

Dominican Republic Election Special

- The Dominican Republic will hold elections this Sunday, May 16, 2004.
- Former President Leonel Fernandez is expected to win.
- Such a result should be positive for bond prices and for avoiding a debt restructuring.
- This is because his track record and campaign announcements are consistent with macroeconomic stability and economic growth.
- Risks remain, however, both in terms of near-term illiquidity and medium-term debt-service challenges.

Overview

Dominicans will vote this Sunday, May 16, in national elections in which, polls suggest that former President Leonel Fernandez will win in the first round. As his track record and campaign platform are consistent with macroeconomic stability, a peaceful, transparent, and convincing victory would be good for credit risk over the medium term. The potential for surprise stems from incumbent President Mejia's recent populist pronouncements, which could marginally erode Fernandez' support, forcing a second-round vote on June 30. The immediate, key question from the election results will be implications for filling the US\$100 million financing gap of the government which has allowed the specter of sovereign default in 2004 to linger. We see a Fernandez win as facilitating the closing of the financing gap without a restructuring of sovereign bonds because the chance of more stability ahead provides the best chance of attracting new resources.

Candidates

Dominicans are choosing among three candidates, Leonel Fernandez, Hipolita Mejia, and Eduardo Estrella.

Leonel Fernandez, 51, was President of the Dominican Republic from 1996 to 2000. A trained lawyer, Fernandez became active in politics in college when his mentor and one-time President, Juan Bosch founded the Dominican Liberation Party (PLD) in the early 1970s. Fernandez spent the next two decades as both a professor and active party member before being named Vice Presidential candidate in Juan Bosch's unsuccessful bid to replace President Balaguer in 1994. Since his Presidency, Fernandez has remained a vocal member of the opposition in his seat as Director of a local consultancy FUNGLODE.

Hipolito Mejia, 61, is the current President of the Dominican Republic. He is an agronomist by trade who spent the first part of his career largely in the private sector in agroindustry.

Table 1: History of Dominican Leaders

Leader	Period	Party	Ascent to Power	Departure from Power
Rafael Trujillo	1930-1961	--	Military Revolt	Assassinated
Juan Bosch	1963-1963	PRD	Elections	Military Coup
Military Rule	1963-1965	--	Military Revolt	US invasion
Joaquin Balaguer	1966-1978	PRSC	Elections, Fraud	Loses Election
Antonio Guzman	1978-1982	PRD	Elections	One-Term Limit
Salvador Jorge Blanco	1982-1986	PRD	Elections	One-Term limit
Joaquin Balaguer	1986-1996	PRSC	Elections, Fraud	International Pressure
Leonel Fernandez	1996-2000	PLD	Elections	One-Term limit
Hipolito Mejia	2000-2004	PRD	Elections	Running for reelection*

* Reform of Constitution in 2003 permits two consecutive terms

Source: Goldman Sachs

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Mejia rose to Minister of Agriculture in 1978 in the first democratically elected administration after Balaguer. Upon completion of his term, Mejia returned to the private sector as a consultant in agro-business but maintained an active role in his party, the PRD. He was named Vice Presidential candidate in an unsuccessful bid in 1990 but then won the presidency in 2000 with 49% of the vote, the first time the PRD held the Presidency in 14 years. In 2003, Mejia supporters in Congress changed the constitution to allow for two consecutive terms, even though 94% of Dominicans indicated they did not want Mejia to run again. Mejia won a primary election against eight challengers amid widespread allegations of fraud and very fractious party politics.

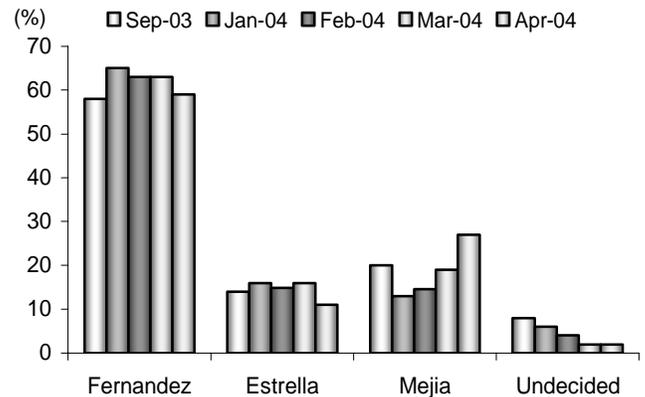
Eduardo Estrella 51, began his career as a diplomat before returning to the Dominican Republic to hold various positions in academic administration. Estrella entered public life in the Public Works department during the 1980s and subsequently became Senator in the Province of Santiago, the second-most important province in the country. Like Mejia, Estrella faced a difficult primary race this year that was marred by allegations of corruption. Subsequently, the party expelled several leaders who had voiced opposition to Estrella in order to consolidate power. His party, the PRSC, has struggled to form a united position of strength now that its leading member, Joaquin Balaguer, passed away in 2002.

