

ECONOMIC OUTLOOK 2009:

Getting through a difficult year

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José L. Carmona
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Traveling through uncharted economic territory

Puerto Rico entering its fourth consecutive year of recession, but administration is confident it can turn things around



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This year will be the most perilous in Puerto Rico's modern economic history. The forces at work are unlike any Puerto Rico has seen before. It is uncharted territory.

As the glow of a historic electoral victory transforms into a glare of sky-high expectations, the biggest reality facing Governor Luis Fortuño is that he will have to move fast to get the depressed Puerto Rico economy on its feet.

The Planning Board's revision for FY '08 shows the growth of the Puerto Rico economy contracting by 2.5%. The Planning Board's

projections point toward an economy that will have contracted by 3.4% during the current FY '09 (ending on June 30, 2009) and that will suffer a further estimated reduction of 2.0% during FY '10.

If the projections hold, Puerto Rico's economy will not only not have grown in ten years, but will also have contracted 9.9% in the last four years. The textbook definition of an economic depression is any period of time marked by economic contraction of 10% or more.

"The economic reality that Puerto Ricans are currently living clearly shows a negative trend through indicators such as employment, construction permits, sale of cement and Treasury Department revenue. These indicators contrast

dramatically with the positive projections that the Planning Board released at the beginning of 2008," said Héctor Morales Vargas, president of the Planning Board.

The Puerto Rico economy is hurting not only from locally misaligned fundamentals, but also from the hurricane-force winds blowing through the world financial markets that have toppled some of Wall Street's biggest financial companies, remade the financial landscape and produced pervasive, self-reinforcing investor mistrust that is scaring away credit.

Puerto Rico entered the U.S. recession already in battered shape. Fortuño inherited one of the

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most difficult legacies of any governor: a crippled economy—in a recession for three years—and a huge fiscal hole. The public debt exceeds \$55 billion; the budget deficit (FY '09) is projected to run more than \$3.2 billion; government revenue is expected to decline by \$888 million, or 10.5%, this fiscal year; and most public corporations don't have any cash and little credit.

Puerto Rico has not been spared from big budgetary dramas in the past. But the real crisis occurred when the government lost control of public finance, and now a weakening global economy has confabulated to push the deficit to previously unforeseen and unimaginable levels. It will haunt both local political parties, the New Progressive Party (NPP) and the Popular Democratic Party (PDP), as they both approved the previous budget.

Expenditures for this current fiscal year are expected to be around \$11 billion, while the most recent estimates for collections and revenues for the Commonwealth are between \$7.6 billion and \$7.8 billion.

The upcoming budget debate of 2009 will prove to be challenging. Lowering taxes could improve government revenue over time, but in the short term, it will further aggravate the government revenue base. The budgetary crisis has its roots in the old habit of Puerto Rico government administrations and legislatures to spend, spend and spend.

Not to say that his first 45 days as governor have not been demanding, but today (Thursday) and Friday Governor Fortuño will have the most demanding and challenging days of his governorship so far, critical to the future of Puerto Rico. He will speak at a credit conference taking place at the Puerto Rico Art Museum in San Juan.

Fortuño and his new financial and economic team will have the task of convincing the U.S. and global financial community (bondholders, potential bond buyers, investment and commercial bankers and credit-rating agencies, among others) that he is putting together the correct road map to travel the uncharted territory that lies ahead to achieve Puerto Rico's fiscal and economic reconstruction.

The administration will also use this occasion to let Puerto Rico hear what these bond buyers and credit-rating agencies are certain to tell us: either put your fiscal house in order—and we do mean it this time—or you'll be slapped with a credit downgrade faster than you can say *chatarra* (junk bond).

The Fortuño administration has already taken some first steps by enacting legislation that approved four urgent fiscal measures on January 15, only two weeks after the governor was sworn in. Fortuño implemented a fiscal emergency executive order and revised and projected gross national product (GNP) figures up to FY '10 to allow for policy decisions on fiscal measures, as well as federal and local stimulus packages. The administration is in the process of completing



*Luis G. Fortuño,
governor of Puerto Rico*

the evaluation of the fiscal deficit, has tried to create consensus by communicating the severity of the fiscal challenges, developed a local stimulus package (PEC, by its Spanish acronym), completed due diligence on key public corporations and established new Government Development Bank (GDB) oversight controls on operations, loan disbursements, capital expenditures and planned investor outreach initiatives.

Locally, Fortuño's performance will be measured on how he and his staff set about negotiating the inevitable pitfalls of an economic crisis. While none of us can predict the future with any certainty, there is always precious ground for hope and the knowledge that after a period of economic upheaval, good sense often prevails.

"I consider it a privilege to have been elected governor in these difficult times. Yes, it is true that no incoming governor has faced quite the daunting economic challenges that we have before us. But all the same, we will be measured by the results we can produce for the people and by the honesty and integrity with which we set out to do that job for the people.

"There's no question that the economic challenges we face will require that we take some bitter medicine, medicine that we should have taken a long time ago. But as I said during my inaugural address, I have absolutely no doubt that if we do what we have to do, we will not only come out of this mess but also face a bright future indeed. Our economy will prosper, and we will all be better off. And I don't mean years down the road, I mean in this four-year term. We are working on a plan to conjure this deficit and grow



*Carlos M. García,
chairman & president,
Government Development Bank*

our economy in this four-year term," Fortuño told CARIBBEAN BUSINESS.

The Puerto Rico economy is facing the worst economic downturn in its modern history, a decline of more than 8% in three years and now also faces a continuous contraction of the U.S. economy.

The world economy, too, is facing a deep downturn, financial markets remain under stress, a pernicious feedback loop between the real-estate and financial sectors is taking its toll, advanced economies are suffering their deepest recession in 70 years, and emerging and developing economies are experiencing a serious slowdown. The anemic global growth has reversed the commodity-price boom, inflation pressures are subsiding, global monetary and fiscal policies are providing substantial support and the uncertainty surrounding the outlook is unusually large.

