29, 2004 (DR$35 per dollar).

C. 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.

Arrears on debt service rescheduled under the April 2004 Paris Club Agreed Minute ("Paris III") will be excluded, until the conclusion of bilateral agreements with creditors implementing this agreed minute. Arrears on pre-cutoff date current maturities in 2005 and 2006 that could be treated under a possible new rescheduling by Paris Club creditors will also be excluded, provided that the Paris Club expresses its willingness to reschedule those maturities, and until the respective bilateral agreements with individual bilateral creditors are concluded. The Paris Club cutoff date is June 30, 1984. Arrears on the debt to private external creditors that is part of the ongoing debt restructuring efforts (paragraph 10 of the Memorandum of Economic and Financial Policies) will also be excluded.

D. Cumulative Ceiling on the Contracting of External Debt by the Public Sector

The contracting of external debt[1] by the public sector is defined as the contracting or guaranteeing of medium and long-term external debt with original maturity of one year or more by the central government, the rest of the nonfinancial public sector, and the central bank, and approved by Congress by each relevant date. For the purposes of the program, such debt will be considered to have been contracted as of the date when both: (1) an agreement to provide such a lending facility or guarantee has been concluded and signed; and (2) the proposed borrowing or guarantee has been approved by Congress.

The contracting of external debt will be measured in U.S. dollars (debt denominated in other currencies will be converted to dollars using the exchange rates as of end-2004) and will exclude arrangements with the IMF.

The ceiling excludes debt instruments to be issued as part of the process of debt restructuring.

For December 2004, and March, June, September, and December of 2005, the cumulative ceiling will be measured from end-September 2004.

The data used to monitor debt contracting will be provided by the *Credito Publico* unit of the Secretaria de Finanzas after reconciliation with the Secretaria Tecnica de la Presidencia and the central bank.

E. Floor on Central Bank Net International Reserves (NIR)

NIR is defined as the difference between gross international reserves of the central bank and reserve liabilities.

[1] This performance criterion applies not only to debt as defined in point no. 9 of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision no. 6230-(79/140), August 3, 1979, as amended by Decision nos. 11096 (95/100), October 25, 1995 and 12274 (00/85), August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received.

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 of the central bank as intervention or financing of payment imbalances. Such assets include gold (valued in dollars at the rate used by the central bank on December 30, 2004), 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 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. Medium- and long-term foreign-currency denominated liabilities, with residents or non-residents, issued by the central bank after December 30, 2004, will be considered part of the reserve liabilities regardless of their maturity. For the purpose of program monitoring, domestic banks' deposits at the central bank in foreign currency (including those related to reserve requirements) will be counted as part of reserve liabilities. Assets and liabilities denominated in SDRs will be converted to dollars at the rate prevailing on December 31, 2004, as published by the IMF.

To meet this performance criterion at each relevant date, the 10-day average of daily NIR values must be above the floor. The 10-day average will be calculated on the basis of the last ten working days of each relevant month.

II. Indicative Targets: Definition of Variables

A. Cumulative Ceiling on the Change in NFPS Net Borrowing from the Domestic Banking System

NFPS net borrowing from the domestic banking system, including the central bank, is defined as the stock of loans and advances, net of deposits, to the central government and the rest of the nonfinancial public sector at each relevant date, in foreign and domestic currencies. Public bonds held by banks, will be included as loans to the central government. Also, the definition will include the loans negotiated with a pool of domestic banks for US$70 million that banks are expected to finance with external resources.

For accounting purposes, dollar figures will be converted to *pesos* at the exchange rate of September 29, 2004 (DR$35 per dollar).

For December 2004, and March, June, September, and December of 2005, the cumulative ceiling will be measured from end-September 2004.

B. Ceiling on Monetary Base

Monetary base is equivalent to *emision monetaria,* which includes currency issue (currency in circulation plus cash in vault) and *peso* deposits held by financial institutions at the central bank (peso reserve requirements and other *peso* deposits).