Indeed, the 2004 election is a watershed in Dominican politics in that it is the first political contest since the 1950s in which the *caudillo* Joaquin Balaguer of the PRSC is not playing a critical role. Balaguer was President seven times for a total of 22 years, often via elections largely considered fraudulent. Even when not directly holding official positions, Balaguer wielded considerable power, and largely determined the results in each of the last two elections via his support. The absence of Balaguer has left the election largely open to a contest between the two other parties, the PLD and the PRD.

Polls

Polls favor former President Leonel Fernandez and suggest a decisive win with 54% of the vote, well above the 27% for current President Mejia and 14% for Eduardo Estrella. Fernandez has particularly high support among the young (69%), relatively well-to do (63%), and female (59%) but even among the poorest surveyed he receives 53% of the vote. No candidate since 1978 when elections were restored has received support above 50% in polling and local analysts think the election result is one of the most assured in the country's democratic history.

Chart 1: Electoral Polls



Source: Penn, Schoen, & Berland

According to some polls, the substantial support for Fernandez has moderated in recent months, falling from a peak of 63%. Meanwhile, Mejia has posted a 13% point gain following a reduction in his party's internal dissension and a substantial intensification in populist deliverables such as a promised 30% public sector wage hike, payment of arrears to domestic suppliers, free land and property titles to swing constituencies, and soft-term financing for everything from small businesses to motorcycles.

The main implication of this modest decline in support seems to have more to do with how smooth a Fernandez win would be, than whether it will happen. While a successful surge by President Mejia's campaign could undermine the needed 50% of the vote to win outright, second-round simulations suggest Fernandez would still win 63% to 30%. However, a prolonged election (run-off would be June 30), particularly when one out of every two Dominicans thinks there will be fraud in the election, could spark instability and violence, providing further noise in bond prices.

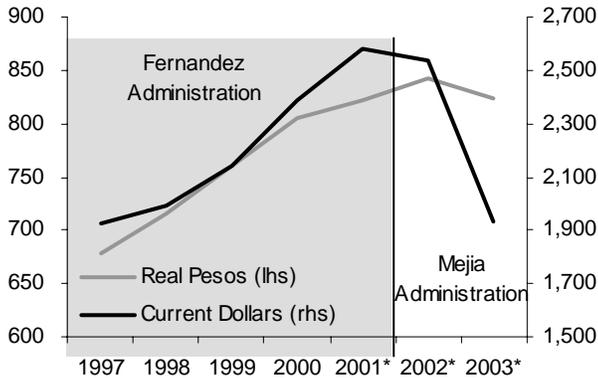
Policies

This election is significant for economic policy and bond prices given relatively important differences between the two major candidates. The fact that both of the major candidates have had stints as President provides a rare opportunity to judge their respective responses to power.

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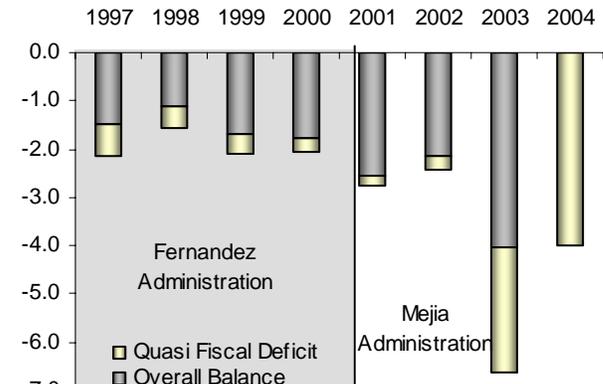
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Chart 2: Per Capita Income



