

## Puerto Rico Economic Outlook 2011

**Guarded optimism  
regarding the  
growth prospects for  
Puerto Rico in 2011???**

By Carlos Márquez  
pages 16-24

### TOP STORY

**St. Regis posts  
record-breaking  
winter  
occupancy**  
page 2

### INSIDE

**FDIC going after \$367 million in  
Westernbank losses**

page 28

**Moody's move won't impact P.R. plans to tap  
U.S. bond market**

page 15

**Go Forward with Vía Verde!**

page 27

### SPECIAL REPORT

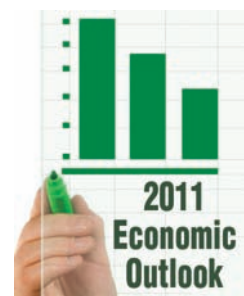
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# The local 'Great Recession' has turned into a depression

## Will this be the year Puerto Rico's economic depression ends?



BY CARLOS MÁRQUEZ  
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In a climate of uncertainty, it is difficult to make firm predictions about the future. But prevailing economic conditions, and expert analysis, can provide vital indicators for an assessment of Puerto Rico's economic prospects in 2011.

Puerto Rico enters its sixth-straight year of economic recession in March 2011. The recession has been so long and deep that it has turned into Puerto Rico's own "Great Depression." It is projected to continue, albeit at a lower rate, during 2011.

It is the longest recession of any

developed country in the world in modern times—in absence of war or natural disaster—since the Great Depression of the 1930s.

The textbook definition of an economic depression is any period of time marked by economic contraction of 10% or more, or a recession lasting more than two years.

Which definition is preferred doesn't matter; Puerto Rico qualifies on both counts. The island has been in a recession for five years, and its economic contraction, cumulative over these five years, has surpassed 10%.

The consensus among economists interviewed by CARIBBEAN

BUSINESS is that during 2011 the economy will suffer an additional contraction of between 1% and 2.2%.

Puerto Rico's economy suffered contractions of approximately 3.4% in fiscal year (FY) 2010 (measured locally from July 2009 to June 2010) after economic reductions of 3.7%, 2.8% and 1.2% in Puerto Rico's FY 2009, FY 2008 and FY 2007, respectively.

A total contraction of 11.1% makes this the most prolonged and deepest recession in Puerto Rico since the Great Depression. Add to that the projected contraction of FY 2011 of 1% to 2.2% and it becomes

a reduction in the island's Gross Product (GP) of between 12.1% and 13.1% during the last five years.

### RATE OF ECONOMIC CONTRACTION HAS SLOWED DOWN

The good news is that the rate of economic contraction has slowed down and the depression is weakening, as the 2011 projections are a clear improvement from the contraction of 3.4% in FY 2010.

"We have stopped the deep decline in the economy and the tendency is toward entering positive economic growth," said Leslie J. Hernández

Continued on next page



Continued from previous page

Crespo, interim president of the Puerto Rico Planning Board. “We are on the right track and implementing the correct measures. The implementation of the first phase of the Tax Reform will surely help.”

The Planning Board doesn’t publish projections for calendar years, but the revision for FY 2010, CARIBBEAN BUSINESS sources say, shows the Puerto Rico economy contracting by approximately 3.4% and projects a 1% to 2.2% negative growth in FY 2011, which ends June 30.

## GDB ECONOMIC ACTIVITY INDEX SHOWS SIGNS OF IMPROVEMENT

Several indicators, summarized in the Government Development Bank Economic Activity Index (GDB-EAI), have consistently pointed to a slowing of the fall during the last few months of 2010. The GDB-EAI is comprised of four main components: payroll employment, electric-power consumption, gasoline consumption and cement sales, all of which have shown signs of improvement.

“Although still in negative territory, if we continue at the current level, we should be seeing a positive sign by the first quarter of 2011 when compared with the same period of the prior year,” Government Development Bank (GDB) Chairman & President Carlos M. García said.

The GDB-EAI has a 98% correlation with the island GP, so when it is in negative territory, the economy most probably is as well. In November 2010 the GDB-EAI was down 2.5%.

## A WEAKER RECESSION

The economy should begin to reflect some improvement in 2011, experts say.

