After a decade of rapid economic growth, the Dominican Republic entered a downward spiral in 2003. The economy shrank for the first time since 1990, the inflation rate quadrupled, the Dominican peso collapsed, government debt more than doubled, interest rates soared, and the central bank incurred large losses.

That cascade of bad economic news followed a botched bank bailout. What had started as a garden-variety lender-of-last-resort operation ended with the central bank taking over the second-largest private bank in the Dominican Republic. That move decapitalized the central bank in one stroke and directly cost the Dominicans about 15 percent of GDP.

The public has lost confidence in the government and the central bank. To turn the economy around, president-elect Leonel Fernández must embrace a bold set of confidence-enhancing reforms. The centerpiece of those reforms must be a new Dominican monetary regime that will produce stable money.

The country should choose one of three monetary reform options: a currency board, a dollarized system, and a free banking regime. Each is feasible and would restore confidence in the Dominican Republic. In addition to a monetary reform, the Dominican Republic must implement a bold tax reform that encourages legal work in the formal economy, savings, and investment. A flat-tax system set at 15 percent of income is recommended.
Introduction

During the decade 1992–2002, the Dominican Republic was an economic success story. The real gross domestic product grew 74 percent. As a result, the Dominican Republic closed its income gap with the United States, moving from a real GDP per person of approximately 12 percent of the U.S. level in 1992 to 18 percent in 2002. Inflation was in single digits, except in 1995, when it hit 14.3 percent, and in 2002, when it was 10.5 percent. Government debt was relatively low, reaching only 26 percent of GDP in 2002.

The success story came to an abrupt halt in 2003, when the economy shrank for the first time since 1990 (by 0.4 percent) and inflation jumped to 42.7 percent. The official central exchange rate of the Dominican peso depreciated from 17.76 per U.S. dollar at the end of 2002 to 35 per dollar at the end of 2003. It is currently close to 45 per dollar. Government debt more than doubled (to 57 percent of GDP), and the government teetered on the edge of default. The government’s Price Controls Department also swung into action. Chicken, eggs, cement, and bottled water were added to the list of items covered by price ceilings, and the price control police promised to add 25 more items to the list. Not surprisingly, record numbers of destitute Dominicans took to the sea in rickety vessels destined for Puerto Rico and brighter employment prospects.

The Dominican Republic entered this downward spiral following a botched bank bailout. The collateral damage from the bailout has now spread throughout the economy. Lacking a strategy to restore confidence and growth, the Dominican Republic will record a second straight year of recession and double-digit inflation.

On May 16, 2004, Leonel Fernández was elected president. That was the easy part. Now Fernández must develop a strategy to turn the economy around. That will require a bold set of confidence-enhancing reforms.

The Botched Bailout

A bungled bank bailout caused the Dominican Republic’s current problems. In September 2002 the country’s third-largest bank (and second-largest private bank), Banco Intercontinental, began to experience increased withdrawals of deposits. To tide over Baninter, as the bank is nicknamed, the central bank freely provided loans. Indeed, it was a classic case in which the lender-of-last-resort skids had been greased for abuse. Baninter’s president Ramon Báez Figueroa had seen to that by distributing lavish gifts to government officials. Thanks to a media empire controlled by Baninter, the public supported (at least initially) the central bank loans.

In March 2003 another local bank, Banco del Progreso, expressed interest in acquiring Baninter. However, when it examined Baninter’s books, it found evidence of extensive undisclosed problems and backed out of the acquisition. A further investigation discovered that Baninter’s top management had kept a double set of books for 14 years. Those accounting shenanigans had fooled everyone, including the government bank auditors.

The scale of the fraud ended any possibility of a normal takeover. As a result, the central bank took over Baninter in April 2003 and in one stoke decapitalized itself. Baninter was declared bankrupt in May and dissolved in July. Baninter’s liabilities exceeded its assets by 55 billion pesos, or $2.2 billion, at the exchange rate of the time. That amounted to a whopping 15 percent of the Dominican Republic’s GDP and more than two-thirds of the annual government budget.

