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BANCO CENTRAL DE LA REPUBLICA DOMINICANA
REPORT: OCTOBER 1982

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PROGRAMME OF WORK

Introduction

1. The purpose of this report is to give a brief account of progress in carrying out the programme of work which we are undertaking in collaboration with officials from the Banco Central under the agreement between the Banco Central and Samuel Montagu. The report also mentions some of the subjects which we hope to discuss at the Banco Central during our regular visit to Santo Domingo in the working week beginning 25 October.

Financial report

2. Following our last visit, we have prepared a second edition of our financial report on the Dominican Republic, updating the first edition and incorporating a new section on the President's new economic programme. Copies of the financial report were distributed to banks at the annual meeting of the IMF in Toronto in September.

Foreign debt rescheduling

3. As instructed, we have prepared a paper on the technical aspects of rescheduling the Dominican Republic's foreign debt, if a decision is made that such a course of action is necessary. We have visited Dusseldorf to discuss our ideas in outline with Dr. Völling, who we understand is in broad agreement with them. During our meeting Dr. Völling made a distinction between the question of whether there is political support within the Dominican Republic for an agreement with the IMF and negotiations with foreign banks (the question which he addressed during his visit to the Dominican Republic in September), and the technical question of the form that any negotiations with foreign creditors should take. It is this question which is addressed in our paper, together with suggestions about how we can assist the Banco Central in the preparation for and conduct of any negotiations that take place with foreign banks.

Management of the foreign reserves

4. In view of the likelihood that the gross level of the Banco Central's liquid reserves will increase, following an agreement with the IMF, we have prepared a paper on the management of the foreign reserves for consideration by the Banco Central. A copy of the paper is included in this report. The paper suggests that a set of investment guidelines should be drawn up within which the foreign reserves should be managed in future.

Rosario Dominicana

5. Following our last visit, we prepared a preliminary paper on the likely impact of the new refinery at Rosario Dominicana on the foreign exchange budget. A copy of the paper is included

in this report. Since the paper was prepared, we have drafted a further paper on the subject, of which a copy is also included in this report. However, there are gaps in this paper for the information that we need to collect from Rosario Dominicana and the subjects that we need to discuss with their representatives during our visit to Santo Domingo in the working week beginning 25 October, prior to the submission of the final report.

Interest rates

6. A copy is included in this report of our comments on the papers considered at the Monetary Board on a rise in Dominican interest rates.

Public Debt Office

7. On our last visit, we submitted a paper on the establishment of a Public Debt Office as a Secretariat to the Monetary Board. We are available to discuss this paper during our visit in the working week beginning 25 October, if convenient.

Foreign exchange budget

8. On previous visits to Santo Domingo, we have discussed the preparation of the foreign exchange budget within the Banco Central. We have been receiving foreign exchange budget figures from the Banco Central, which we have used as the basis for our weekly telexes to the Banco Central since our last visit. We are available to discuss the financing of the foreign exchange budget during our visit in the working week beginning 25 October, if required.

Financial assessments

9. We are available to review financial proposals submitted to the Banco Central by foreign banks and securities houses when requested by the Banco Central to do so. Since our last visit, the main subjects of the telex correspondence between us have related to gold transactions by the Banco Central and "so called" promissory notes of the International Chamber of Commerce.

Seminars and training

10. During our last visit, we held a seminar for officials from the Banco Central, and will be ready to hold a further seminar on our visit in the working week beginning 25 October, if convenient. We would also like to discuss the question of training officials from the Banco Central in commercial banking operations in London.

FOREIGN DEBT RESCHEDULING

Introduction

1. The purpose of this paper is to analyse the public sector foreign debt of the Dominican Republic and to discuss how, if necessary, this debt may be rescheduled. The paper is divided into six sections as follows:

(i) a brief discussion on the factors upon which a decision will be based regarding the advisability of the Republic rescheduling its foreign debt;

(ii) an analysis, by lender, of the public sector's foreign debt stock and debt service;

(iii) a discussion on the practicality of rescheduling different types of debt;

(iv) an outline of the steps which need to be taken to carry out a successful rescheduling operation if such an operation is deemed necessary;

(v) a summary of the conclusions reached in this paper; and

(vi) a statement of how Samuel Montagu would be able to help the Banco Central in any rescheduling exercise undertaken by the Government.

The need to reschedule

2. With the limited information that we have, it is difficult to establish whether the Republic needs to reschedule its foreign debt or to what degree such a rescheduling exercise needs to be undertaken if such an operation is deemed necessary. If the study of the full figures shows that the foreign debt does need to be rescheduled then after the political backing within the Republic for such an exercise has been sought and found the Banco Central should make the appropriate initial approaches. The form of such approaches is discussed within this paper.

3. Of crucial importance to a study of a possible rescheduling are the balance of payments forecasts for 1983 and 1984 and indeed some tentative projections beyond that date. It is of course highly difficult to produce such forecasts and impossible to accurately forecast the future. However, without such projections it will be difficult to argue a coherent case with the Republic's creditors, particularly the commercial banks.

4. The Banco Central already has the basic building block for balance of payments forecasts, namely the foreign exchange budget. Indeed much work on forecasts may already have been undertaken in conjunction with the demands made by the IMF team during their visit to Santo Domingo. In order to produce balance of payments forecasts it will be necessary to produce a foreign exchange budget not only for the year ahead but further into the future. The forecasts drawn up will be sensitive to a wide range of differing factors which will include the following three major areas:

(i) sensitivity to commodity prices. The price of much of the Republic's exports are determined by international commodity markets where wide fluctuations may occur, particularly in the case of gold which is a speculative commodity;

(ii) sensitivity to capital inflows; and

(iii) sensitivity to:

(a) short-term bank lines. It cannot be assumed that such lines can be automatically refinanced upon their maturities;

(b) the volume of letters of credit under the negotiated agreements between the Banco Central and foreign commercial banks and between domestic commercial banks and their foreign correspondents. These agreements are reviewed on an annual basis and the willingness of banks to maintain their lines cannot be taken for granted; and

(c) the situation regarding arrears. The level of arrears during the forecast period may contribute significantly to the perceived creditworthiness of the Republic. The present discussions with the IMF may have focussed upon this problem.

5. It is important that any rescheduling operation reflects the anticipated financing shortfalls and tries to defer debt service repayments until years which may support them. Whether debt service deferrals will be sufficient in themselves to plug any financing gap will only be determined when the appropriate forecasts have been prepared. If the forecasts show continuing difficulties in the years ahead then lenders, particularly commercial banks, may be reluctant to agree to any rescheduling. However, an agreement with the IMF, based upon discussions now taking place, will not only bring balance of payments support but will indicate those measures that the Government of the Dominican Republic will undertake to help the country's balance of payments to move into surplus. The Republic's creditors will wish to study this agreement and the performance criteria set forth therein will form the basis of detailed negotiations concerning any rescheduling operation. An IMF agreement is a prerequisite to a successful refinancing exercise.