The U.S. and Western Europe have become the epicenter of the turmoil. The collapsing real-estate and financial-asset markets are delivering the knockout punch to their citizens' conspicuous consumption. The declining job market has accelerated the collapse of consumption. In the last decade, households made decisions to take on additional debt based on several false assumptions: an ever-increasing real-estate market; ever-increasing financial assets; and ever-present jobs. These forces are beyond the scope of economic policies to manage. Diminished retirement savings forced many close-to-retirement workers to remain in the labor force and many retirees to return to the labor force at much lower occupational levels.

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The barrage of job reductions is expected to help increase unemployment substantially for several years, with real salaries decreasing. The blow to the most critical “currency” of the financial system—confidence—is evident in the lack of confidence between banks and financial institutions that has already caused several security markets to disappear from a lack of liquidity and lack of understanding of the underlying assets. In a climate of uncertainty, it is difficult to make firm predictions for the future. But prevailing economic conditions and expert analysis can provide vital indicators for an assessment of Puerto Rico’s economic prospects in 2009. Despite the dangers inherent in forecasting future trends, we can be sure that the prospects for 2009 will be defined largely by Puerto Rico’s and the U.S. mainland’s capacity to recover from the economic slump.

The key members of Puerto Rico’s financial and economic team expected to participate in the credit conference are: Carlos M. García, chairman & president, Government Development Bank (GDB); Juan Carlos Puig, secretary, Treasury Department; José Pérez-Riera, secretary, Economic Development & Commerce; Héctor Morales, president, Puerto Rico Planning Board; María Sánchez Bras, director, Office of Management & Budget (OMB); Fernando L. Batlle, GDB, executive vice president financing & treasury; and William Lockwood, GDB, executive vice president fiscal agent.



*Juan Carlos Puig,
secretary, Treasury Department*

If they fail to gain the trust, confidence and support of this relatively small group of financial executives who manage trillions of dollars and hold most of Puerto Rico’s public debt in their portfolios, we can then literally pack our bags and go somewhere else. Where? There are very few options.

ECONOMIC PROJECTIONS FY '09 AND FY '10

Committed to transparency, Héctor Morales, president of the Puerto Rico Planning Board (PB) will present the revised economic forecasts showing the recession will continue during FY '09 and FY '10. The local economy “officially” entered into a recession during FY '06.

All main variables are going to



*José Pérez-Riera,
secretary, Economic Development
& Commerce*

be down on the base-case scenario prepared by the PB for FY '09. For example, the largest segment, personal consumption, is expected to be down 0.6% in FY '09 and just increase 0.2% in FY '10. Personal consumption turned negative in FY '08 mainly due to record-high oil prices and government taxes and fees.

Construction and equipment investment will also continue to contract. Fixed investment, also affected by oil prices, increased prices of commodities and previous overheating of the construction sector, is expected to be down by double digits. Construction is expected to be down 11.1% this fiscal year and an additional 10.5% in FY '10. Investment in equipment will also contract by 9.9% and 11.3% in FY '09 and FY '10, respectively, as will government spending—-2.8% in FY '09 and -1.4% in FY '10 (see chart).

Airlines and the Ports Authority are already seeing a drop of 20% in the number of airline passengers this year versus last year. Domestic travelers are included in this number, so the number could be higher. Visitors’ expenditure has dropped as well.

“All these factors paint a recessionary picture of no economic growth for Puerto Rico’s economy—in all sectors in FY '09. Likewise, in FY '08 we had all sectors negatively impacted, unlike FY '07, which still had certain sectors with positive variables,” Morales said.

“Considering the numbers for FY '09, Puerto Rico will enter,

for the very first time, into its third recessionary year. A closer look at individual variables, however, will show personal consumption will be entering its second consecutive year in the red (negative). What does this mean when we look at the historical data?” commented Morales.

Morales explained that it’s the first time in local history that personal consumption has dropped in the red (negative) for two consecutive years. He said these are two things we should be looking at in the coming months, because as the experience from the 1982-'83 recession tells us, in only one of those two years personal consumption was down.

Consumer spending will continue to be cautious due mostly to increases in the unemployment rate, which reached 13.1% in Dec. 2008. In addition, individuals are experiencing tighter restrictions in the granting of loans from commercial banks.

“We expect that by 2010, personal consumption should start to improve, but still in 2009, it will continue down. This could be attributed to many other factors, among them the price of oil, which increased to record historic levels and obviously limited personal consumption,” said Morales.

Construction investment continues to drop. FY '09 will be the fourth consecutive year of decline in the sector. Consequently, there is a reduction in machinery investment, and within that segment, the heavy equipment variable, which is directly related to construction, is also declining (in the red).

“Government expenditures are also in the red, and obviously we need to see this within the context of the fiscal situation. There has been a decline in revenue, but government expenditures have not diminished at the same rate as revenue. We have a government spending more than the revenue it gets,” stated Morales.

U.S. ECONOMY AND FEDERAL FUNDS

“Obviously, we must add to the equation all the exogenous variables that affect Puerto Rico, such as the stateside recession, which is projected to be at -1.4%. This is a factor that directly impacts the island. However, among the exogenous variables that also directly impact Puerto Rico is the arrival of federal funds,” said Morales.

Key variables of Puerto Rico’s Gross National Product (GNP)

GNP main variables	FY 2007 ^R	FY 2008 ^P	Base case	
			FY 2009	FY 2010
Real GNP	-1.9%	-2.5%	-3.4%	-2.0%
Personal consumption	1.9%	-0.5%	-0.6%	0.2%
Construction investment	-7.6%	-8.8%	-11.1%	-10.5%
Equipment investment	0.9%	-8.1%	-9.9%	-11.3%
Government spending	-1.3%	-6.5%	-2.8%	-1.4%
Average oil prices*	\$63.4	\$96.8	\$65.3	\$47.3

* Estimate
R - Revised
P - Preliminary
Source: Puerto Rico Planning Board

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The federal government stimulus package is expected to provide more than \$5.2 billion to the Puerto Rico economy over the next two years. Some of the preliminary estimates of the federal stimulus package include: \$590 million in state fiscal stabilization fund, of which 61% must be spent on such education programs as Title 1 and special education; \$1.6 billion for education, including \$311 million for renovation of public schools and universities; \$721 million in increases for Pell grants, which some 80% of the island's university students receive; and \$1 billion in tax credits for working people who make up to \$70,000 a year.