A law adopted in 2002 provided for a deposit insurance fund to guarantee deposits up to 500,000 pesos per depositor (at the market exchange rate of the time, about $24,000). But at the time Baninter failed, the fund was not yet operational. The government nevertheless decided to bail out all Baninter’s depositors for the full value of their deposits, including amounts in excess...
of 500,000 pesos. The main beneficiaries of that socialization of Baninter’s deposit losses were 80 large depositors whose deposits accounted for three-quarters of the total. Their benefactors—the Dominican taxpaying public—have involuntarily been left holding the bag, and a large bag it is. Indeed, taxpayers have been saddled with a large increase in the public debt, one that carries very high interest rates. Not surprisingly, the public has lost confidence in the government and the central bank.6

This episode is yet another case in which a garden-variety lender-of-last-resort operation ended in a looting fiasco.7 In the 1980s there were 45 major banking crises around the world, and, like the Dominican crisis, they resulted in most, if not all, of the banking systems’ capital being wiped out. In the 1990s the number of banking crises jumped to 63. The average direct costs of those bailouts amounted to a staggering 15 to 20 percent of GDP.8

The Vicious Circle

To finance the direct costs of the Baninter bailout, the government resorted to the classic measures: printing money, issuing more debt, and raising tax rates. The resulting indirect costs are classic, too: a toxic combination of surging inflation, a depreciating currency, higher interest rates, a collapse in public confidence, and a shrinking economy.

The monetary base rose from 39 billion pesos in April 2003 to 78 billion pesos in December. The government understood, though, that resolving the bailout by printing money alone might lead to a complete meltdown of the currency. In consequence, the central bank also issued about 55 billion pesos of new securities in 2003. To make the securities attractive to the public, more cheese had to be placed in the trap. The central bank has done that by paying very high interest rates. For example, at the auction of May 19, 2004, the weighted average yield on 14-day central bank certificates of deposit was 60.25 percent; for the less popular 35-day CDs the yield was 58.78 percent, and for the still less popular 56-day CDs it was 56.12 percent.9 The total of financing from printing money and issuing debt exceeded the original bailout amount of 55 billion pesos for Baninter, because of the peso’s depreciation and because the central bank lent to the smaller troubled banks, too. The government also increased taxes, notably a 5 percent tax on exports, and introduced more price controls.

To ease the pain, the Dominican Republic struck a deal in January 2004 with the International Monetary Fund. The IMF forecasts inflation of 14 percent, economic growth of –1 percent, and government debt of 54 percent of GDP for 2004. Private observers are less optimistic. For example, the Swiss bank UBS forecasts inflation of 25 percent, growth of –4 percent, and government debt of 61 percent of GDP.10 However, the government is paying very high rates of interest and runs the risk of falling into a “debtor trap.” Although most observers still think the country will avoid such a trap, the economy is on a knife’s edge. With no turnaround strategy on the table, prognostications concerning the avoidance of a debt trap could quickly become little more than wishful thinking.

A History of Problems with Local Monetary Policy

The Dominican Republic has never suffered a typical Latin American–type hyperinflation, but the long-term record of Dominican currency has been spotty at best. The Dominican government began issuing paper money in 1844. When first issued, the Dominican paper peso was nominally equal to the silver dollar (peso fuerte) issued by Spain, Mexico, and the United States. However, the government resorted so often to the printing press that the rate eventually depreciated to 50 paper pesos per silver dollar. In 1869 the government authorized a national bank to issue
paper money. That led to a substantial currency depreciation, with the exchange rate falling from 1 new paper peso (short term) per silver dollar to 17 paper pesos. Dissatisfaction with the inflation created under those arrangements led the Dominican Republic to cease issuing domestic paper money in 1903. Instead, the Dominican Republic used the U.S. dollar—in other words, it was dollarized.

The Dominican Republic’s dollarized monetary regime lasted until 1947, when the dictatorship of Rafael Trujillo established a central bank, the Banco Central de la República Dominicana. The central bank was established according to the intellectual fashion of the time: the belief that every independent country should have its own central bank and currency. The mantra of monetary nationalism was embraced and promoted by the United States under the influence of Henry Morgenthau and Harry Dexter White.\(^\text{11}\) Not surprisingly, experts from the Federal Reserve System wrote reports supporting a Dominican central bank and “dollarization.”\(^\text{12}\)

Since its inception, the central bank has been subject to political pressures. From 1947 until 1985, the initial exchange rate of one Dominican peso per U.S. dollar held. For much of that period, exchange controls were used to prop up the exchange rate. Since 1985 the exchange rate has depreciated persistently. At present, there is little confidence in the Dominican peso, and under the existing central banking arrangements, prospects for peso stabilization are not good.