Foreign debt by lender

6. As at the end of 1981, the foreign debt owed by the private and public sectors amounted to RD\$1,887m split up as follows:

Dominican Republic: public and private sector foreign debt

RD\$m: end-1981	Long term	Medium term	Short term	Total
Multilateral	395	43		438
Bilateral	372	111		483
Commercial banks	235	61		296
	<u>1,002</u>	<u>215</u>	<u>-</u>	<u>1,217</u>
Short-term bank lines	-	-	233	233
	<u>1,002</u>	<u>215</u>	<u>233</u>	<u>1,450</u>
Total public sector debt			43	437
Private sector debt	394			
	<u>1,611</u>		<u>276</u>	<u>1,887</u>

7. In studying the above figures the following points should be borne in mind:

(a) excluded from the table are:

(i) foreign liabilities of the Banco Central;

(ii) commercial and bank liabilities other than foreign debt;

(iii) obligations under letters of credit; and

(iv) the arrears position,

and any one of these may itself have a significant impact upon any rescheduling operation or balance of payments forecast;

(b) the debt is categorised into short (0-1 year), medium (1-8 years) and long term (over 8 years) obligations according to original maturity. Although a useful guide, such a categorisation does not allow accurate debt service figures to be either accurately calculated or indeed just estimated; and

(c) the debt figures used are those outstanding as at the end of 1981. Although the precise details of the outstanding debt will have altered slightly since that date the general points raised in the following sections and the conclusions drawn from them will remain valid.

Rescheduling possibilities of each category of debt

(a) Multilateral borrowings

8. Multilateral borrowings of the public sector amounted to RD\$438m at the end of 1981 as follows:

Dominican Republic: public sector's multilateral foreign debt

RD\$m: end-1981	Long term	Medium term	Short term	Total
IDB	283			283
World Bank	86			86
AIF	17			17
Opec Special Fund	8			8
IMF		43		43
IFAD	1			1
	<u>395</u>	<u>43</u>	<u>-</u>	<u>438</u>

It has never been the policy of such institutions to agree to any rescheduling of debt owed to them. In particular, the IMF will not on any condition agree to defer either principal or interest owed to them. Countries which have fallen into arrears on debt service payments to the IMF have always been obliged to make good such arrears as a precondition for obtaining new funds. This strict stance is particularly onerous to borrowing countries as IMF loans are relatively short-term; debt service on IDB and World Bank loans are less burdensome given their soft interest rates and long repayment periods. However, the IDB and the World Bank are equally stringent in their attitudes to borrowers. The two bodies consider that their reputations would suffer if repayment of monies lent to support development projects which themselves performed as forecast were seen to be deferred for reasons other than those related to the project. In particular, general balance of payments difficulties of the countries responsible for the projects would not be regarded by the IDB and the World Bank as a suitable reason for the refinancing of their debt.

(b) Bilateral borrowings

9. Bilateral borrowings of the Republic amounted to RD\$483m at the end of 1981. In summary these borrowings were as follows:

Dominican Republic: public sector's bilateral foreign debt

RD\$m: end-1981	Long term	Medium term	Short term	Total
US	283	69		352
USAID	171			171
PL480	70			70
CCC		69		69
Eximbank	38			38
Federal Home Loan Bank	4			4
Spain	64			64
Government	25			25
Export credits	39			39
Venezuela		40		40
Investment Fund		40		40
Other	25	2		27
Various	25	2		27
	<u>372</u>	<u>111</u>	<u>-</u>	<u>483</u>

The major international forum for the rescheduling of bilateral borrowings is the Paris Club.

10. The Paris Club arose out of the concern of creditor countries that their rescheduling terms should be no less favourable than those of the others. The Paris Club meets informally under the Chairmanship of the French Treasury and convenes if the borrowing country in difficulties has requested a meeting and if the creditors agree to such a meeting; creditors' agreement is usually conditional upon the borrower having entered into discussions with the IMF and any rescheduling agreed at the Paris Club will be conditional upon the borrower have reached agreement with the IMF on a stabilisation plan. The procedures followed are fairly speedy once the borrower has made informal indications to the French Treasury as to what is being sought. At the Paris Club meeting the debtor country will present its case and its requests. The IMF follows with its own assessment of the financial position. The negotiations then follow (and if there are no hitches, these usually only last two days) and agreed minutes are signed summarising the rescheduling terms. Thereafter the debtor country must conclude separate agreements bilaterally with each member of the Paris Club on interest rates and the mechanics of payment. The terms of the agreed minutes are likely to follow the outline given below:

(i) the debtor country will undertake to renegotiate its official foreign debt to commercial banks with an original maturity of over one year;

(ii) the payments of principal and, in many cases, interest as well to be rescheduled will be defined;

(iii) the proportion of the debt service payments to be rescheduled will be defined. In many cases 100% of debt service payments have been rescheduled but in some cases a lower percentage has been agreed;

(iv) the method for determining interest rates. The minutes usually state that market rates will be used, which in practice means the current rates charged on new loans by the agencies or institutions whose existing debts are being rescheduled;

(v) the consolidation period will be agreed. Consolidation periods have in practice been between 1 and 2½ years and may constitute one or more of the following:

(a) a specified period before the day of the renegotiations during which arrears have accumulated; and

(b) obligations falling due during a specified period after the date of the renegotiations.

Reschedulings may take in both principal repayments and interest payments not only for future periods but also on arrears. It may be possible to link the length of the future period of a consolidation period with the length of the assisted period under an IMF agreement; and

(vi) the grace period (usually 2½ to 5½ years) and the repayment periods (usually 7½ to 10½ years, inclusive of the grace period) will be set out.

11. The Paris Club is most suitable for debtor countries which expect to experience payment difficulties to the export credit agencies of a considerable number of countries. Given the structure of the Republic's bilateral debt it is unlikely that the Paris Club could fulfill any useful role if a rescheduling exercise was deemed necessary. Some 70% of bilateral debt is lent by the US. US AID and PL480 aid is long-term and debt service payments are not burdensome. Monies from Commodity Credit Corporation and the US Eximbank are given on a medium-term basis and these may well be prime candidates if a rescheduling exercise was thought necessary. Other important bilateral borrowings are from Venezuela and Spain. The terms under which the Republic is borrowing from Venezuela are unknown to us but there may be some scope for the loan to be rescheduled. Bilateral loans from Spain are stated to be long term and it may not be worthwhile trying to alter the terms under which they were granted.