To meet this indicative ceiling at each relevant date, the 10-day average of daily monetary base values must be below the ceiling. The 10-day average will be calculated on the basis of the last ten working days of each relevant month.

Evaluation of performance of base money with respect to this ceiling will take appropriate account of any changes in regulations affecting the level of banks' required reserves or of any similar investment requirements, and of any changes in the definition of bank assets eligible to be counted toward fulfilling such requirements.

III. Indicators of Electricity Sector Performance

The monitoring of the performance of the electricity sector reform plan, as discussed in paragraph 38 of the MEFP, will focus on the monthly path of the indicators for the regular electricity market (excluding areas served through the *Programa de Reduccion de Apagones* (PRA) set out in the attached Table 1 for the three distribution companies (Edenorte, Edesur and Edeste), and 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 PRA subsidies, FETE (*Fondo de Estabilizacion de la Tarifa Electrica*) and transfers to electricity companies.

IV. Verification and quantification of domestic arrears as of December 2004.

As mentioned in paragraph 22 of the Memorandum of Economic Policies, the government plans to complete an inventory and verification of central government's domestic arrears outstanding as of end-December 2004. Arrears will be computed in accordance with the following definition:

Domestic arrears are defined as the sum of (1) any invoice that has been received by a spending agency from a supplier of goods and services delivered and verified, and for which payment has not been made within the contractually agreed grace period, or in the absence of a grace period, within 30 days; (2) unpaid wages, pensions, or transfers, pending for longer than 30 days. Given the program's cash accounting system, the clearance of domestic arrears, other than the exceptions described in section I.A, will be reported above-the-line, as expenditures.

V. Monitoring and control of externally-financed capital expenditure

To ensure that total capital spending remains within the levels envisaged in the program, as mentioned in paragraph 23 of the MEFP, ONAPLAN, in coordination with the *Credito Publico* unit of the Secretariat of Finance, Onapres (Oficina Nacional de Presupuesto), and the International Department of the central bank, will produce monthly statistics to monitor in-kind capital expenditure (to be included in the calculation of total central government expenditure, as mentioned in I.A). The list of projects being executed will be compared with those included in the budget approved by Congress on a monthly basis.

VI. 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, 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.
- Average bid and ask exchange rates (Dominican pesos per U.S. dollar) and trading volumes at commercial banks and exchange houses.
- 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).
- Tax revenue collection

B. Bi-monthly

- Stock of public external late payments and arrears (program definition), by debtor and creditor, on the 15th and final day of each month, with details on new arrears incurred in the period and clearance of old arrears, with a lag of no more than 5 working days.

C. 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 June 2005, Revenue, Expenditure, and Financing of the nonfinancial public sector, including decentralized agencies and public enterprises.
- 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.
- Authorizations and stock of administrative debt, including the economic classification of the expenditure that has been financed with such debt.
- 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 December 2003.
- Changes in budget appropriations for 2005 with respect to the law approved by Congress and amendments to total authorized expenditure.
- 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).
- Quasi-fiscal balance of the central bank.
- Stock of central bank certificates by type of holder.
- Maturity of certificates, detailing weekly amortizations in the following four weeks and 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 and cash recovery index.

D. Quarterly

- Revised balance of payments outturn for the preceding quarter and quarterly projections for the forthcoming year, with a lag o no more than two 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 two 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 domestic arrears, starting with figures for December 2004, with details on new arrears incurred in the period and clearance of old arrears.

E. Periodic

- Decisions of the *Superintendencia de Bancos* and Resolutions of the *Junta Monetaria*, in relation to actions included in the matrix of financial sector reforms.
- Results of actions taken by *Superintendencia de Bancos*, in relation to the matrix of financial sector reforms.
- Financial statements of banks and their compliance with prudential regulations.