A single person would get a \$400 credit, while couples would receive \$800. The Commonwealth Treasury Department must come up with a plan for the island's allocation.

"In that sense, and without considering the local and federal stimulus packages, we should start to feel, in great measure due to the reduction in oil prices, a positive effect within the formula that will take us to -2% growth without the injection of additional funds. What we see is that this injection of funds [local and federal] should be enough to stimulate the economy and keep it on the path to growth," said Morales.

THINK BIG

"Puerto Rico fell behind while trying to solve day-to-day situations without a clear vision as to where we were headed. In his government platform, Gov. Fortuño established



*Héctor Morales,
president, Puerto Rico
Planning Board*

a clear vision of Puerto Rico's future, and to achieve it, we have to think big. I've asked several groups where Puerto Rico is headed, and it's obvious we don't have a clear picture of where we're going. I use a trip analogy to explain this. If you're about to take a trip, you wouldn't pack your luggage first without knowing where you are headed, because the destination determines the type of clothing to take, and I would want to reach my destination safely and prepared. The same thing happened with Puerto Rico," Morales commented.

"Puerto Rico has to think big. That's the way of thinking in today's globalized world. There's only one speed to advance globally—as fast



*María Sánchez Bras,
director, Office of Management
& Budget*

as those who lead this movement: Dubai, Beijing, Singapore, Miami, Panama and others. We ask ourselves, are we advancing? Is Puerto Rico braking or speeding? Do we have the capacity to act? It's time to leave fear behind. We must position ourselves and think big."

OVEROPTIMISTIC

FORECASTING DIDN'T WORK

Overoptimistic forecasts of local economy growth increase the likelihood of overstating forecasts for tax revenue that lead to budget deficits (see chart).

"He who lives by the crystal ball soon learns to eat ground glass" and "If you have to forecast, forecast often" are sayings attributed to Edgar Fiedler, an American economist who served as vice president of the Conference Board and as Assistant Secretary of Treasury during the U.S. presidencies of Richard Nixon and Gerald Ford.

"In early 2008, the PB projected growth in FY '09 (which ends June 30th) to be 2.1%, a dramatic turnaround from a contraction of 2.3% in FY '08. The PB's assumption was that 90% of the federal reimbursement would be spent on new consumption. That did not happen; but even if it had, no one took the projection seriously," commented José "Joaco" Villamil, CEO of Estudios Técnicos.

"The PB's recently announced projections for FY '09 and FY '10 make more sense. In fact, the PB took the unusual and welcomed step of inviting outside economists

to discuss the projections and the underlying assumptions with its staff. It is by now fairly clear that the economy contracted in FY '07 and FY '08, and that FY '09 will see an even larger contraction," Morales added. "The PB's old projections were not in tune with today's reality, especially when you already had a downward trend.

"However, the PB's revenue projections were still high, on the positive side. How could anyone explain the economy would grow 2.1%? Their explanation was that they presumed Bush's economic stimulus package would jump-start the economy, but that didn't happen. That jump was too optimistic, when you are already seeing a clear downward trend. The 5.5 percentage-point gap was abysmal. And that's the story," commented Morales.

"We have to be prudent because Hacienda will make their revenue estimates according to these projections. If I'm too optimistic, what occurred the last couple of years will happen again, where the gap between revenue and economic growth is too big. Revenue fell 13.4%, and the Hacienda secretary talked about adjusting his revenue projections down by \$888 million. This is of significant impact, so the PB has played a role of trying to be within reasonable numbers. But if I have to sin somewhere, I'd rather sin by being pessimistic rather than overly optimistic when there are still too many unclear and undefined factors," Morales added.

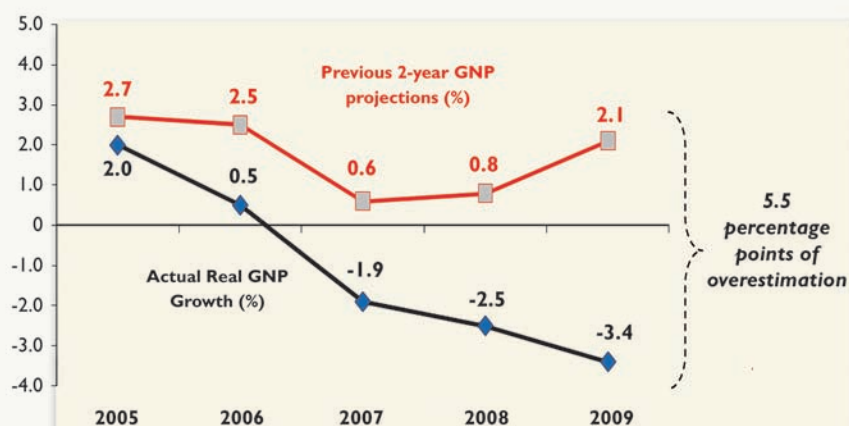
"It does represent a challenge because the current projection for this fiscal year and the projection for the next fiscal year basically provide for an expectation of four consecutive years of economic decrease in activity. This is something that is unprecedented for the Puerto Rican economy," added GDB president García.

The lowest growth in the last 26 years was in the fiscal years '82 and '83 where the economy decreased in two consecutive years by 2.6%.

"Obviously, we're seeing a very profound recession in Puerto Rico that is expected to accelerate during this current fiscal year," he added.

García explained that in terms of the local economic trends, two of the most significant challenges for the economy of Puerto Rico have to do with the price of oil and the correlation to the U.S. economy.

Comparison of two-year projections and actual GNP (% Growth by Fiscal Years)



GNP - Gross National Product
Source: Puerto Rico Planning Board

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"The biggest challenges we have in stabilizing the economy, just by looking at these two factors, are that we will need the U.S. economy to achieve a gross (economic growth) of over 2% and we will need oil prices to be around \$40 to \$45 a barrel," noted García.

As a rule of thumb, each \$10 increase in the price of oil negatively impacts the local economy by approximately -0.6%; 1% reduction in the U.S. economy (GDP) has approximately the same equivalent impact on the local economy.

"The key to the recuperation or the stabilization of the Puerto Rico economy lies in three significant factors. One of them is the U.S. economy; the second is the stability of the cost of oil; and third is the ability of the Government of Puerto Rico to generate significant investments, especially on the construction side, to be able to stabilize the economy," said García.