12. An approach to the Paris Club is regarded by the international financial community as being the start by a debtor country of a formal rescheduling operation. Such an approach is an effective declaration of insolvency and therefore carries with it a certain stigma. The immediate effect is a drying up of sources of finance both official and commercial and is thus a step which should only be taken if all other avenues have been exhausted. It is partly for this reason and partly because much of the bilateral debt is in the form of aid that the better course of action, if a rescheduling exercise is found to be appropriate, would seem to be informal bilateral approaches to the US and to Venezuela. The Republic should enter into separate negotiations with the two countries having made the initial approaches at the political level.

(c) Commercial bank debt

13. Long term and medium term commercial bank foreign debt which accounts for 25% of the public sector's long and medium term debt is split up as follows:

Dominican Republic: public sector's commercial bank foreign debt
- excluding bank lines

RD\$m: end-1981	Long term	Medium term	Short term	Total
Royal Bank of Canada	9	5		14
Royal Bank of Canada, etc.	180			180
Citibank		20		20
Bank of Nova Scotia	2	21		23
Chase Manhattan	10			10
Orion Bank	10			10
Bank of America	11			11
Others	13	15		28
	<u>235</u>	<u>61</u>	<u>-</u>	<u>296</u>

Bank debt will be a major contributor to the burden of debt service payments during the next few years and if a rescheduling operation becomes necessary then commercial bank debt should almost certainly be rescheduled. Commercial banks will not agree to any capitalisation of interest but may agree to refinance repayments of principal as they fall due within selected periods.

14. The usual course of action is for the commercial banks to appoint a steering committee (made up of the largest creditors amongst the banks) which will enter into negotiations with the Republic. This course of action is one in which the Republic already has gained some experience in its negotiations with banks regarding letters of credit. The points to be agreed follow those outlined above under the Paris Club agreed minutes. The agreed interest rate margin on the amounts refinanced will be increased, reflecting a penalty rate for the Republic. Documentation is usually drawn up in the form of a new loan agreement under which principal repayments falling due under existing loan arrangements will constitute new borrowings by the Republic. This form of documentation allows existing loan agreements to remain unchanged. The maturity date under any rescheduling arrangement is likely at most to be only seven to eight years from signature with repayments falling due in equal semi-annual instalments after a two to three year grace period. Past experience indicates that banks are unwilling to commit new monies to a country which has recently rescheduled its debt unless there has been a significant improvement in that country's balance of payments position.

15. Commercial banks will wish to be assured that appropriate IMF arrangements are being entered into and will require that negotiations are completed before any amount is rescheduled. An IMF agreement is thus considered essential by the commercial banks for any agreement to reschedule long and medium debt.

16. The Republic should seek to reschedule all commercial bank debt in any general rescheduling exercise and not seek to be selective. Banks always wish to rank parri passu with other banks (unless these other banks have taken security) and will not wish to see their position weakened in relation to others. A partial rescheduling exercise is thus difficult if not impossible to achieve. Naturally, the major US\$180m loan to the Republic will need to be refinanced as a priority given the substantial repayment of principal now falling due. Bank debt which has been provided on a co-financing basis with the World Bank under a parallel financing arrangement (i.e. under a separate loan agreement) need not be rescheduled if the amounts involved are not too substantial. If the amounts are high, however, then a rescheduling operation will need to be attempted. If the monies have been lent jointly with the World Bank (i.e. under the same loan agreement) a rescheduling may prove very difficult and unless absolutely essential should not be attempted. The margins on co-financed borrowings have historically been lower than countries could have commanded on their own, reflecting the support of the World Bank behind such borrowings. It is likely, therefore, that the agreed margin under any rescheduling agreement will be substantially higher than those obtained under co-financed loans.

17. It must be borne in mind that many of those commercial banks whose long and medium term debt may need to be rescheduled are in addition providing short-term bank lines to and issuing letters of credit on behalf of the Republic. It is essential therefore that due regard is paid to the other obligations of the banks if a rescheduling operation proves necessary. It would probably prove to be counter-productive to try and substantially alter the terms and conditions of the agreements covering letters of credit when these agreements are reviewed at the end of this year.

(d) Short-term debt

18. Short-term foreign debt bank lines to Banco de Reservas, Banco Central and Consejo Estatal del Azucar amounted to RD\$233m as at the end of 1981 split up as follows:

Dominican Republic: public sector's short term foreign debt bank lines				
RD\$m: end-1981	Long term	Medium term	Short term	Total
Correspondent banks abroad			48	
Libra Bank			76	
Other foreign banks			109	
			<u>233</u>	

By definition such lines need constantly to be renewed and must therefore be borne in mind during any rescheduling exercise. The foreign banks making such lines available must be satisfied that any general rescheduling operation undertaken by the Republic will not prejudice their position. It would be very harmful to the Republic if the banks involved were to try and cancel the lines made available or refuse to renew them. It must also be remembered that any of the banks involved in granting short-term finance are also members of banking syndicates granting long and medium term finance to the Republic.

Private sector borrowings

19. Of the total foreign debt some RD\$437m is owed by the private sector split up as follows:

Dominican Republic: private sector's foreign debt

RD\$m end-1981	Long term	Medium term	Short term	Total
Various	394		43	437

No precise details are known by us of the make-up of this figure but it is likely to include a great many small individual debts. As such it would be difficult to reschedule so many differing facilities even if the Government were to assume responsibility for the obligations under those facilities. If the level of debt service under the loans of the private sector is burdensome then a general moratorium under which provision is made for the repaying of the debt over a defined period of months may be required. If foreign export credit agencies have guaranteed facilities made available to the private sector then some scope may exist for including such facilities in general discussions for the rescheduling of bilateral loans.

The rescheduling operation

20. The steps that the Banco Central will need to take if a rescheduling operation is found to be necessary are as follows:

- (a) using the foreign exchange budget as a basis, and to the extent not already prepared for the IMF, draw up a balance of payments forecast for 1983 and 1984, with tentative projections thereafter;
- (b) to the extent that such projections have not been made, draw up a maturity profile of total public sector debt together with projected debt service obligations over a six to ten year period;
- (c) approach the US Government and perhaps the Venezuelan Government to arrange informal bilateral discussions for the rescheduling of certain debt obligations;
- (d) send to each foreign commercial bank creditor an information package setting out the Republic's financial position (and this package will detail the points drawn up in (a) and (b) above) and proposing a course of action;

(e) ask those commercial banks with the greatest exposure to the Republic to form a steering committee so that negotiations may be entered into with that committee on the rescheduling proposals;

(f) agree with the IMF, on the basis of the negotiations that have already started, the steps that will be taken by the Government under a stabilisation programme.