“The economy will still be in a recessionary mode in 2011, but the year should reflect a weaker recession, particularly in the second half, which is the first half of FY 2012,” said Juan Lara, chief economist at Advantage Business Consulting and a member of the governor’s economic advisory committee. “Although this is good news, what is important is to avoid the presumption that a full-scale recovery is on the way.

“When the dust settles, the numbers will show that the economy



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



*José R. Pérez-Riera, secretary of Economic Development & Commerce,*



dropped maybe another 1% in the 2010 calendar year, an improvement over the hard fall in 2009. Does this mean that we are about to see a strong rebound in 2011? Not likely. It means that we should be seeing more and more signs of a gradual turnaround in 2011.”

The slow pace of recovery is due in part to a local construction industry only just beginning to come out of hibernation.

“One reason why recovery will be slow is that a major increase in construction investment will not occur until sometime after 2011,” said José “Joaco” Villamil, chairman of economic consultant Estudios Técnicos Inc. and also a member of the governor’s economic advisory committee.

“What we are expecting in calendar year 2011 is a contraction of around 2.2%. The economy will be in worse shape in the first half of the year and should show improvement in the second half. Why? The impact of the ARRA funds allocated to construction will be felt and, we hope, some of the PPPs [public-private partnerships] will come on line.”

Added Vicente “Chenti” Feliciano, president of Advantage Business Consulting (ABC): “There are some signals that recovery is on the way in the short term.”

Those signals will remain relatively weak given how deep a hole Puerto Rico has dug for itself economically, Villamil said.

“What we have experienced in

Puerto Rico is a process that has generated conditions that became worse with time and, in effect, generated a negative spiral that has made recovery more and more difficult with time,” the Estudios Técnicos chairman said. “This is why turning the economy around in one or two years is illusory. There is much accumulated damage that will take time to correct.”

He explained that an economy is, in some ways, like an oil tanker. It requires a major effort to make it change direction.

“After five years in recession, many people find it understandably hard to believe that 2011 will likely witness a turnaround in the local economy,” economist Lara added. “However, several key indicators continue to signal that the recession will bottom out during the first half of 2011. This doesn’t mean there will be anything like a strong rebound in the second half of the year, but the worst of the downturn will be history by then.”

“The main concern is not the short term, which seems on the mend,” economist Feliciano said. “The medium term is more worrisome as the impact of Law 154 [which levies a 4% excise tax on major multinational manufacturing operations and makes changes to the source rule] is still uncertain, and a resurgent Republican Party in the U.S. Congress makes certain that there will be little in the way of new federal government programs.”

Lara noted that the local sectors that rebound the fastest are likely to be those most closely linked to a recovering U.S. economy.

“In fact, the local tourism industry already left the recession behind and is enjoying the beginning of a recovery,” he said. “The same will soon be happening in nonpharmaceutical manufacturing, which will naturally react to growing demand in the U.S. and the world economy.”

Villamil cautioned that any projection, even a conservative one, must take into account that there are always wild cards, events that are “beyond our local control.”

“An increase in petroleum prices, the curtailment of the U.S. health reform, interest-rate hikes and a weaker-than-expected recovery in the U.S. would all have a negative

Continued on page 18



Continued from page 17

impact,” he said. “Our 2.2% projected contraction assumes low interest rates, stable petroleum prices and a moderate recovery of the U.S. economy.”

As a rule of thumb, each \$10 hike in the price of a barrel of oil negatively affects the local economy by approximately -0.6%, and a 1% reduction in the U.S. gross domestic product (GDP) has the equivalent impact on the local economy.

Federal funds will continue to help reduce the rate of shrinkage of the local economy. The projections for 2011 are that net federal expenditures on the island will be some “\$26 billion, including \$2.2 billion in American Recovery & Reinvestment Act (ARRA) funds.

Nevertheless, the availability of \$4.6 billion in ARRA funds and \$500 million from the local stimulus package during the last two years were not sufficient to ignite the local economy.

While the ARRA funds will surely continue to provide support to the economy, the federal stimulus alone won’t spur rapid growth before running out in December. As helpful as ARRA funds are, economic observers are more than a little concerned about what is going to happen after ARRA.