To restore confidence and reverse its downward spiral, the Dominican Republic must implement a bold set of reforms. To ensure success, a new Dominican monetary regime must be the centerpiece.

**Options for Monetary Reform**

Before considering proposals for overhauling the Dominican Republic’s monetary regime, a few words about the current state of affairs at the central bank are in order. When the central bank took over Baninter in April 2003, it acquired substandard assets that were worth much less than Baninter’s liabilities. That and a host of other quasi-fiscal operations—activities that were not directly related to the objective of maintaining monetary stability—have impaired the central bank’s balance sheet.\(^\text{13}\) The central bank’s income statement has not gone unscathed, either. Operating losses in the first quarter of 2004 were 4.5 billion pesos, or US$100 million. Those losses pushed the central bank’s negative net worth to 69.3 billion pesos, or US$1.54 billion, in March 2004.\(^\text{14}\)

The quasi-fiscal operations in the Dominican Republic have resulted in the fiscalization of the central bank. To ensure future stability, the monetary and fiscal regimes must be separated. Moreover, a monetary regime that imposes a hard budget constraint on the fiscal authorities is necessary.

The central bank’s foreign reserve position also merits comment. At the end of February, the central bank had US$354 million of gross foreign reserves. After subtracting short-term foreign liabilities, the net foreign reserves were US$129 million. Against a monetary base of almost 82 billion pesos, the gross and net foreign reserve coverages amount to only 20 percent and 7 percent, respectively (calculated at 45 pesos per dollar).\(^\text{15}\) The central bank has a large portfolio of domestic assets that it might sell to raise foreign exchange, but without more detailed information, it is not possible to assess what those assets are worth and how much foreign exchange they might fetch. Accordingly, the monetary reform options presented assume that few U.S. dollars will be quickly forthcoming from sales of the domestic bond portfolio. Even so, bold, dollar-based monetary reforms are feasible.

**A Currency Board**

One dollar-based system would require the conversion of the central bank into a currency board. Such a conversion would ensure that president-elect Fernández could deliver...
on his pledge to retain and strengthen the Dominican peso.\textsuperscript{16}

An orthodox currency board is a monetary authority that issues domestic notes and coins (and deposits, in some historical cases), convertible without restriction into an anchor currency at a fixed exchange rate. To ensure convertibility, an orthodox currency board holds net foreign reserves, in foreign assets only, equal to 100 percent, or slightly more, of its monetary liabilities—notes and coins in circulation (plus deposits, if any). The balance sheet of a currency board contains only foreign reserve assets (there are no domestic assets, or if they exist, they are frozen) and monetary liabilities. In combination, those characteristics ensure that an orthodox currency board has no room for discretionary monetary policy. A currency board regime in the Dominican Republic would, therefore, issue domestic pesos (monetary liabilities) that were, in effect, clones of U.S. dollars (foreign reserve assets). And the domestic peso supply would fluctuate in a one-to-one correspondence with changes in the currency board’s foreign reserves.

Currency boards have existed in a number of Caribbean countries, mainly British colonies or former colonies. The Cayman Islands have a currency board today. Currency boards have an excellent record of maintaining fixed exchange rates and allowing full freedom to exchange a domestic currency for a foreign anchor currency.

Currency boards have recently suffered unfavorable publicity because of the collapse of Argentina’s “convertibility” system. Most observers have incorrectly classified the convertibility system as a currency board.\textsuperscript{17} It was never a currency board. Rather, the Argentine regime was a central banking system. It contained certain features that made it appear to the untrained eye as a currency board. The convertibility system maintained a one-to-one exchange rate between the peso and the U.S. dollar and guaranteed peso convertibility, but unlike an orthodox currency board, the central bank held substantial amounts of domestic assets. Moreover, Argentina’s Convertibility Law of 1991 permitted the central bank to alter the level of its domestic assets, allowing for discretionary monetary policy. The central bank used its discretionary powers liberally, particularly after 1994.\textsuperscript{18} That would not have been possible under a currency board regime. Accordingly, the Argentine convertibility system’s reputation as a currency board is a classic case of mistaken identity.\textsuperscript{19}