FINANCING MEASURES

To address the government fiscal crisis, the Legislature swiftly passed four measures on its first day of session in January (CB Jan. 29). The two most important were an amendment to the Puerto Rico Sales & Use Tax Financing Corporation (Cofina, by its Spanish acronym) law, where the Legislature approved to pledge an additional 1% of this tax to the dedicated sales tax fund, and the restructuring of the Puerto Rico Infrastructure Financing Authority (AFI, by its Spanish acronym) corpus account.



*Fernando L. Batlle,
executive vice president of financing
& treasury, GDB*

"By doing this, we're able to—with the additional 1%—access the credit markets with our best credit which is the Cofina structure. It is important to note that under the proposed structure, the existing bondholders will not be affected by the new bonds," said Fernando Batlle, GDB executive vice president. The sales and use tax has presented a favorable outlook in terms of collection. During the last six months, its average has been around \$93 billion, which validates the average in December of 2006 when the sales and use tax was enacted. Back in the late 1990s when the local telephone company was sold, part of the proceeds was deposited in a corpus account.



*William Lockwood,
executive vice president
for fiscal agency, GDB*

"Because of market dislocations that happened during the course of last year, a disparity arose between the value of the underlying securities securing an existing bond issue and the value of the security. We took advantage of this opportunity and essentially sold the Treasury SLGS securities in the underlying corpus and defeased the bonds leaving us with an approximate gain of about \$704 million," said Batlle.

The proceeds of that transaction will be divided in the following way: \$300 million will be deposited at the GDB in the guaranteed investment contract that will grow to \$1.2 billion by year 2040, thus, preserving the original intent of the law. The balance will go two-thirds to help cover part of the actual cash deficit and one-third to strengthen GDB's capital.

The net result of these two transactions is that the net increase in public debt is really about \$710 million, or 1.3%, of total public debt (see chart). Since a substantial part of the new Cofina transaction will not be new debt, it will go to repay existing debt that sits at the GDB without a repayment source. The balance, which is about \$1.8 billion, will go to three different sources. One of them will be to fund the \$500 million criollo economic stimulus program, \$700 million will go to pay off existing supplier debt and the balance will be used to cover operating deficits.

AN \$887 MILLION SHORTFALL IN GOVERNMENT REVENUE

According to the Secretary of the Treasury, the most recent projection is that revenue for the General Fund of the government will be down by around 10% for this current fiscal year. That reduction comes principally from an expected reduction of 7% in individual tax revenue, an 18% reduction on corporations principally driven by lower corporate earnings, some reduction on nonresident withholding and also reduction on motor vehicles. The total provides for an expected shortfall of approximately \$887 million.

"My two main objectives are pretty straightforward: improve service to our clientele and increase revenue by enforcing compliance," said Juan Carlos Puig, Treasury secretary.

Compliance, however, will be priority No. 1 and will be strictly enforced. Therefore, this taxman is letting people know the ax will fall on those who don't pay their taxes.

CLEANING UP THE MESS

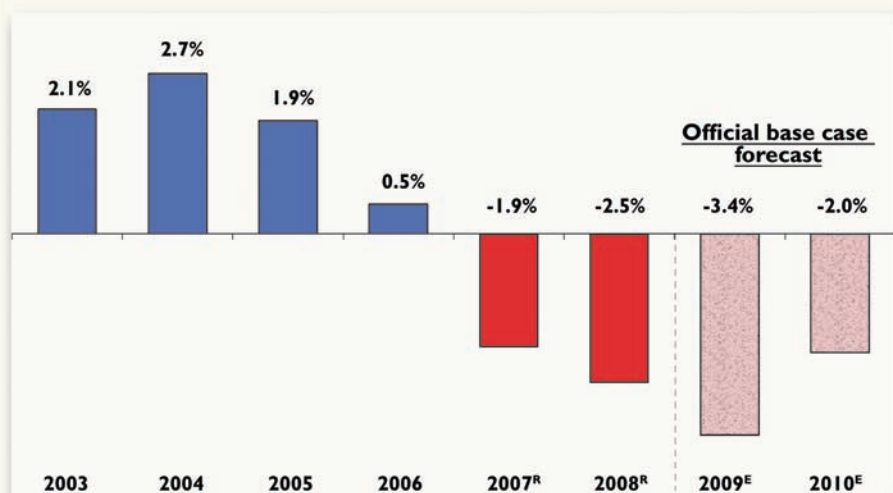
María Sánchez Bras, executive director of the governor's Office of Management & Budget (OMB) said that there have been 877 noncareer positions already eliminated with 70% of public agencies reporting progress in implementing the governor's Executive Order No. 1 (EO) of January 28, 2009 with potential savings of \$91.4 million during the second semester of FY '09.

EO No. 1 prohibits the creation of new government positions and eliminates vacant positions, and also calls for a 30% reduction in noncareer government positions and a 10% annualized reduction (5% in FY 2009) in operational expenses.

"We are in the process of elaborating longer-term budgets to bring about more stability to the fiscal planning process, implementing zero-based budgeting and taking expense control measures. In addition there will be a stronger analysis and monitoring of government agencies and we will gain control of the federal-grants process. A thorough analysis and specific measures for agencies and public corporations in more difficult situations will also be implemented," added Sánchez Bras.

Another executive order issued last week by Fortuño reduces the number of vehicles assigned to government agencies to one, prohibits the

Annual growth in real Puerto Rico GNP (Fiscal Years)



GNP - Gross National Product
R - Revised
E - Estimate to the base case forecast
Source: Puerto Rico Planning Board

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use of credit cards paid by public funds, limits travel expenses and use of cellular phones and orders measures to reduce electric-energy consumption at government agencies and the excessive accumulation of vacation days by government employees.

No single action will be sufficient to allow us to be able to provide for a significant deficit in the order of around 40% of current expenditures.

STRATEGIC PROJECTS TO SPREAD ECONOMIC DEVELOPMENT

José Pérez-Riera, secretary of Economic Development & Commerce and a former municipal finance banker, thinks he has a good idea of the challenges Puerto Rico is facing and is ready to tackle them head-on in order to help the economy grow.