#### UNEMPLOYMENT WILL CONTINUE TO BE A CHALLENGE THIS YEAR

Unemployment and a very low labor-force participation rate will continue to be major areas of concern and challenge in 2011. Like in the mainland U.S., improvement in economic conditions will not necessarily mean significant gains in employment.

Unemployment hovered above 16% in Puerto Rico for much of 2010. That is up from the 11% range at the onset of the local recession. The jobless rate, which measures people actively looking for work, was kept in check as frustrated job seekers gave up their searches, which pulled the labor participation rate below 42%. The good news is that in December the local unemployment rate went down to 14.7%.

“In 2011 we will continue implementing the strategies contained in the Strategic Model for a New Economy Plan [MENE by its Spanish acronym], which is undoubtedly



*Leslie J. Hernández Crespo,  
interim president of  
Puerto Rico Planning Board*



*José 'Joaco' Villamil,  
chairman  
of Estudios Técnicos*



the best designed and most comprehensive economic-development plan that Puerto Rico has had in decades,” said Economic Development & Commerce Secretary José Ramón Pérez-Riera. “Last year was full of achievements and challenges, but we are confident we have established the baseline that will enable us to reverse the process of decline and make 2011 a defining year in the process of reviving our economy.

“We are ensuring that we continue restoring growth both in the short and long term, and across all sectors of the economy, investing in the development of our infrastructure—including the participation of the private sector through public-private partnerships—and in meeting the challenges of cost, efficiency and functionality that, if left unaddressed, would undermine competitiveness to our economy and limit our ability to

attract investment to the island.

“Working closely with the Legislature, already six major reforms for competitiveness have been adopted, including reforms to the public-private partnerships, permits reform, reorganization and modernization of the executive branch, energy reform and tax reform. By 2011, we have an aggressive plan of promotions to promote internationally the incentives offered by the government of Puerto Rico to attract foreign investment, and have a full agenda of events designed to help our local entrepreneurs increase their export markets such as Spain, Panamá, Chile and China, among others.

“Promotional activities we have planned for 2011 include activities to attract investment in different sectors such as cinema and creative services to the newly approved incentives to continue promoting the industry of

cinema in Puerto Rico. With the adoption of the new law, we take this industry to the next level, further improving our competitiveness with a new incentive structure for film-production projects on par with other jurisdictions competing with us to attract projects, and the economic activity associated with them. We will continue to attract investment in renewable-energy projects, large-scale tourism projects in general and investment in the purchase of ‘second homes’ and investment properties. We are confident that the competitiveness reforms and these additional projects create an environment unparalleled in the Caribbean and one that is extremely competitive for investment throughout the world.

“We continue to work with programs to diversify energy sources, ensuring that the generation of electricity on the island is affordable, viable and sustainable. This continued injection of local and foreign money, along with many projects already in advanced stages, will be a reality during 2011. Air capacity, hotel occupancy and average hotel tariff growth trends continue.

During 2010 we managed to increase air access to Puerto Rico with new Jet Blue and AirTran flights between other airlines, and continue with our efforts to position Puerto Rico as the most important air destination in the Caribbean, helping not only tourism but also trade. Along these lines, the establishment of new ‘charter-flight’ routes to Madrid and Barcelona and the arrival of new cruise lines this year have already been announced,” Pérez-Riera stated.

#### PPPs AND STRATEGIC PROJECTS TO HELP DRIVE THE ECONOMY AFTER ARRA

The administration of Gov. Luis Fortuño is counting on several of its initiatives for reviving the island economy to begin taking effect in 2011.

“We have done most of what we have to on the fiscal side,” GDB President García said. “Now, we are concentrating on economic growth.”

After the ARRA funds are used up, the government is looking to PPPs,

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as well as strategic projects, to drive the economy in 2011 and beyond. It estimates PPP investment could reach \$4.5 billion by 2013. The administration expects to have at least five projects committed during 2011.

“As we look toward the future of Puerto Rico’s economy, and as we strive to turn the tide, the most important problem we face, and our utmost challenge, is to promote growth in the economy,” said Carlos Colón De Armas, an economist and finance professor at the University of Puerto Rico. “For growth to occur, however, productive investments from both the public and the private sectors must also occur.