BOX 1: DOMINICAN REPUBLIC—FINANCIAL SECTOR REFORMS

Objective	Action	Completion date
I. Bank re-capitalization	a. Issue a Superintendency circular specifying procedures for bank recapitalization, including requiring banks to submit 2004 financial statements by end-April, 2005 that must (1) be audited by a major accounting firm under the supervisions of a partner from an investment grade country and (2) include a supplement indicating the impact on the financial statements of adopting the new prudential regulation for asset valuation.	Dec. 2004
	b. Complete evaluation (including by sharing the report with Fund staff) of progress made in bank recapitalization up to September, alerting banks that cannot meet the recapitalization schedule and ensuring that capital increases are in conformity with international accounting standards.	Dec. 2004
	c. Take prompt actions to restructure any bank that does not meet capitalization requirements as of end-2004 in accordance with the current legal framework.	May 2005
	d. Issue a report on the verification by the Superintendency of the quality of capital increases made by banks.	July 2005
	e. On the basis of the supplement to the 2004 financial statements, require all banks to submit a five-year business plan substantiating their viability and ability to comply fully with capital requirements according to the new asset valuation regulation by the end of a three-year transition period beginning in Jan. 2005.	
	(1) Issue a monetary board resolution requiring banks to submit business plans by May 2005.	Before Board
	(2) Complete evaluation (with assistance of international experts) of the business plans and sign memoranda of understanding with the banks committing them to meeting the recapitalization schedule.	July 2005
	(3) Require six-monthly audits of all banks' financial statements, to be undertaken by the banks external auditors with participation of a partner from an investment grade country, and updates to the business plans ensuring compliance with the recapitalization calendar established in the new asset evaluation regulation.	Jun. and Dec. each year, from Dec. 2005
	(4) Ensure that to be admissible, the quality of fresh capital must meet international accounting standards.	Continuous
II. Strengthen the financial system	a. Finalize agreements for the banks resolved in 2003, ensuring they meet required solvency levels.	Before Board
	b. Appoint a special prosecutor to conduct the judicial cases against management and shareholders of the failed institutions.	Before Board
	c. Complete an evaluation of banks' progress in compliance with regulations for related party lending and offshore subsidiaries.	Dec. 2004
	d. Invite and hold discussions with the independent panel on the identification and handling of banking problems regarding their final report.	Jan. 2005
	e. Initiate assessments, with technical assistance from external advisors if appropriate, of (1) the use given to liquidity support by the three failed banks, and (2) the treatment of their offshore liabilities.	Feb. 2005
	f. Publish final report of the independent panel on the banking crisis.	March 2005
	g. Publish the first report on progress made in civil and criminal judicial cases against management and directors of the failed banks.	March 2005
	h. Develop a plan to strengthen nonbank financial intermediaries, specifically (1) savings and loans associations, (2) finance companies and (3) specialized public sector financial institutions.	Sept. 2005

Objective	Action	Completion date
III. Strengthen the prudential framework	a. Revise by-law on asset valuation (including loan classification) and provisioning to reflect international best practices and Fund staff comments.	Before Board
	b. In consultation with the IMF, bring by-laws and prudential regulations in line with international best practices, including on:	
	(1) Definition of financial groups and criteria for consolidated accounting.	March 2005
	(2) Treatment of market risk and liquidity. The regulation will specify actions to be taken by the SB if a bank requests BCRD liquidity support. If liquidity support is requested an on-site special inspection team will be placed in the bank to monitor the use of liquidity and asset disposals. If support rises above (1) 20 percent of capital, lending activities will be suspended; (2) 50 percent of capital, a plan to collect connected commercial loans must be submitted within two weeks; (3) 100 percent of capital, shareholders must pledge their shares as collateral for additional liquidity assistance.	March 2005
	(3) Consolidated supervision.	April 2005
	(4) Implementation of the law for bank resolution under systemic risk, allowing for the creation of a high-level coordinating committee in case of need.	April 2005
	c. Update the chart of accounts governing financial institutions in line with new regulations and international accounting standards.	June 2005
	d. Bring revised chart of accounts into effect.	Dec. 2005
IV. Strengthen banking supervision	a. Initiate procedures to monitor banks' liquidity, including by producing a summary report showing liquidity ratios, compliance with reserve requirements and changes in banks' cash positions, on a daily basis.	Before Board
	b. Finalize an institutional strengthening plan for the Superintendency of Banks, to include (1) a diagnostic of current weaknesses; (2) an intensive capacity building program; (3) specific actions to improve financial analysis and on-site inspection (including information and control systems); (4) provision of adequate technological support and (5) reduction in administrative procedures.	Jan. 2005
	c. Appoint a director at the bank superintendency to supervise implementation of the strengthening plan.	Feb. 2005
	d. Begin implementation of a plan to bring the credit risk bureau to the highest regional standards.	March 2005
	e. Prepare a plan for completion of the liquidation of all intervened financial institutions within two years.	June 2005
	f. Complete credit bureau improvement plan.	Dec. 2005