Source: BCRD

Chart 3: Combined Public Sector Balance



Source: BCRD

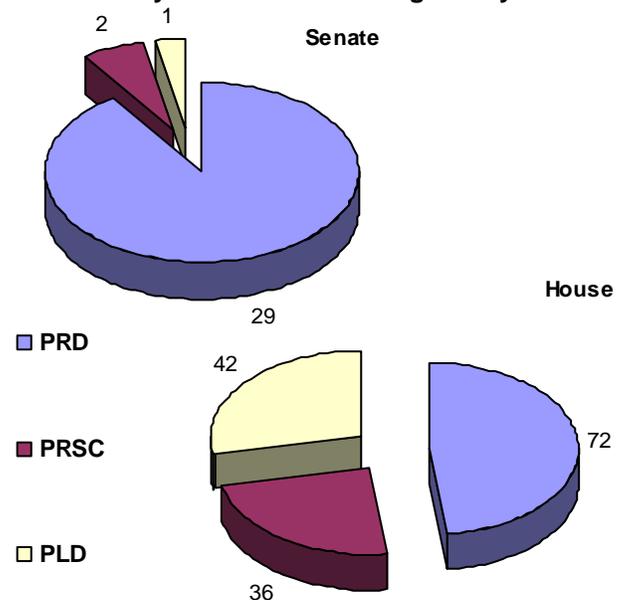
Leonel Fernandez is considered a market-friendly candidate thanks to a track record during his administration that includes fiscal discipline, low inflation, privatization, and trade openness. His reforms were not uniformly welcomed – particularly the privatization of electricity distribution – but his administration is associated with average 8% real GDP growth. Fernandez’ *Programa de Gobierno* 2004-2008 is similar to policies he pursued in office and hard to distinguish from the basic policies embedded in the current IMF program. However, Fernandez has expressed a strong preference for lower taxes and seeks to maintain fiscal discipline via controls on public spending which he argues has grown irresponsibly.

President Mejia has shown a consistently populist and statist response to economic problems including the bank bailout and the renationalization of two electricity distribution companies. He has expressed a commitment to free trade, the IMF program, and fiscal austerity, but has also consistently sought to consolidate domestic support via promises of handouts, a refusal to reduce the public sector payroll, and support for price controls. There is no doubt that Mejia has faced a more difficult economic environment than Fernandez, with the terrorist attacks of September 11, 2001 on a tourism-dependent economy and the realization of widespread bank fraud at Baninter that likely began long before his administration. Furthermore, Mejia was the first President to issue Global bonds, opening the country up to more vulnerability from global capital markets. However, the very political nature of the responses to largely economic crises has likely worsened the economy’s fallout.

Congress

A major consideration to keep in mind is the entirely lopsided representation in the Dominican Legislature. Fernandez’ PLD has only one Senator and 42 Deputies while Mejia’s PRD has 29 Senators and 72 Deputies, the largest party in a Congress that has 150 seats. As Congressional seats are up for reelection every four years but in non-Presidential election years, the make-up we see now will be the Congress that the

Chart 4: Party Breakdown in Congress by Seats



Source: Junto Central Electoral.

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next President faces. Fernandez insists that if he wins this will not be a problem for governance and indeed he had only one Senator and 12 Deputies the last time he governed. Nonetheless, given the significant need for reform, this would be a concern in a Fernandez administration.

Sovereign Debt Restructuring

On the specific issue of restructuring, there has been a lot of noise about what each candidate will do. In recent weeks, we have seen the Mejia administration actively seek to avoid restructuring sovereign bonds by trying to locate new private sector resources to fill the remaining financing gap. Thus, in practice, we have proof that the Mejia administration recognizes the importance of respecting contracts. However, the Mejia administration has also taken a number of steps that have directly led the country to a situation where restructuring is a possibility including: (1) the bank bailout worth 20% of GDP; (2) the renationalization of electric companies; and (3) the less-than-austere fiscal policy in recent years.