Among the areas that must be addressed is infrastructure. "We need to make sure that we can push projects forward that are going to make different areas of Puerto Rico grow, not just the areas that surround San Juan," said Pérez-Riera.

As part of the reconstruction road map, expect the government to provide emphasis to key infrastructure projects such as Roosevelt Roads in Ceiba, Port of the Americas in Ponce, the Aguadilla Airport, the Martin Peña Canal project and the Golden Triangle Development in San Juan.

Major reforms are also expected in health, energy, the permitting process and the nonprofit sector. In addition, major efforts are expected in the development of bioscience projects, the highway network, potable water, housing, mass transportation and agricultural projects.

REVAMPING THE PERMITTING PROCESS

"We must also become more efficient. One of the things that we have been hearing from all the sectors that do business in Puerto Rico is that the permitting process needs to be revamped. People can't do business efficiently if the government doesn't allow them the means with which to engage in business activities in an orderly fashion, and we are doing exactly that," said Pérez-Riera.

The government plan is to reduce the number of permits required in Puerto Rico by 50% and to make things more efficient so that people have the certainty that once they get a permit, that permit is going to stand and they can invest in Puerto Rico without feeling that the permits are going to be revoked down the road.

BECOMING MORE COMPETITIVE

"Another area that we need to emphasize is how competitive Puerto Rico is in comparison to other jurisdictions. We have to create an economy based on knowledge that is going to allow us to leverage our role, which is very substantial already in the pharmaceutical manufacturing sector, into the next stage that would include entering into research and development (R&D) as well as clinical testing. We need to make sure that we provide the companies in Puerto Rico with a future source of synergy and revenue so that they can stay here, despite the fact that the sector overall is diminishing, including the amount of revenue available to it. We also need to establish a new sector that will provide for future growth, particularly in R&D as well as clinical testing," Pérez-Riera added.

ECONOMIC RECONSTRUCTION

In terms of economic reconstruction, given the ongoing recession in the Puerto Rico economy, it would be very difficult to implement a combination of the fiscal measures if we are not able at the same time to provide significant stimulus to the economy. There are two stimulus plans that are expected to assist in the combination of fiscal and economic reconstruction.

"The first of these will be a local stimulus plan in the order of \$500 million. That local stimulus package will be driven toward providing relief to taxpayers, toward promoting stimulus to the local, small and midsize business and also providing worker retraining. The dual roles of providing stimulus and at the same time seeking savings in the public sector are critical to the role of being a fiscal agent," said William Lockwood, GDB executive vice president for fiscal agency.

"For the first time in many years, there's a full alignment between the objectives of the Treasury Department, the OMB and the GDB. Virtually on a daily basis, we have been working with the deputy director of the OMB and with the Assistant Secretary for Information Technology and for Central Government Accounting, focusing on what can be done to take information technology to the frontier and design new processes. Fiscal management therefore will be centralized in collaboration with the three institutions and supported by technology for major re-engineering," explained Lockwood.

"They're following a very strict project-management guideline and seeking synergies to make full use of their institutional controls at Treasury, OMB and the GDB to look for savings in payroll, procurement, real estate and to bring controls into government payables. This new approach supported by information technology and by new processes in working together will lead to stabilizing things and improving the general obligation bonds rating and to sustaining the required levels of infrastructure investment," added Lockwood.

COMMITMENT TO SOUND FISCAL MANAGEMENT

"The road map to fiscal and economic reconstruction has already been drafted, and we are

moving ahead diligently with further analysis and definition of the implementation phase. The local recession has affected revenue and has aggravated the financial condition of the Commonwealth; the recurring fiscal deficit is no less than \$3.2 billion for FY '09. The new economic and financial team understands the challenges ahead and is committed to a reconstruction road map. We have made significant progress in the first 30 days in office, and the GDB will continuously reach out to investors in order to provide transparency," said García.

As part of the administration's road map, fiscal management will be centralized and supported by optimal use of information technology for re-engineering and savings. Government agencies will be required to develop multiyear budgets with specific milestones for operations, cash flow, capital investment and asset management. Integration to Prifas will lead to comprehensiveness, accuracy, real-time data, performance measurement and faster audit cycles.

"Monthly monitoring will enhance fiscal control. Each agency will have specific financial ratios to comply with by certain dates, will share the same underlying assumptions for economic trends and future revenue growth, and risk management will be integrated into all decision-making on investment, financial, operational, infrastructure technology and asset management," said Lockwood.

Availability of \$5 billion from the federal stimulus package and around \$500 million from the local stimulus package will support the combination of ongoing efforts both on the fiscal and economic side. But that by itself will not be sufficient, given the current outlook for the economy of Puerto Rico.

There are two other significant areas that should promote economic reconstruction. The second part is a comprehensive legislation for public-private partnerships. The third portion will be the necessity for additional stimulus. Given the state of the economy, the GDB has to be front and center and focused on promoting economic development in Puerto Rico.

There are two ongoing efforts by the Government Development Bank. The GDB filed just last Friday a trouble asset relief program (TARP)

General Fund tax revenue forecast* FY 2009

(\$ in millions)

Forecasts by revenue sources	Initial forecasts FY '09	New average forecasts FY '09	\$ Change	% Change
Individual	\$2,770	\$2,569	(\$201)	-7.3%
Corporations	\$1,751	\$1,432	(\$319)	-18.2%
Nonresident withholding	\$1,015	\$879	(\$136)	-13.4%
Sales & Use Tax (IVU)**	\$977	\$911	(\$66)	-6.8%
Motor vehicles	\$414	\$342	(\$72)	-17.4%
Permit fees & penalties	\$195	\$137	(\$58)	-29.7%
Other	\$1,366	\$1,331	(\$35)	-2.6%
Total	\$8,488	\$7,601	(\$887)	-10.5%

* Forecast as of February 2, 2009

** Aggregate 5.5% sales and use taxes 3.6% below FY 2008 year-to-date
Source: Puerto Rico Treasury Department

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request to the U.S. Department of Treasury and has also filed a petition this week with the Federal Reserve to obtain emergency funding under their Section 13-3.

"We believe that the combination of those three efforts, both on a short-term and long-term basis should provide for the economic reconstruction of Puerto Rico, taking advantage of the diversification and deepening of the capabilities that Puerto Rico has on biosciences," said García.