21. It is possible that the IMF, the World Bank and the IDB will actively support any rescheduling exercise entered into by the Republic. Full use of their services should be taken as such organisations may put considerable pressure on foreign governments and on the major foreign commercial banks thereby helping to secure a successful outcome to any rescheduling negotiations.

22. Past experience has shown that once a country has restructured its debt official creditors will resume making monies available to that country. Commercial banks however do not easily make new loans available and much lobbying in the subsequent period is required. An improvement in the country's balance of payments position will help the process of persuading banks to make new monies available. It is also advisable that all arrears of principal or interest are paid or properly structured if a country wishes to restore its creditworthiness.

Summary

23. In summary, our recommendations for the course of action that should be undertaken by the Republic are as follows:

(a) the Banco Central should proceed with the negotiations with the IMF for balance of payments support and, with the Government, agree the terms under which such support will be given;

(b) to the extent that they are not already available the Banco Central should prepare balance of payments forecasts for 1983 and 1984 and indicate the assumptions upon which the forecasts have been prepared;

(c) to the extent that they are not already available the Banco Central should prepare:

(i) projections of foreign debt stock positions, for the next six to ten years, based upon existing obligations; and

(ii) projections of future debt service on existing debt;

(d) the Republic, through diplomatic and political channels, should seek to enter into rescheduling negotiations with the US Government and perhaps the Venezuelan Government. It is probably not worthwhile to enter into discussions with other governments or to approach the Paris Club;

(e) no approaches are possible to multilateral lenders;

(f) the Banco Central should send to commercial banks an information package containing details of the Republic's financial position and outlining possible rescheduling terms. Certain of the commercial banks should be invited to form a steering committee;

(g) all commercial banks should be asked to agree to a rescheduling exercise except, perhaps, those who have lent on a co-finance basis with the World Bank;

(h) the IMF, IDB and the World Bank should be asked to support any rescheduling operation undertaken by the Republic.

Ways in which Samuel Montagu may help the Banco Central

24. SM can help in two broad areas. The first area is in the drawing up of relevant projections and papers. Help, to the extent required by the Banco Central, may be given on the following points:

(a) the drawing up of a position paper for discussion with the IMF;

(b) the drawing up of balance of payments forecasts for 1983 and 1984;

(c) the projections of debt stock figures and debt service figures for each year between 1988 and 1992;

(d) the collation of information for a package to be sent to foreign commercial bank creditors; and

(e) after studying in detail the projections made, to advise Banco Central on what rescheduling terms should be sought from bilateral and commercial bank creditors.

25. The second area in which SM would be able to help is in negotiations with foreign commercial banks. We would be pleased to assist the Banco Central in putting the Republic's case forward to the commercial banks and to negotiate the best possible terms with the banks, bearing in mind the current state of the eurocurrency markets. If it was felt useful for SM to be present during any bilateral discussions then we would be pleased to assist in any such talks. We would also be pleased to put forward the Republic's financial position to those banks currently providing short-term bank lines and letters of credit to the Republic's autonomous agencies.

MANAGEMENT OF THE FOREIGN RESERVES

Introduction

1. We have reviewed the report on the subject of the management of the Banco Central's foreign reserves dated March 1980. The report is both descriptive and normative. It describes the different types of financial instruments available in the international financial markets in which the Banco Central could invest its foreign reserves. The report is also normative in the sense that it makes a number of suggestions about the Banco Central's investment policy. In this paper we concentrate on those aspects of the report that relate to investment policy.

Liquid and non-liquid reserves

2. The foreign reserves can be divided into liquid and non-liquid reserves. Liquid reserves can be defined as foreign reserves that can be encashed in order to finance a deficit on the foreign exchange budget. Treasury bills, Federal funds, repurchase agreements, bank deposits and certificates of deposit (in the US domestic and eurocurrency markets), bankers' acceptances, commercial paper, US government securities, domestic US and eurodollar bonds all meet this criterion in principle. However, in practice, term bank deposits cannot necessarily be encashed until they mature, and securities (including CDs) cannot necessarily be encashed at their face value. They can only be encashed at the market price prevailing at the moment of sale.

3. The Banco Central also holds non-liquid reserves, which cannot be encashed, such as subscriptions of international institutions. Some of the other foreign reserves in the Banco Central's portfolio must be classified as non-liquid as well. Although they can be encashed, the policy of the Banco Central is either not to encash them (e.g. holdings of SDRs) or to hold them above a minimum level (e.g. foreign notes and coin). Investment policy relates by definition to the liquid rather than the non-liquid reserves.

Gold reserves

4. Holdings of gold in the foreign reserves of the Banco Central have traditionally been regarded as non-liquid in the sense that the Banco Central's policy has until recently been to leave the level of gold in the foreign reserves unchanged. However, the recent decision to sell a proportion of the Banco Central's gold reserves raises the question of whether an active investment policy in respect of the gold reserves is going to be followed in future. If an active investment policy was followed, the level of the gold reserves would change from time to time, depending on the Banco Central's requirements for foreign exchange and its views about the outlook for the gold price. Gold holdings in the reserves would be increased by taking a proportion of Rosario Dominicana's production into the reserves rather than allowing Rosario Dominicana to sell it on the market. Gold holdings would be reduced by making sales on the market from the

Banco Central's reserves as well as from Rosario Dominicana's production. So long as Rosario Dominicana was compensated at the market price for gold taken into the foreign reserves of the Banco Central, Rosario Dominicana's cash flow would not be affected by any change in the Banco Central's investment policy.

Currency distribution of the reserves

5. Apart from gold, the main policy considerations affecting the investment of the liquid reserves concern their currency distribution, maturity structure and asset composition. As far as we are aware all the liquid foreign currency reserves are currently denominated in US dollars. There is a strong case for continuing the policy in which the foreign reserves are all invested in US dollars, for three reasons. First, the exchange rate of the Dominican peso is tied to the US dollar. Secondly, the greater part of Dominican foreign trade is denominated in US dollars. Thirdly, a far larger proportion of the foreign debt of the Dominican Republic is denominated in US dollars than in any other currency. Although there may from time to time be investment grounds for switching a small proportion of the foreign reserves into other convertible currencies (e.g. Deutsche marks, Swiss francs and Japanese yen), it is important to take account of the exchange risk involved when investing in currencies other than the US dollar.

Maturity structure of the reserves

6. Under the agreement whereby the Federal Reserve Bank of New York manages the Banco Central's Treasury bill portfolio, the Federal Reserve invests Treasury bills up to a specified minimum amount in overnight repurchase agreements. While the level of liquid reserves remains low, it is important to maintain all the liquid reserves in very short dated financial instruments in order to maximise the Banco Central's ability to encash them without loss or delay should the need arise. However, if the liquid reserves increase above the level required for working balances, a proportion of the reserves can be invested in slightly longer dated negotiable financial instruments. This will have the effect of increasing the return achieved on the Banco Central's reserve portfolio in conditions in which US dollar interest rates are falling. It can be done either by directing the Federal Reserve Bank of New York, or by taking over the management of that part of the reserve portfolio currently managed by the Federal Reserve and making investment decisions within the Banco Central.