Objective	Action	Completion date
V. Asset management	a. Complete the design of the organizational structure of a unit to manage and dispose of assets acquired as a result of the resolution of the three problems banks, and develop a timetable for asset disposal. b. Initiate procedures to foreclose on assets placed in guarantee by former shareholders of resolved banks, by resolving the contractual agreement. c. Prepare a market-based methodology to determine the transfer prices of BCRD assets passed to the asset disposal unit, and initiate inventory identifying and classifying all assets, rights and potential claims, and establishing legal title. d. Appoint key staff and approve budget and charter of internal controls of the asset disposal unit. e. Complete inventory of central bank assets. Transfer assets to the disposal unit at prices established using the market-based methodology.	Before Board Before Board Feb. 2005 Feb. 2004 March 2005
VI. Restructuring of public banks	a. Submit to Congress legislation requiring public banks to meet the same regulatory and capital quality requirements as private banks. Specifically, changes should remove the provision of the Monetary and Financial Law granting a five-year transition phase before equal application of prudential regulations and oversight to public banks. b. Apply the same recapitalization strategy and conditions specified above to public as to the private banks.	April 2005 Continuous
VII. Institutional reform	a. Submit to Congress amendments to the Monetary and Financial Law providing for: (1) the lengthening of the term of appointment of the Governor of the BCRD and the Superintendent of banks to at least five years; (2) the provision of budgetary independence to the bank superintendency; (3) independence of the bank superintendency in decisions concerning sanctions for violation of prudential regulations and the banking law; (4) accountability of the BCRD and bank superintendency before Congress; (5) clear delimitation of the respective regulatory responsibilities of the BCRD and bank superintendency; and (6) reduction of the role of the Monetary Board in supervisory matters.	July 2005

Table 1. Electricity Sector Indicators

	Jan-05	Feb-05	Mar-05	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05	Oct-05	Nov-05	Dec-05	Total 2005
EDESUR/EDENORTE													
Loss rate	42.6%	41.7%	40.8%	40.0%	39.1%	38.1%	37.3%	36.4%	35.5%	34.7%	33.8%	32.9%	37.7%
Collection rate	77.9%	79.1%	80.4%	81.7%	83.0%	84.3%	85.6%	86.9%	88.1%	89.4%	90.7%	92.0%	85.4%
EDEESTE													
Loss rate	24.4%	23.8%	23.2%	22.5%	21.9%	21.2%	20.6%	20.0%	19.3%	18.7%	18.0%	17.4%	20.8%
Collection rate	68.8%	70.5%	72.3%	74.0%	75.8%	77.5%	79.3%	81.0%	82.8%	84.5%	86.3%	88.0%	79.1%
Total Distribution Companies													
Loss rate	37.4%	36.0%	36.0%	34.5%	34.1%	32.8%	32.1%	31.2%	30.1%	29.8%	28.5%	27.9%	32.5%
Collection rate	74.9%	76.0%	77.9%	79.0%	80.6%	81.9%	83.4%	84.8%	86.2%	87.8%	89.1%	90.6%	83.2%
Central Government Transfers 1/	-47.4	-40.3	-39.4	-39.3	-32.1	-30.3	-25.2	-27.0	-22.9	-23.2	-12.5	-10.5	-350.0

1/ In millions of U.S. dollars.