“To promote public investments, we need to strengthen the finances of the government’s public corporations, which have been languishing while all the attention was directed to the central government. Returning these public corporations to their financial health should be at the top of the agenda for 2011.”

#### PPP PROJECTS TO BE AGGRESSIVELY PURSUED IN 2011

The Fortuño administration has vowed to aggressively pursue PPPs, and some projects will take shape in 2011, such as islandwide school modernization, concessions for the existing PR-22 and PR-5 toll highways, the management concession for Luis Muñoz Marín International Airport (LMMIA), and the Puerto Rico Aqueduct & Sewer Authority (Prasa) project of implementing remote technology for reading water meters.

Other PPP projects are expected to take longer, such as the toll concession for existing PR-52 and PR-66 and the construction of the PR-22, PR-53 and PR-66 extensions.

“Some analysts have expressed criticism concerning the implementation of the PPPs,” Villamil said. “They forget that putting in place a PPP is a complex and time-consuming process, and that in Puerto Rico’s case, the process is well within the parameters of other jurisdictions in terms of the time taken for implementation. PPPs will make a positive contribution to development, but no one should underestimate the complexities involved and the time required.”



*Vicente ‘Chenti’ Feliciano,  
president of Advantage  
Business Consulting*



*Juan Lara,  
chief economist at Advantage  
Business Consulting*



*Carlos Colón De Armas,  
economist and finance professor  
at the University of Puerto Rico  
Graduate School of Business*

#### SCHOOL-MODERNIZATION PROJECT TO REACH TOP GEAR IN 2011

The school-modernization project, which involves the modernization of 100 schools, should be at full speed during 2011. Construction activity is expected throughout the year, with an investment of approximately \$756 million financed through Qualified School Construction Bonds (QSCB), an ARRA-related stimulus program that offers 15-year, interest-free qualified school-construction bonds for school modernization and construction that are expected to be issued during 2011. Interim financing is being provided by the GDB.

#### CONCESSION FOR TOLL ROADS PR-22 AND PR-5 TO BE AWARDED BEFORE APRIL

The Puerto Rico Highways & Transportation Authority (PRHTA) is expected to enter into a long-term concession agreement for existing toll roads PR-22 and PR-5 by March 21. Four consortia have been short-listed. Any or all money paid upfront by the concessionaire will go to the defeasance of the outstanding debt to bondholders guaranteed by revenue from the toll roads. No major investment that would produce new economic activity is anticipated in 2011.

PR-22 is the most-traveled toll road on the island and generates approximately \$85 million a year in revenue.

#### LMMIA CONCESSION TO BE AWARDED BEFORE YEAR’S END

The Puerto Rico Ports Authority

(Ports) will continue to actively pursue the full concession at LMMIA, the island’s principal airport. A cycle of meetings with the airlines that operate at the airport is underway as the approval of 65% of them is required by the Federal Aviation Administration (FAA) for the airport to enter into a concession agreement with a private operator.

Once the airlines give their approval, a Request for Proposals (RFP) will be issued and an agreement is expected before the end of the year.

#### PRASA TO ENTER INTO CONTRACTS WITH 3 PRIVATE OPERATORS

During the first half of the year, Prasa will enter into contracts with three private companies to reduce the current amount of so-called nonrevenue water (NRW) through the implementation of advanced technologies, including remote meter-reading technology and geo-referencing of customer accounts.

The three companies are expected to invest \$600 million during the terms of the contracts and create 1,200 new jobs.

#### STRATEGIC PROJECTS

The administration is also expected to concentrate on various strategic infrastructure projects in 2011 to promote growth, among them the redevelopment of the San Juan waterfront; the Port of the Americas in Ponce; Science City; Vía Verde, the natural-gas project of the Puerto Rico Electric Power Authority (Prepa); and Roosevelt Roads.

#### REDEVELOPMENT OF THE SAN JUAN WATERFRONT

The redevelopment of the San Juan waterfront area, known as “Bahía Urbana,” is expected to start in a few months. The initial construction project, to be completed by the end of 2012, will consist of an investment of \$25 million for improvements to piers 6, 7, and 8. The money is coming from the \$500 million local stimulus plan.

#### PORT OF THE AMERICAS TO GET AN ADDITIONAL \$40 MILLION

After a government investment of \$210 million, the Port of the Americas in Ponce (PofA) is expected to receive another government investment of \$40 million. An additional \$750 million investment is required from the private sector.

