Session 2: Global Financial Crisis and capital flows
Dominican Republic

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Contents

1. Capital flows in DR
2. Exchange rate market in DR
3. Transmission mechanisms
Exchange rate policy and capital flows in DR during the last two decades have been conditioned by several internal factors:

I. Domestic financial crisis (2003-2004), leading to:
   
   - Economic recession and high inflation
   - Drop of exchange rate as nominal anchor
   - Total loss of international reserves (IR)

   The CBDR needed to accumulate IR, while going through a process of capitalization.

II. The adoption of Inflation Targeting (2012), combined with a managed float exchange rate regime, considering:

   - A high exchange rate pass-through to inflation
   - Relevance for financial stability

III. Highly concentrated exchange rate market, still in early stages of development
Capital flows in DR
The DR ranks first within Central America in outstanding portfolio investment, as annual inflows have averaged 2.1% of GDP over the last decade...

*Liabilities from the International Investment Position (IIP)

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### Outstanding Portfolio Investment (% GDP)

<table>
<thead>
<tr>
<th>Latin America</th>
<th>Outstanding Portfolio Investment (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>40%</td>
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<tr>
<td>Chile</td>
<td>32%</td>
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<tr>
<td>Panamá</td>
<td>29%</td>
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<tr>
<td>Perú</td>
<td>27%</td>
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<tr>
<td>Brazil</td>
<td>27%</td>
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<tr>
<td>Colombia</td>
<td>24%</td>
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<tr>
<td>Argentina</td>
<td>22%</td>
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<td>Dominican Republic</td>
<td>20%</td>
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<td>El Salvador</td>
<td>19%</td>
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<td>Costa Rica</td>
<td>15%</td>
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<tr>
<td>Honduras</td>
<td>9%</td>
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<tr>
<td>Guatemala</td>
<td>6%</td>
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<tr>
<td>Nicaragua</td>
<td>1%</td>
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</tbody>
</table>
The increase of capital flows during the last decade is reflected in the financial account, which, in addition to a lower CA deficit, has contributed to a positive performance of the BoP...
Which allowed the accumulation of international reserves...

Gross International Reserves

In US$MM and as Months-of-Imports

As % GDP

Source: CBDR
Exchange Rate Market in DR
Annual FX operations represent around 50% of GDP. Most of these transactions are carried through financial intermediaries...

60% of these operations are carried out by three entities and 98% of them take place at the spot market...
In recent years the CBDR has decreased its participation in the ER market, while interbank operations have increased their role...

Source: CBDR
Transmission Mechanisms
There has been a reduction of the exchange rate pass-through to inflation in recent years, even though it is still significant…

Previous studies evidenced:

- A pass-through to inflation close to 80% in the medium-run (Williams et al. (2003); Hernández (2006); Fuentes et al. (2007).
- An asymmetric pass-through by income quintile (Fuentes et al., 2009)

However, after the implementation of the IT regime, a reduction of the pass-through on impact, as well as for the medium-run, has been observed…

Source: CBDR
This relates to the strengthening of the IT regime and greater anchorage of inflation expectations ...
Regarding financial stability considerations, dollarization of the financial system have remained relatively low and stable...

- Studies evidence that interest rate differential impacts deposit dollarization, specially when combined with an acceleration of the exchange rate depreciation.
- In addition, the CBDR is working on the development of hedging instruments that moderate financial vulnerabilities to Exchange rate volatility.
Despite the increase in capital inflows after GFC, the Real Exchange Rate has depreciated, influenced by the accumulation of IR and lower inflation...

Prior to the GFC, the REER was up to 20% below equilibrium (Vásquez & Rivas, 2012)...

Source: SECMCA, Fred and CBDR
A more competitive REER and more favorable terms of trade have allowed the Current Account balance to improve...
Recent developments and challenges ahead...

- Implementation of the CBDR electronic FX trading platform
  - Fostering transparency and efficiency in the FX market.
- **Use of derivatives in FX interventions**
  - With the purpose of moderating the monetary effects of FX interventions and smoothing the seasonal demand for FX.
- **Improving regulatory framework** for FX operations and macroprudential policies
- **Challenges in communicating** the objectives of FX interventions and its consistency with monetary policy stance.