PUBLIC-PRIVATE PARTNERSHIPS

New Public-Private Partnerships (PPPs) legislation to be presented this fiscal year (FY '09) is expected to provide a clear legal framework to execute agreements.

PPPs are an alternate but proven mechanism to provide financing to fund needed infrastructure investments. In addition, they can reduce debt issuance by the central government and public corporations. Ongoing PPP efforts at the Puerto Rico Highway & Transportation Authority and the Puerto Rico Ports Authority will be pursued within the new legal framework.

"I see these [PPPs] as an additional initiative to the process. How can we raise structures, how can we do more infrastructure, without compromising our financial resources? Here's a variable that in addition to the Criollo Economic Stimulus Package (PEC by its Spanish acronym) is going to have a positive impact, and that's the PPPs," said Morales.

"PPPs have received a negative

connotation, described as synonymous with privatization. PPPs are not privatization. They allow the completion of certain projects which would not have been possible otherwise, and we already have a very successful example in the Teodoro Moscoso Bridge. This bridge is not private; it's a public good for the use and enjoyment of taxpayers and happens to be managed and serviced by a private company under a long-term contract," explained Morales.

"Given the weak financial condition of the principal public corporations, PPPs are an essential part of the financing mix needed to carry out their ambitious capital improvement programs (CIP). The CIP for the top five public corporations exceeds \$3 billion for the next two fiscal years. Without PPPs we will not be able to finance this. This in turn will have a further negative impact on economic growth. Public-Private Partnerships are an essential tool for the economic development of Puerto Rico," added Batlle.

Efforts to establish PPPs under the previous administration included the operation of the existing PR-22, the construction and operation of the PR-22 extension, the Phase II of PR-66 and the operation and construction of additional parking facilities at the Luis Muñoz Marín International Airport.

CRIOLO ECONOMIC STIMULUS

All indicators say we're still in a recessionary process. We must now take into consideration what has been discussed of what's to come. What is coming is the Obama economic stimulus package and Fortuño's PEC.

"The PEC intends to inject money into the variables we've found to have the greatest impact in the economy. For example, we've found that \$1 invested in construction translates to \$1.63 in the economy. That's why we say construction is one of the variables with the highest multiplier

again and pay their mortgages. Another area is to provide stimulus to the small and midsize businesses, which are employee-dependent and have a going concern to keep their operations running.

Basically, the government will tend to those areas or sectors not impacted by the federal stimulus program, noted Morales.

**We ask ourselves, are we advancing?
Is Puerto Rico braking or speeding? Do we have the capacity to act? It's time to leave fear behind. We must position ourselves and think big."**

effect in the economy. Taking that into consideration, it's one of the areas we're recommending for the use of these funds," said Morales.

Within the construction sector, the administration has identified infrastructure and social-interest housing as the two areas that could have the greatest impact. "If you build something without a market, then you don't complete the cycle within the process," added Morales.

In order to maintain certain stabilization of the mortgage market and assist those people who are having difficulties making their mortgage payments, the administration is looking for ways to provide mechanisms or assistance until people can get on their feet

IMPACT OF A DOWNGRADE

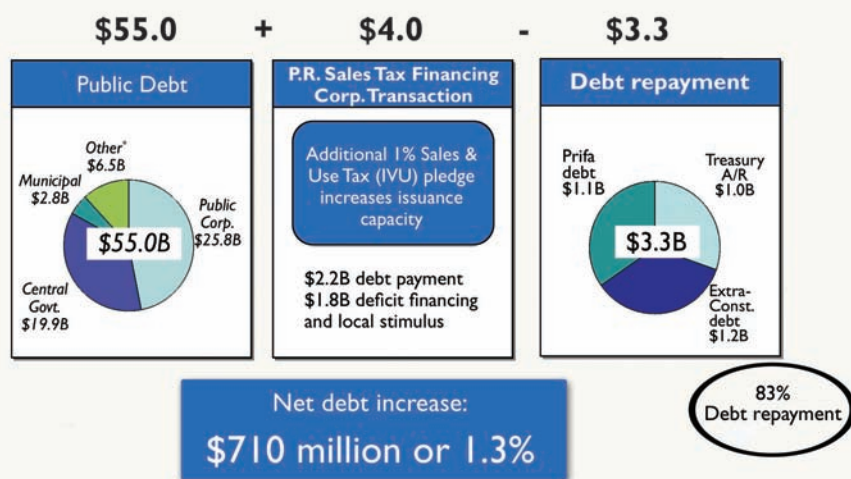
"The impact of a potential credit downgrade has catastrophic implications for Puerto Rico. Access to the capital markets would be severely constrained, and the little access we would have to credit would be at a very high cost, thus limiting the ability to finance public investment. This in turn would have a negative impact on economic growth and employment, pushing Puerto Rico deeper into a recession, potentially doubling the forecasted contraction of the economy for the next two fiscal years.

The devaluation of savings, retirement and investment accounts would be brutal to individuals and corporations. Other downgrade effects such as posting of collateral would require liquid resources that are not available. The additional collateral that would be required to support the Commonwealth's swap portfolio as a result of the downgrade could reach \$900 million.

"Recuperating from a credit downgrade could mean a lost decade. This unthinkable event must be avoided. It requires a concerted action from the executive and legislative branches as well as the support of the general public," concluded García. ■

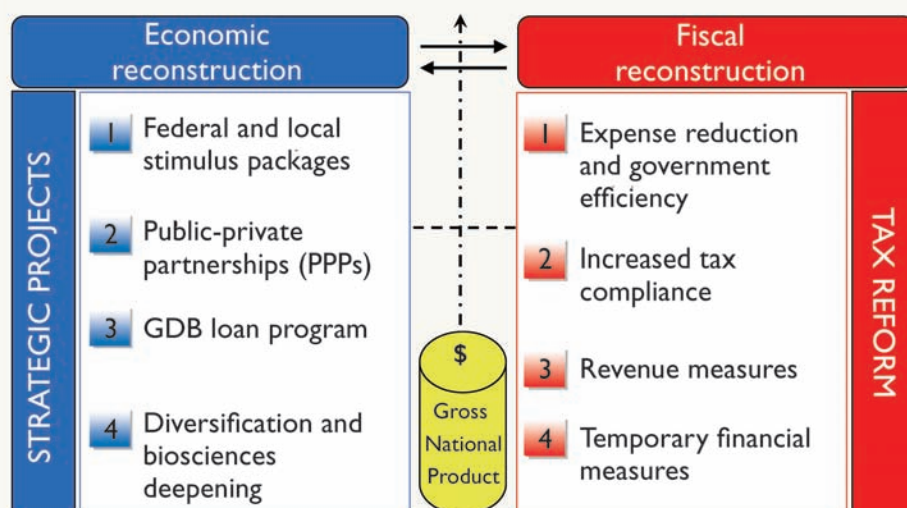
Proposed measures and impact on local debt levels