A currency board in the Dominican Republic would be forced to start with less than 100 percent net foreign reserve coverage against its monetary base. It would not even have 100 percent gross reserve coverage, unless it were to obtain a foreign loan.\textsuperscript{20} That would not preclude the establishment of a Dominican currency board, however. A successful currency board could be established if increases in its monetary liabilities were required to be fully backed by foreign reserves. That rule would enhance confidence in the peso’s fixed exchange rate, and demand for the peso would grow. In consequence, there would be a steady increase in the foreign reserve-to-base money ratio and the currency board would progress toward a fully orthodox system. That was the experience of the East African Currency Board from 1920 to 1950.

The East African Currency Board, which operated mainly in Kenya, Tanzania, and Uganda, began operations with a foreign reserve coverage ratio of considerably less than 100 percent. The board built up reserves by requiring those who demanded domestic currency to deposit foreign exchange of equal value with the board (calculated at the fixed exchange rate maintained between the domestic currency and its pound sterling reserve currency). Except for a few years during the Great Depression, the demand for domestic currency was strong, and the board’s foreign reserve assets, which were invested in safe, interest-bearing securities, grew. The earnings from the board’s assets raised its foreign reserves from a low point of 10 percent during the Great Depression to more than 100 percent of its monetary liabilities in 1950.
Dollarization

Another dollar-based option would require the Dominican Republic to replace the peso with the U.S. dollar. The Dominican Republic has historical experience with dollarization (1903–47). Although the system functioned smoothly from an exchange-rate perspective, the Dominican Republic did suffer, along with the United States, as a result of the worst blunder in U.S. monetary history: the Federal Reserve’s great monetary contraction during the Great Depression.

On a brighter note, Ecuador’s recent experience with dollarization is relevant and noteworthy. In 1999 Ecuador experienced a crisis that bore all the hallmarks of the Dominican Republic’s. To reverse its severe downward spiral, Ecuador’s domestic currency, the sucre, was replaced with the U.S. dollar in 2000. That provided Ecuador with a positive confidence shock, stability, and generally good economic results despite continuing fragility in the political system.21 Indeed, even The Economist, which has cast a skeptical eye on dollarization, recently concluded: “After decades of economic instability—and in spite of fears over the sustainability of Ecuador’s hasty switch to the dollar four years ago—GDP grew by an estimated 2.7 percent last year. The public finances were in the black; inflation dropped to a record low of 6 percent; foreign investment reached a record high; the trade account was almost in balance.”22

Without a foreign loan, it would not be possible to replace all the Dominican pesos in circulation with dollars immediately. That would not preclude the eventual full dollarization of the Dominican Republic, however. The government could announce its intention to fully dollarize and begin the process by introducing a parallel currency system in which both the peso and the dollar circulated. Under that temporary setup, the peso monetary base would be frozen and the peso paper money would be removed from circulation one denomination at a time, starting with the highest denominated notes. Dollars would replace pesos in circulation as economic growth permitted the government to accumulate dollars through budget surpluses, sales of government assets, or sales of domestic assets in the portfolio of the central bank. Until all pesos were retired from circulation, the government would maintain whatever conversion rate it fixed for accepting tax payments in either pesos or dollars.23

Before the third monetary reform option is discussed, comments by the U.S. Under Secretary of the Treasury for International Affairs John Taylor merit attention. Testifying before the U.S. House of Representatives on October 1, 2003, Taylor said, “We also recognize that, especially in the case of small open economies, there are benefits from a ‘hard’ exchange rate peg, whether dollarizing, as with El Salvador, joining a currency union, as with Greece, or using a credible currency board, as in Bulgaria or Hong Kong.”24 Under Secretary Taylor’s testimony covered, therefore, the two above-mentioned options. Moreover, he subsequently told the Wall Street Journal that if the Dominican Republic wanted to dollarize, the U.S. Treasury would support it.25 Recently, Taylor went even further, when he endorsed the elimination of central banks in countries that had weak institutions and stated that the United States would provide technical assistance to the Dominican Republic if it decided to dollarize.26