Ironically, with Fernandez, the rhetoric has been consistently more in support of renegotiation of foreign debt and has led to substantial confusion regarding what he will do. To be clear, in a recent speech to the American Chamber of Commerce, he said he would avoid the worst of scenarios which is default on payments by stepping up efforts to renegotiate the debt and extend its terms. We think the Fernandez team has not made up its mind on restructuring and is more likely to pursue policies that would make any restructuring that might be

necessary less significant for bondholders.

Consequences for External Debt Service in 2004

Once the results of the election are in, all eyes will return to the very near term issue of filling the public sector financing gap of US\$100 million for 2004. To be clear, filling this gap is necessary to avert a default in 2004, not just to comply with the Paris Club's principle of comparability of treatment. The result of the elections could have some bearing on how easy this problem is to solve in two respects.

First, the assumption that the remaining financing gap is US\$100 million is predicated on relative stability in the balance of payments and a roughly 3% point of GDP adjustment in the fiscal balance. A Mejia win could spark further capital outflows as a fear of ongoing instability in economic management returns. At the same time, such a result might provide more incentive for Mejia to be careful with fiscal policy as he will be inheriting any economic mess that is created. A Fernandez win might have the opposite effect: good for capital inflows but bad in that it may reduce the incentive for careful fiscal policy by a lame duck Mejia administration.

Second, assuming no change in the assumptions underlying the size of the financing gap, the government is considering four options for locating US\$100 million: (1) new loans from the private sector; (2) restructuring non-Paris Club bilateral debt; (3) restructuring non-bond private sector debt; and (4) restructuring bonded debt. We see options 2 and 3 as holding

Table 2: Sovereign External Debt Service in 2H04

US\$ mn	Jul		Aug		Sep		Oct		Nov		Dec		Total 2H04	
	Princ	Ints	Princ	Ints										
TOTAL	38.13	42.93	42.15	22.89	29.25	41.22	36.74	23.80	42.78	21.21	74.17	25.78	263.22	177.83
Multilateral	12.52	5.80	9.38	13.47	8.02	8.35	18.19	13.41	10.98	7.45	4.79	5.44	63.88	53.92
Bilateral	19.93	5.60	14.27	3.05	19.27	3.63	16.10	6.03	22.70	5.06	64.75	15.69	157.02	39.06
Paris Club	10.48	2.01	2.50	0.39	0.29	0.24	2.02	0.28	4.11	0.55	46.08	10.15	65.48	13.62
Non-Paris Club	9.45	3.59	11.77	2.66	18.98	3.39	14.08	5.75	18.59	4.51	18.67	5.54	91.54	25.44
Private	5.68	31.53	18.50	6.37	1.96	29.24	2.45	4.36	9.10	8.70	4.63	4.65	42.32	84.85
Commercial Banks	5.08	0.99	8.02	1.83	0.98	0.55	1.71	0.95	8.36	1.91	3.88	1.26	28.03	7.49
BONOS BRADY	0.00	0.00	9.88	1.12	0.00	0.00	0.00	0.00	0.00	3.39	0.00	0.00	9.88	4.51
Sovereign Bonds	0.00	27.12	0.00	0.00	0.00	25.28	0.00	52.40						
Suppliers	0.60	3.42	0.60	3.42	0.98	3.41	0.74	3.41	0.74	3.40	0.75	3.39	4.41	20.45

Source: BCRD.

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very little promise as there is relatively little remaining debt service to both groups of creditors in 2004 and portions of those credits are ineligible to be restructured. This leaves finding new private sector resources as the only real option for filling the financing gap that does not entail restructuring bonded debt. On balance, we think a Fernandez win that has a higher probability of generating domestic confidence and economic stability on balance has a better chance of attracting the necessary private sector resources.

Conclusion

The results of the elections appear likely to favor Leonel Fernandez. However, a surge in support for Mejia could extend the electoral process, introducing uncertainty into

political leadership going forward. Assuming this does not happen, our base case remains that Fernandez wins, increasing local confidence and improving the chances of economic stability going forward. In the near term, the higher expectations of stability that may accompany a Fernandez win should help the Technical Secretariat close the financing gap with new resources from the private sector, thus avoiding restructuring sovereign bonds. Over the medium term, a Fernandez administration would still have substantial work in improving fiscal accounts, strengthening the electricity sector, and improving oversight in the banking system before one should have confidence restructuring can be avoided.

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