(\$ in billions)



Prifa - Puerto Rico Infrastructure Financing Authority
A/R - Accounts Receivable
Source: Government Development Bank

Road to reconstruction



GDB - Government Development Bank
Source: Government Development Bank

The economic record of the Puerto Rico administrations for the past 40 years

Seven U.S. recessions over the last forty years yield different degrees of impact on Puerto Rico's economy under six different governors

BY CARLOS MÁRQUEZ & JOSÉ L. CARMONA
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“If you want to know your past, look into your present conditions. If you want to know your future, look into your present actions.” —Chinese proverb

Over the last 40 years, the U.S. economy has suffered seven recessions, some longer and deeper than others, but it has always been able to come back.

In Puerto Rico, five different governors have been able to handle the impact of U.S. recessions with different degrees of success. Nevertheless, all of them were able to keep Puerto Rico's economic growth (real gross product, or GP) on the positive side during their terms in office, with the exception of Aníbal Acevedo Vilá.

It was not until the 1968 elections that Puerto Rico became a true two-political-party system. Since 1948, Luis Muñoz Marín and his Popular Democratic Party (PDP) had exercised government control. In 1968, Luis A. Ferré (New Progressive Party) was elected governor. A change of government policies started to take place where in the last 40 years (10 four-year terms) both principal political parties have shared the governorship for 20 years each.

Not even a year after Gov. Ferré took office in December 1969, the U.S. economy entered a recession that lasted 11 months until November 1970. This late 1960s recession was characterized by high unemployment and high inflation in the U.S., but it was not felt in Puerto Rico. While measures were taken in the U.S. to attack this recession, it marked the beginning of a new era of economic policy in which governments tried new ways of solving the recession problem.

Despite the recession, Puerto Rico's average real economic growth during the four years of the Ferré administration was 6.1% during his term (1969-1972). This economic growth has never been achieved since then.

Manuel A. Casiano, chairman of the board & chief executive officer of Casiano Communications Inc., publisher of CARIBBEAN BUSINESS, was the administrator of the Puerto

Rico Economic Development Administration (Fomento), chairman of the board of the Puerto Rico Industrial Development Co. (Pridco), the Tourism Co. and the Puerto Rico Ports Authority, among others. “Governor Ferré was a businessman and so was I. The government was run like a business, as it should be,” Casiano told CARIBBEAN BUSINESS.

Not long after, Rafael Hernández Colón (PDP), who was elected governor in November 1972, would face another recession created by the oil crisis of the early 1970s that began in November 1973 and lasted until March 1975.

In October 1973, the Organization of Petroleum Exporting Countries (OPEC) stopped exports to the U.S. and other western nations to punish their support of Israel. The immediate results of the oil crisis were dramatic. Gasoline prices quadrupled, rising from 25 cents to over \$1 in just a few months.

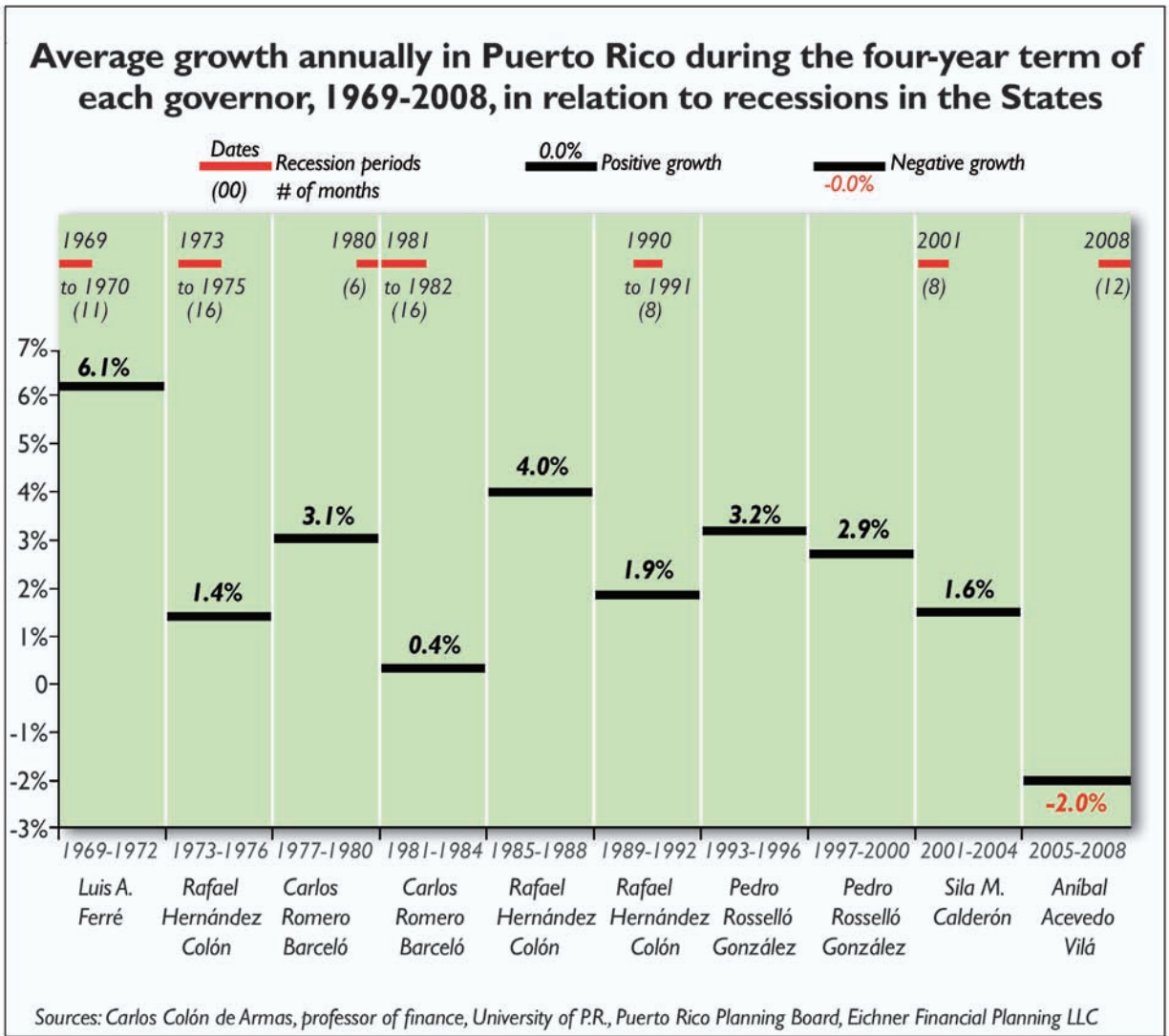
This, along with the increased government spending that came with the Vietnam War, led to severe stagflation in the U.S. This “oil shock,” along with the accompanying stock-market crash, greatly affected the U.S. economy.