Free Banking

Yet another monetary reform option would be free banking—allowing banks to issue their own notes (paper money) rather than rely on government-issued notes. Although free banking does not exist anywhere in the world today, it has a long history. For example, free banking existed throughout the Caribbean in British colonies until the 1950s, when it was replaced by central banking, because governments wanted to appropriate the revenue from issuing notes for themselves. Among the private banks that formerly issued notes was Canada’s Bank of Nova Scotia, which has branches in the Dominican Republic and operates as Scotiabank today. When free banking was not burdened by
restrictions, it had a good record of providing stable money.\textsuperscript{27} In principle, banks would be at liberty to issue notes denominated in any currency they pleased, but in practice, in the Dominican Republic they would be most likely to issue notes denominated in U.S. dollars, just as they already offer deposits denominated in dollars.\textsuperscript{28} The U.S. government is at the moment the only issuer of dollar notes and coins, but it has no exclusive right to do so, even in the United States. Until 1935 banks in the United States issued notes alongside the U.S. government, and in recent years it has become legal for them to do so again, although few bankers are aware of the possibility and no bank has yet taken advantage of it.\textsuperscript{29} It would be desirable to allow complete freedom in note issuance. Any entity could issue notes. Under free banking, the public would not be compelled to accept notes it did not want because, unlike government notes, privately issued notes would not be forced tender. Accordingly, competition among note issuers would ensure currency quality and stability. However, because the Baninter affair revealed weaknesses in the Dominican financial sector, it would be prudent to limit note issue initially to banks that meet high standards of liquidity and transparency.

To start free banking in the Dominican Republic, the government could announce that it was freezing the peso monetary base and that the soundest private banks could issue private notes. Under such a parallel currency regime, government notes would continue to circulate and to be accepted by the government in payment of taxes at a fixed exchange rate with the dollar, but bank-issued notes would eventually become dominant. Another possibility would require the government to make an agreement with banks to transfer certain assets to them along with the liabilities for currency now issued by the central bank. In a more remote scenario, the banks would simply accept government notes from the public, paying out their own notes in exchange, without any correspondingly transfer of assets from the government, to gain market share.

**Common Features**

All of the monetary reform options presented would allow the Dominican government to escape from the horns of its current dilemma: On the one hand, a stable peso can be realized only by imposing punishingly high interest rates, which act as a drag on economic growth and push the government into a debt trap. On the other hand, because the peso lacks credibility, low interest rates, such as those in the United States, would result in a collapsing peso and higher inflation rates. Both alternatives would result in undesirable outcomes. Those could be avoided by adopting any of the dollar-based reform options. Indeed, the dollar-based options would separate monetary and fiscal functions in the Dominican Republic and ensure both stable money and a hard budget constraint. In addition, the adoption of a dollar-based option would allow for the abolition of exchange controls and the bureaucracy that enforces them. With monetary policy no longer a tool of local politics, there would be no reason to maintain the regulations that now exist to prop up the peso. All of the options would also be compatible with allowing Dominicans to hold and conduct business in any foreign currency they choose, not just the dollar. Should the dollar, at some time in the future, start to become an unreliable currency, Dominicans would have the freedom to switch to other currencies that met their needs better. Using the dollar as a monetary anchor would not be an end in itself; it would be a step toward greater competition and freedom in monetary matters.

The monetary reform options presented would require changes to existing Dominican laws. If the central bank were converted into a currency board, it would be necessary to rewrite the central bank charter to remove any legal basis for discretionary, central bank–type operations that would defeat the purpose of having a currency board. Dollarization or free banking would work best if the central bank were to be completely eliminated.

The dollar-based options would separate monetary and fiscal functions in the Dominican Republic and ensure both stable money and a hard budget constraint.
and its functions not connected with issuing currency were delegated to other parts of the government.

**Tax Reform**

Marketing professionals know that successful sales campaigns are mounted with unique selling propositions and great brand images. Any of the dollar-based currency regime options would provide the Dominican Republic with the ingredients for a sales campaign and a confidence shock. But a monetary reform should be complemented with other reforms. For example, a privatization program should be introduced. To start, the electric distribution companies that were nationalized in 2003 should be privatized. The revenues from privatization should be earmarked and used to facilitate the transition to a new monetary regime.