Asset composition of the reserves

7. The liquid reserves must be invested in prime quality financial instruments. At least a proportion of the reserves should always therefore be held in the form of US Treasury bills. But if the whole of the reserve portfolio is kept in the form of US Treasury bills, the return on the portfolio is likely to be lower than if a proportion of the reserves is

invested in similarly dated bank certificates of deposit or commercial paper. The use of bank deposits will also have the effect of widening the range of bank counterparties which might be prepared to provide credit lines to the Banco Central. However, in conditions in which arrears exist on the Dominican Republic's foreign payments, a policy of widening the range of the Banco Central's counterparties through the placement of bank deposits has to be followed with extreme caution, because of the possibility that banks will use the deposits placed with them as offsets against arrears. Business can be given to bank counterparties without the risk of offsets arising if the Banco Central directs banks to purchase Treasury bills on its behalf as well as making use of the Federal Reserve Bank of New York.

Investment return on the reserves

8. As the Banco Central's report makes clear, investment policy is a matter of obtaining the highest return on the reserves compatible with the security and liquidity of the financial instruments in which investment is made. Apart from investment considerations arising from changes in interest rates, there are three additional factors that need to be taken into account in optimising the return on the Banco Central's liquid reserves: the speed with which foreign currency receipts are channelled through the commercial banks to the Banco Central; the extent to which the Banco Central can earn interest on its working balances with foreign banks (e.g. by consolidating these balances into larger amounts); and the ability to switch a proportion of the reserves out of Treasury bills into higher yielding financial instruments of a similar maturity.

Investment guidelines

9. In the recent past, the potential for the active management of the Banco Central's foreign reserves has been relatively limited because the level of liquid reserves has been extremely low. This position is likely to change under an IMF agreement, which is likely to prescribe an increase in the gross level of liquid reserves to be held by the Banco Central over the period of the agreement. In these circumstances, we consider that it would be appropriate to construct a set of investment guidelines (to be approved by the Monetary Board) within which the reserve managers in the Banco Central can make day to day decisions about the investment of the Banco Central's foreign reserves, and we would be willing to draft a set of possible investment guidelines for consideration within the Banco Central, if appropriate.

Investment information

10. The ability of the reserve managers to obtain the best results is likely to be enhanced in the following circumstances: (a) up to date information is available about the currency distribution, maturity structure and asset composition of the Banco Central's foreign reserve portfolio on the Banco Central's computer; (b) regular information is received

from foreign banks and dealers (especially from New York) about investment opportunities available to the Banco Central within the investment guidelines; and (c) the reserve managers have a short period of training with financial institutions in international financial markets to increase their knowledge of the workings of the markets.

OPR/dss
22.10.82

ROSARIO DOMINICANA'S NEW REFINERY

INTRODUCTION

1. In the light of the imminent completion of the construction of Rosario Dominicana's new gold and silver refinery, we have been asked to comment on the various production and marketing policies, which it would be possible for the company to pursue from the point of view of their impact on the foreign exchange payments and receipts of the Dominican Republic. In this paper we give our preliminary conclusions based on:-

- (i) introductory talks with the company itself and the Central Bank of the Dominican Republic;
- (ii) study of the existing marketing contracts with J. Aron and the Credit Suisse Group;
- (iii) study of the contract with Davy McKee for the construction of the refinery;
- (iv) examination of a feasibility study prepared by Pincock Allen & Holt in 1980 and a comparative analysis made in the same year by Rosario Dominicana of various proposals put forward for the construction of the gold and silver refinery.

In view of the limited nature of our enquiries to date we have not been able to come to any final conclusions and in particular at this stage we are not able to quantify the various foreign exchange effects to which we refer. The paper therefore gives only an indication of the factors to be considered and of the order of magnitude of their impact on the country's foreign exchange position. It can of course be followed by a more definitive study, if the Central Bank wish.

2. The paper is divided into the following sections:-

- (i) possible production policies to be followed by Rosario Dominicana in relation to the new refinery;
- (ii) possible marketing policies (which are obviously inextricably connected with production policies);
- (iii) summary of conclusions;
- (iv) the next step.

It should be emphasised that the paper is exclusively concerned with foreign exchange effects and not with any other policy considerations (e.g. profitability, employment, etc.).

PRODUCTION POLICY

3. It would be possible for Rosario Dominicana to pursue one of the following production policies:-

- (i) to maximise the production of good delivery bars of gold and silver through the new refinery;
- (ii) to close the new refinery and continue to produce Dore bars on the present basis;
- (iii) to produce good delivery bars on a limited basis and to continue to produce a reduced quantity of Dore bars for direct sale to the market.

These policies are considered in turn below.

4. The policy of maximum production of good delivery bars would clearly be attractive from the balance of payments point of view if the construction of the refinery enabled Rosario Dominicana significantly to increase its production of gold and thereby increase foreign exchange receipts. However we understand that the production possibilities of the new refinery are strictly limited by the existing capacity to produce Dore bars, and that Dore production is already at a maximum. No greater rate of production of gold and silver can therefore be achieved following completion of the new refinery. Moreover, given the limited life of existing reserves and the absence of commercially exploitable new reserves, it may not in any case be considered prudent to increase the current rate of production.

5. Under the policy of maximum production of good delivery bars the following additional foreign exchange costs could be involved as compared to the present situation:-

- (a) there would be a significantly greater risk of loss of gold and silver through theft given the transport difficulties involved and the ease of disposal of good delivery bars;
- (b) expenditure on security measures at the new refinery as well as on the necessary insurance policies would be a major factor in any costs and a high percentage of such expenditure would probably be in foreign currency;
- (c) an additional technical services arrangement for the operation of the refinery may be needed with Rosario Resources Inc. and this would presumably also represent an additional foreign exchange cost;
- (d) spare parts for the new refinery would also be required from time to time.

6. On the other hand there would be certain gains in terms of foreign exchange from operating the new refinery at the highest possible capacity.

- (i) there would probably be a slight reduction in the time needed for payment to be made for Rosario Dominicana's production of gold and silver. On the basis of a maximum seven-day refining period for gold, a similar period of five days for silver and two days for delivery to the market and payment, it should be possible slightly to reduce the overall time needed to obtain payment as compared with the present situation. This would be particularly true where, under present arrangements, difficulties over assaying arise, thereby causing delays in receiving full payment;
- (ii) there would be a small gain in foreign exchange receipts from the increased purity of the product. We understand that at the moment only 99.7% of the gold content and 99.5% of the silver content of Dore bars are used in calculating the respective values for payment purposes;
- (iii) there would be small savings on treatment, refining and other charges which are currently levied by J. Aron and the Credit Suisse Group. With the new refinery in operation such charges would be local currency rather than foreign currency costs.