Nevertheless, during the first Hernández Colón administration (1973-1976) Puerto Rico real gross product managed an annual average growth of 1.4% during the four years.

Carlos Romero Barceló (PNP) became governor in 1977. During his first term as governor (1977-1980) Puerto Rico's GP grew by an annual average of 3.1%. But it would not be long before he too would have to face another U.S. recession.

The early 1980s recession—from January 1980 until November 1982, which lasted approximately

Continued on page 26



The economic record

Continued from page 25

22 months, can be attributed mostly to the Iranian Revolution, which took place in Iran in 1979. This revolution caused another sharp increase in the price of oil all around the world, causing the 1979 energy crisis.

The new Iranian regime exported oil not only at inconsistent levels, but also at a much lower volume. This forced the price of oil up. The U.S. enacted a tight monetary policy to control inflation, and this led to another recession.

These monetary changes needed to be made not only for the sake of current inflation, but also because of the inflation that had carried over from the 1973 oil crisis and the 1979 energy crisis. The Federal Reserve, in an effort to control the inflation, changed the monetary policy.

Nevertheless, during the second consecutive administration of Romero Barceló, the island GP increased at an annual average rate of 0.4%, slim but still in positive territory, under very trying circumstances, especially considering that interest rates surpassed 20% and the stateside unemployment rate went up to 10% during President Carter's administration.

Hernández Colón regained the governorship in November 1984. Between 1985 and 1988, the U.S. was spared the negative impacts of a recession, and the island GP achieved an annual average growth of 4%. But Hernández Colón would face another recession during his second consecutive term (1989-1992). The early 1990s recession, that lasted eight months from July 1990 to March 1991, was caused by a lot of different adverse financial stimuli on the economic environment of the early 1990s. U.S. Black Monday, which occurred in October 1987, caused a stock-market collapse that cut almost 23% off the Dow Jones Industrial Average.

While the economy did well bouncing back from this trial, long-term effects definitely took hold. For instance, the savings and loan banks began collapsing, putting millions of dollars in savings in danger of being lost. The recession that followed this initial panic was sharp, and not only affected the U.S. but countries close to it such as the Western European economies and the United Kingdom, Canada and Australia. Nevertheless, during Hernández Colón's second term the island's economy grew at an average annual rate of 1.9%.

Pedro Rosselló González (PNP) won the election held in November 1992 and was spared of any U.S. recessions during his two terms as governor. Puerto Rico's GP grew at an annual average rate of 3.2% during the four years of his first term (1993-1996) and by 2.9% during his second term (1996-2000).

In November 2000, Sila María Calderón (PDP) won the elections and soon afterwards came the recession of the early 2000s that lasted eight months, from March 2001 to November 2001. It took place for various reasons. One was the collapse of the dot.com bubble. A false high, created in the initial, money-making wave of the Internet that swept the world, finally came crashing down to a realistic level.

The September 11, 2001 terrorist attacks against the Pentagon and the World Trade Center Towers also had a huge impact on the U.S. economy. Although Americans rallied and stayed positive, the economy took a hit as people stopped spending money.

A series of outrageous accounting scandals (e.g. Enron and Worldcom), along with the collapse of the dot.com bubble and the September 11th terrorist attacks, contributed to a relatively mild contraction in the U.S. economy.

The recession didn't last long, and although it

is probably still fresh in the minds of many, most people moved on. The economy recovered, and things looked up. Puerto Rico's economy contracted 0.5% in 2001, but overall it grew at an average annual rate of 1.6% during Calderón's term as governor (2001-2004).

Aníbal Acevedo Vilá was elected governor of Puerto Rico in November 2004. For seven years, until January 2008, the U.S. economy was growing at a healthy pace for a mature economy—between 2.4% and 3.4%—but the Puerto Rico economy by itself entered into an “official,” self-inflicted recession in March of 2006. During Acevedo Vilá's term as governor (2005-2008) the Puerto Rico economy contracted 2% and is expected to contract an additional 3.4% this fiscal year because of the three-year private recession in Puerto Rico and the start of the recession in the States in January 2008.

This late 2000s recession was started by the collapse of the housing market. Suddenly, it seemed as though nobody could sell real estate. This put many real-estate and mortgage companies in jeopardy, and many went out of business. Then, bank collapses caused a sort of public panic both in the U.S. and Europe. The amount of available credit spiraled downward, making it almost impossible for anybody to get a loan. This recession has been especially hard on auto-makers. Thousands upon thousands of workers (approximately 50,000) from major automotive factories have been laid off because of decreased auto sales. Millions of others have lost their jobs in all industries.

As consumer confidence continues to plunge, things will continue to get worse. Many have called this recession the worst since the Great Depression that lasted from August 1929 to June 1938.

Now we will have to wait and see how Luis Fortuño handles the present U.S. recession. ■

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