In addition, the Dominican Republic needs bold tax reform. Income taxes start at such low levels of income that they discourage legal work in the formal economy. The lowest income tax bracket, 15 percent, starts at a bit under 200,000 pesos of taxable income a year, which is almost $4,500 at the current exchange rate. The top bracket of 25 percent starts at a bit under 500,000 pesos a year, which is about $11,000 at the current exchange rate. Tax brackets in the Dominican Republic are indexed for inflation annually, but when inflation is as high as it was last year, it creates significant “bracket creep” during the course of a year.

Although $4,500 a year is a reasonable income by Dominican standards, it must be remembered that the country is competing against others to attract and retain workers. Most Dominicans face higher income tax rates at home than they would in the United States. Although few people pay all the income tax required by law, the tax is still a disincentive for most workers and entrepreneurs to stay at home rather than try their luck in the United States or elsewhere.

The current structure of income taxes promotes tax evasion because it starts at such low levels. In 2002, the last full year for which information is available, taxes on income (personal income tax, corporate income tax, payroll tax, etc.) generated 25 percent of central government revenue in the Dominican Republic, compared with 92 percent of federal revenue in the United States. To reduce tax evasion and concentrate collection on people who generate most of the revenue, the income tax should become a low, flat-rate tax with a threshold that is high by local standards. For example, the upper rates could be eliminated, leaving a single rate of 15 percent, and the threshold could be raised from the current level of about $4,500 to $20,000 a year.

Payroll taxes on the employer and employee total 11 percent of salary, but because of widespread tax evasion, they contribute much less to revenue than in the United States. The government’s biggest generator of revenue is the value-added tax, whose local acronym is ITBIS (for Impuesto sobre Transferencias de Bienes Industrializados y Servicios). Its rate is 12 percent. The rate was raised from 8 percent at the start of 2001, and the scope of the tax was broadened from mostly goods to services. (On the other hand, import duties were reduced at the same time.) Value-added taxes are harder to evade than income taxes, but, especially in a developing country, when they reach the level that now exists in the Dominican Republic, they often start suffering from large-scale evasion. It would be desirable to reduce the ITBIS to 10 percent and ultimately back to no more than 8 percent, while retaining the broader base that has existed since 2001.

The corporate income tax is 25 percent. That is a lower level than in the United States, but it could stand to go lower, ultimately to the level of the proposed flat personal income tax rate of 15 percent.

While these tax reforms are ambitious, they are desirable and feasible. Indeed, Russia adopted similar measures in January 2001. The results have been good: tax compliance has improved; incentives to work, save, and invest have improved; and government revenues from the new, flat personal income tax
have increased by almost 80 percent in real terms.  

Conclusion

Thanks in large part to a botched bank bailout, the Dominican Republic is suffering the woes of a deep economic crisis. To restore confidence and turn the economy around, the Fernández government must do better than just muddle through. It must embrace bold reforms. The centerpiece should be a dollar-based monetary reform aimed at producing a hard budget constraint and stable money. In addition, the tax system should be reformed to improve compliance and enhance the incentives to work, save, and invest.

Notes

The author thanks Kurt Schuler for comments on an earlier draft and Gabriel Sanchez Zinny for suggestions.


5. Dominican Republic, Monetary and Financial Law, Law No. 183-02, November 20, 2002. The inoperative deposit insurance fund was called the Fondo de Contingencia.

6. In addition to bailing out the bank, the government nationalized two electric distribution companies in October 2003. That, too, shook business confidence.


17. For an exception to this common error of misclassification, see Steve H. Hanke, “Argentina Should Abolish Its Central Bank,” Wall Street


20. The precise foreign reserve-to-base money coverage ratio deficit would depend on the rate at which the peso/dollar exchange rate was fixed. For a detailed explanation of the recommended method for setting a fixed exchange rate, see Steve H. Hanke and Matt Sekerke, “Monetary Options for Postwar Iraq,” Cato Institute Foreign Policy Briefing no. 80, September 22, 2003, pp. 12–15.


23. For a detailed explanation of the recommended method for setting a fixed exchange rate, see Hanke and Sekerke, pp. 12–15.