7. Of the various gains and losses in foreign exchange considered under the strategy of maximum production of good delivery bars, the most important in amount are the possible loss through theft and the extra security and insurance costs. Loss through theft is of course a risk only and would not normally represent a cost. The other items mentioned above are probably of limited significance in comparison to income received for the production.

8. If the alternative policy of closing the refinery were pursued, the major foreign exchange cost would be in compensating the contractor for any goods and services which have been ordered but not paid for so far, from which an amount representing the re-sale value of those goods and services could normally be deducted. We imagine that the overall cost involved here would be relatively small given the fact that the refinery is very close to completion and that payments under the contract are due to be completed at a date in advance of commissioning. It is of course possible that the plant involved in the new refinery could be re-sold, with possible gains in foreign currency to the balance of payments, but we are not in a position to evaluate this possibility. The other gains in foreign exchange from closing the refinery would take the form of the savings on the various items of expenditure mentioned above in paragraph 5. (e.g. security precautions and insurance).

9. If a policy of limited production of both Dore and good delivery bars were pursued, much of the additional foreign exchange expenditure associated with the new refinery would still be necessary and there would remain a risk of loss of bullion through theft. Moreover the gains associated with producing good delivery bars would be diluted in proportion to the reduced level of production below capacity. However the major advantage of a policy of producing both Dore and good delivery bars on a limited basis would be that it would enable the foreign exchange impact of producing and selling in each form to be assessed in detail over a period of time. This would give greater flexibility in determining the appropriate longer term production policy.

MARKETING POLICY

10. We think that different marketing arrangements might be appropriate for Dore bars and good delivery bars. To the extent that Dore bars continue to be sold we feel that the existing kind of marketing agreement (either with the existing counterparties or others) is entirely appropriate. We have briefly examined the present agreements and we doubt that they could be significantly improved from the point of view of flows of foreign exchange to Rosario Dominicana. We have not been able in the time available to check J. Aron's silver prices and bearing in mind that certain charges will be included in these prices, a detailed examination would have to be conducted to determine whether or not the arrangement for silver sales with J. Aron could be improved. Again we have not been able to make direct checks with possible alternative refiners, but our general impression is that significant foreign exchange gains are unlikely to be available by changing refiners. All this suggests a certain caution in changing the existing policy of producing and selling Dore bars.

11. However there may well be good reasons unconnected with foreign exchange payments and receipts for utilising the new refinery either fully or partially. To the extent that good delivery bars are sold on the market the initial marketing policy of the company should probably be to continue to use an agent such as J. Aron or the Credit Suisse Group to sell the bars until they obtain good delivery status in London and other international markets. The time needed to obtain such status is not clear, even though Rosario Dominicana would probably be able to fulfil all the main requirements. However the process is likely to take at least several months and might take longer. When good delivery status is achieved there would seem to be no reason for the company to continue to use a marketing agent provided that it has a trained officer with a knowledge of international markets who can maintain the connections necessary to sell good delivery bars directly on the world markets. This would give maximum flexibility in seeking the best price from a variety of counterparties on different markets at any one time.

12. If a trained marketing officer were not available to the company initially, or it was considered inappropriate to delegate maximum flexibility in selling, then an alternative policy would be to sell all bars immediately after production at the daily London fixings. The rules of operation of the London markets are very clearly established, which means that there would be no danger of the company not getting a fair price for its bars and that it would be readily able to check the prices obtained. In addition, as far as the London gold fixing is concerned, there is a small return commission payable to the seller of good delivery bars.

13. We understand that it is Rosario Dominicana's policy not to withhold production from the market even for minimal periods and we understand the reasons for this at a time of pressure on the country's foreign exchange position. However the company may like to bear in mind that through the use of swaps and other bullion market techniques it would be possible for it to manage its foreign exchange income flows in a more flexible way. We would be prepared to make detailed suggestions if this is appropriate.

SUMMARY OF CONCLUSIONS

14. Our main conclusions from the above preliminary analysis are:-

- (i) operating the new refinery is likely to give rise to increased risk of foreign exchange losses through theft and to other additional costs (see paragraph 5.), although there will probably be benefits from the timing of foreign exchange receipts and savings on charges currently levied by J. Aron and the Credit Suisse Group (see paragraph 6.);
- (ii) moreover there would be foreign exchange savings in closing the refinery (e.g. insurance), although the effect of terminating the contractor's contract at this stage is unclear (see paragraph 8);
- (iii) however the refinery is near completion and if there are considerations other than the foreign exchange situation which lead the company to go ahead with the refinery then the selling policy offering the most flexibility would be to produce partly good delivery bars and partly Dore bars as at present. Good delivery bars could probably best be sold on a regular and continuous basis on the London fixings.

THE NEXT STEP

15. In order to provide a final conclusion with quantification of certain of the effects referred to above we would need to do the following:-

- (i) have further discussions both with the Central Bank and Rosario Dominicana on the basis of our preliminary report;
- (ii) do further research work both in London and the Dominican Republic on quantifying the most important factors involved, for example insurances, the exact timing of payments and the possibilities for re-selling the plant involved in the new refinery.

If this programme is approved by the Central Bank, we believe that a final report could be delivered at the end of our next regular visit to the Dominican Republic, which is scheduled to take place in the latter half of October.

A. B. Shipp
3rd September 1982

Outline Report

ROSARIO DOMINICANA'S NEW REFINERY

Introduction

1. This paper is based upon our previous report to the Banco Central and follows further discussions and studies that we have undertaken both within and outside the Dominican Republic. In particular we have made a careful analysis of the projected running costs of the new refinery and discussed these costs and other matters with officials of Rosario Dominicana. We have also spoken to the consulting engineers and to the contractor.

2. The paper is divided into ten sections as follows:

- (i) an analysis of the costs and profitability of the new refinery's running costs based mainly upon our studies of projected cashflows, etc. and upon discussions with officials of Rosario Dominicana;
- (ii) an analysis of the present marketing contracts with J. Aron and the Credit Suisse Group;
- (iii) a comparison between the costs of the existing arrangements and the expected costs of operating the new refinery;
- (iv) the additional costs and the savings which would be associated with a decision not to operate the new refinery;
- (v) the effect on the foreign exchange budget of the various options open to Rosario Dominicana in relation to the new refinery;
- (vi) the procedures for inclusion in the good delivery list of the London Gold Market;
- (vii) the different production policies that Rosario Dominicana could pursue with or without the refinery;
- (viii) the various ways in which Rosario Dominicana may market refined gold and silver, if a decision is taken to operate the new refinery;
- (ix) a summary of the main points arising from the matters discussed in the paper; and

7. The existing agreement with J. Aron & Company provides a similar pricing arrangement for gold and silver as is applied under the Credit Suisse contract except that the average market price upon which payment is made is based on four consecutive days (as opposed to five consecutive days), after the day of arrival of the shipment at a US airport. However treatment, refining and assaying costs are not applied in the same way. Under the J. Aron contract these costs, computed for an average bar as set out in paragraph 5 above, are as follows:

	<u>US\$</u>
Treatment charge: 1,000 ozs. x \$0.1	100.00
Refining charge: no charge is made	nil
Assay charge: can be borne by either party but the cost is not defined	-
	<u>US\$ 100.00/bar</u>

[It would seem therefore with the information to hand, that the refining and other costs levied by J. Aron are substantially less per bar than those levied by the Credit Suisse Group. This aspect will require clarification.]

8. Under both contracts payment for the gold is not made immediately upon the receipt of the shipment. Under the Credit Suisse agreement 75% of the value of the gold is made on the eighth day after the shipment's arrival and the additional 5% is paid as soon as the precise weights have been determined. Under the J. Aron agreement 100% of the payment is made on the tenth day following the signature of the weighing and sampling report unless there is a disagreement about the precise quantity of metal in the shipment when 95% of the payment is made on the tenth day and the remaining 5% is paid within two days of an agreement of the assays. [The effect of these delays in payments can only be quantified when we know the timing of the refining process.]

A comparison between the costs associated with existing contracts and those projected for the refinery

[9. This section will be based upon the analysis of costs discussed in sections 3 and 4 and the costs analysed in sections 5 to 8.]

[10. This paragraph will draw conclusions from the results of the analyses in paragraph 9.]

The cost effects of not using the new refinery

[11. This paragraph will discuss the penalties, if any, associated with the termination of the construction contract and not operating the refinery. A study of the construction contract will be needed together with discussions with officials of Rosario Dominicana.]

[12. This paragraph will discuss the revenue possibilities of selling the plant and equipment associated with the new refinery.]

[13. This paragraph will set out the cost disadvantages (if so proved) of paying overseas refiners.]

[14. This paragraph will summarise the projections in this section.]

The effect of operating the refinery upon the foreign exchange budget

15. Under a policy of the refinery producing good delivery bars the following additional foreign exchange costs could be incurred as compared to the present position:

- (a) there would be a significantly greater risk of loss of gold and silver through theft given the transport difficulties involved and the ease of disposal of good delivery bars;
- (b) expenditure on security measures at the new refinery as well as on the necessary insurance policies would be a major factor in any costs and a high percentage of such expenditure would probably be in foreign currency;
- (c) an additional technical services arrangement for the operation of the refinery may be needed with Rosario Resources Inc. and this would presumably also represent an additional foreign exchange cost;
- (d) spare parts for the new refinery would also be required from time to time.

16. On the other hand there would be certain gains in terms of foreign exchange from operating the new refinery at the highest possible capacity.

- (i) there would probably be a slight reduction in the time needed for payment to be made for Rosario Dominicana's production of gold and silver.
- (ii) there would be a small gain in foreign exchange receipts from the increased purity of the product. At the moment only 99.7% of the gold content and 99.5% of the silver content of Dore bars are used in calculating the respective values for payment purposes;
- (iii) there may be small savings on treatment, refining and other charges which are currently levied by J. Aron and the Credit Suisse Group. With the new refinery in operation such charges would be local currency rather than foreign currency costs.

17. Of the various gains and losses in foreign exchange considered the most important in amount are the possible loss through theft and the extra security and insurance costs. Loss through theft is of course a risk only and would not normally represent a cost. The other items mentioned above are probably of limited significance in comparison to income received for the production.

18. If the alternative policy of closing the refinery were pursued, the major foreign exchange cost would be in compensating the contractor for any goods and services which have been ordered but not paid for so far, from which an amount representing the resale value of those goods and services could normally be deducted. We imagine that the overall cost involved here would be relatively small given the fact that the refinery is very close to completion and that payments under the contract are due to be completed at a date in advance of commissioning. It is of course possible that the plant involved in the new refinery could be re-sold and this aspect will be investigated with possible receipts in foreign currency. The other gains in foreign exchange from closing the refinery would take the form of the savings on the various items of expenditure mentioned above in paragraph 15 (e.g. security precautions and insurance).

Procedure for inclusion in the good delivery list of the London Gold Market

19. The rules of the London Gold Market state that any company wishing to be included in its good delivery list must fulfil the following criteria:

(a) The company has been in existence for not less than five years and shall have been involved in gold refining operations for not less than three years prior to the application.

(b) The company has an established annual production of gold of not less than 10 metric tons in the form of 400 ounce troy bars.

(c) The company has a financial net worth of not less than the equivalent of five million pounds sterling, or such figure as the Market may from time to time determine.

20. A company meeting the above standards must first obtain recognition of its bars from the Central Bank of the country in which its activities are based, and must then apply to a Member of the Market to act as a sponsor. The request for sponsorship must be accompanied by the following documents:

(i) The Central Bank's letter of recognition.

(ii) A copy of the company's most recent audited financial statements.

(iii) A letter that gives:
The full name and address of the refinery.
A brief history of the business and operations of the company.
Details of the annual gold production of the refinery for the three years immediately preceding the date of the submission, and an estimate of the gold production of the refinery for the two years following the date of the submission.

(iv) Ten colour photographs (minimum size 7" x 5") showing the bars produced by the company.

(v) Ten copies of a technical line drawing showing clear details of the stamps and marks appearing on the bars.

21. If, having considered the information submitted, the Members of the Market agree that the request should be processed further, the company will be so advised by the sponsor, and will then be required to undertake the following procedure for the testing and examination of its melting and assaying capability. The test is stringent and falls into two parts.

22. In the first part the company will be required to submit to the sponsor ten bars of gold that conform in all respects to the specifications and standards laid down by the Market.

The following points should be noted:

(i) The gold content of the specimen bars submitted for testing should be not less than 395 fine ounces troy and not more than 405 fine ounces troy.

(ii) Faults that should be avoided are irregularities of the top surface of the bar, surface cavities, layering and excessive shrinkage. The sides and bottom surface should be reasonably smooth and free from cavities and bubbles, and the edges should be rounded and not sharp. The bars must be easy to handle and convenient to stack.

(iii) In addition to the stamps of the Melter and Assayer, the year of manufacture must be shown as a separate mark.

(iv) It is not the practice of the Market to stamp weights on good delivery bars, but a list of weights and assays should be provided, with the bars denominated in ounces troy, and weighed in accordance with the specifications laid down by the Market. Metric weight lists are not acceptable.

23. Examination of the bars will be made by two independent referees appointed by the Market, who, after a joint inspection arranged by the sponsor, will share the sample bars received. Each referee will melt and assay five bars, using sampling and assaying procedures that have been agreed with the Market.

24. In the second part two referees will be appointed by the Market and they will each prepare twelve samples with agreed assays. The twenty-four test samples, each identified by a reference number, will then be sent to the company, which will be required to make payment to the sponsor covering the gold content of the samples before they are despatched. The company will assay the samples and report its findings to the sponsor, listing the reference numbers and giving the individual assays to five places of decimals. In addition, against each five-figure result, the company shall indicate its four-figure interpretation of that result.

25. For a company to be included in the list as an Acceptable Melter and Assayer, it must satisfy the Members of the Market that it has met the criteria and requirements of both tests.

Production policy

[26. This section will follow the guidelines set out in our preliminary report. However, precise details and the conclusion to be drawn from them can only be drawn up and determined following further discussions with officials of Rosario Dominicana.]

Marketing Policy

27. If it is decided not to proceed with refining of gold within the Dominican Republic and Dore bars continue to be sold then we feel that the existing kind of marketing agreement (either with the existing counterparties or others) is entirely appropriate. We have examined the present agreements and we doubt that they could be significantly improved from the point of view of flows of foreign exchange to Rosario Dominicana. We have made preliminary checks with possible alternative refiners and our general impression is that significant foreign exchange gains are unlikely to be available by changing refiners. All this suggests a certain caution in changing the existing policy of producing and selling Dore bars.

28. If it is decided to refine gold within the Dominican Republic then the initial marketing policy of the company should probably be to continue to use an agent such as J. Aron or the Credit Suisse Group to sell the bars until they obtain good delivery status in London and other international markets. The time needed to obtain such status is not clear. However the process is likely to take at least several months and might take longer. When good delivery status is achieved there would seem to be no reason for the company to continue to use a marketing agent provided that it has a trained officer with a knowledge of international markets who can maintain the connections necessary to sell good delivery bars directly on the world markets. This would give maximum flexibility in seeking the best price from a variety of counterparties on different markets at any one time.

29. If a trained marketing officer were not available to the company initially, or it was considered inappropriate to delegate maximum flexibility in selling, then an alternative policy would be to sell all bars immediately after production at the daily London fixings. The rules of operation of the London markets are very clearly established, which means that there would be no danger of the company not getting a fair price for its bars and that it would be readily able to check the prices obtained. In addition, as far as the London gold fixing is concerned, there is a small return commission payable to the seller of good delivery bars.

30. We understand that it is Rosario Dominicana's policy not to withhold production from the market even for minimal periods and we understand the reasons for this at a time of pressure on the country's foreign exchange position. However the company may like to bear in mind that through the use of swaps and other bullion market techniques it would be possible for it to manage its foreign exchange income flows in a more flexible way.

Summary

[31. This section will contain the major points which arise within the paper upon which the Banco Central will need to base its decisions.]

Recommendations

[32. This section will outline the recommendations of Samuel Montagu and will be based upon the subjects raised in the paper and the conclusions which may be drawn from those subjects.]

22nd October 1982

BANCO CENTRAL DE LA REPUBLICA DOMINICANA
PROPOSAL ON INTEREST RATES

Introduction

1. The purpose of this note is to comment briefly on the proposal prepared by the Finance Department of the Banco Central on interest rates in the Dominican financial system.

Disintermediation

2: The proposal is designed to combat the disintermediation that has taken place in the Dominican financial system in the last few years. The disintermediation is of two main kinds:

(a) There has been a flow of funds out of the banks and into other financial institutions in the Dominican Republic, such as the savings and loan associations, financial development institutions and mortgage banks.

(b) There has been a flow of funds out of the Dominican financial system as a whole and into banks abroad, mainly in New York, Miami and Puerto Rico.

Dominican interest rates

3. The main step that is necessary to stop the flow of funds out of the banks and into other financial institutions in the Dominican Republic is a change in the interest rate structure which will allow the banks to pay more for deposits and earn more on loans than they do at present in relative terms, so that their interest rate structure is more competitive than it is at present.

4. There are three main factors which determine whether bank interest rates are competitive in terms of the interest rates in the rest of the financial system:

(a) the gross level of interest rates (allowing possibly for a small risk premium to differentiate between primary banks and secondary financial institutions);

(b) an adjustment for any tax disadvantage that banks have relative to other financial institutions, such as mortgage banks; and

(c) an adjustment for the relative cost of reserve requirements.

5. The proposal correctly takes all these factors into account. But in proposing the issue of 'financial certificates', it also introduces another factor: maturity transformation. Depositors are to be paid a higher rate of interest, the longer they hold their deposit. Effectively, there is a penalty for cashing financial certificates in early.

6. The idea of financial certificates carrying penalties for early encashment is similar to 'savings bond' schemes that have been introduced for small savers in some of the industrial countries. However, the most effective system for attracting longer term savings from large institutions in the industrial countries is a system that depends on making use of a 'yield curve' and a 'secondary market'.

7. The yield curve describes the interest rates payable on different maturities of financial instrument at any particular time. Relative interest rates between short and longer maturities change depending on supply and demand. But normally a 'positive' yield curve, as a result of which higher interest rates are paid on long maturities than on short maturities, helps to attract longer term savings.

8. The secondary market provides a means whereby holders of longer term financial instruments can exchange them for cash at a price determined by the structure of the yield curve. If the secondary market is made by banks or dealers, the encashment of a financial instrument by one investor will be compensated by a new commitment on the part of another investor. The original issuer of the financial instrument will not have to repay cash until maturity.

9. The development of a proper secondary market depends the development of a market system influenced by supply and demand. At present, the system in the Dominican Republic is one in which the interest rate structure is determined by the financial authorities from time to time.

Foreign currency interest rates

10. The flow of funds out of the Dominican financial system into banks abroad cannot solely be reversed by changing interest rates in the Dominican Republic. There are three main factors involved:

(a) the attraction of US dollars compared with Dominican pesos: this problem can be overcome by offering US dollar denominated savings accounts for certain categories of savers (which is being done);

(b) the competitiveness of US dollar denominated rates in the Dominican financial system compared with the US: Dominican rates will in normal circumstances need to be higher than equivalent US rates to attract depositors;

(c) confidence: neither (a) nor (b) is a sufficient factor in conditions in which the holders of US dollar denominated deposits in US banks do not have sufficient confidence in repayment in foreign currency if they place their deposits in banks in the Dominican Republic.

OPR

6 September 1982