The Fortuño administration considers the PofA a strategic project that will become the economic engine of the island’s southern region. Nevertheless, three different government administrations have been unsuccessful in securing an operator.

#### SCIENCE CITY

The GDB granted a \$116 million loan for the construction of the M.D. Anderson Comprehensive Cancer Center, which will form one of the bookends for the Science City complex. The GDB is also financing a science boulevard to connect the cancer center, and other properties that will be established inside



Continued from page 19

Science City, to the Medical Center (Centro Médico), which will form the other bookend.

### **EFFORTS TO REDUCE OIL DEPENDENCE WILL ACCELERATE IN 2011**

Prepa will continue its aggressive energy-diversification strategy in 2011. Some power-generating units of the Costa Sur Power Plant will be using natural gas this year and the administration will relentlessly pursue the construction of Vía Verde, a 91-mile natural-gas pipeline that will run from the south to the north coast at Arecibo and then eastward to the power plants in the San Juan metro area.

Vía Verde, which has received nearly 70% of required permits, will begin delivering annual energy savings of \$1 billion starting in 2012, officials say. Construction of the \$450 million pipeline should start this year and is expected to create between 4,000 and 5,000 construction jobs.

In addition, there are seven other renewable-energy projects approved and under development that will provide 273 megawatts of electricity to the island power grid, but those will take time, officials say.

### **BANK-CONSOLIDATION ADJUSTMENTS TO BE COMPLETED IN 2011**

The balance-sheet adjustments in the island's banks following the Federal Deposit Insurance Corp. (FDIC)-assisted consolidation last year are slated to be completed by the second half of 2011. The credit environment is expected to improve significantly as a result, industry observers say.

"As this process draws to a conclusion, regular lending can resume," Feliciano said.

Lara added that this, in turn, would loosen the financial stranglehold on housing developers and other key players in the construction industry.

"The adjustment in the banking system and the construction industry is still ongoing," Lara said.

### **GOVERNMENT REFORMS EXPECTED TO PROMOTE GROWTH AND INVESTMENT IN 2011**

To promote economic growth and



continue government fiscal reconstruction, the administration will implement a series of reforms during 2011, including the tax, permit and government reforms.

### **TAX REFORM DESIGNED TO PROMOTE ECONOMIC GROWTH**

A new Internal Revenue Code (IRC) to reduce the tax burden on corporations and individuals was approved last week and signed into law by Gov. Fortuño on Monday. Technical amendments could come later during the current legislative session.

Fortuño emphasized that the Tax Reform is still required to push the island's economy toward a sustained growth pattern.

"There is no doubt that when you leave more money in the pockets of taxpayers, including individuals and small and medium-sized businesses, it stimulates the economy. People have more money to consume, save or invest," the governor said. "All these options—consumption, savings and investment—generating more economic activity, in turn translates into more income and jobs for all."

Economic experts seem to agree that the new tax code is integral to the island's economic recovery.

"Tax cuts will have a positive impact on consumer spending and

investment in several sectors of the economy," Feliciano said.

GDB President García said the "fiscally responsible, revenue-positive" reform focuses on four central objectives to spur economic growth.

"The first one is to be able to provide tax relief for individuals and corporations," he said. "Second, is to foster economic development and job creation. Third, is to achieve simplification of the tax system. Last but not least, is to be able to reduce the tax burden."

"It is the most comprehensive and aggressive tax reform in our history. Over a six-year period, it will lower taxes on individuals by almost 50% and on corporations by at least 30%. The tax system will be flatter and much simpler."

The most dramatic item in the Tax Reform is the reduction of the effective income-tax rate to corporations. The effective corporate tax rate for 2010 is estimated to be 34%, and it will be reduced to 26%.

To assist the corporations that have been experiencing losses from 2005 to 2011, the reform extends the carry-over period for net operating losses from seven to 10 years.

### **PAYING FOR THE TAX REFORM**

The Tax Reform will be paid for by stimulating economic growth and creating new jobs, government

officials say, and will also include an increasing earned-income tax credit (EITC), tax-rate reductions and expanding tax brackets that will be financed through enhanced tax-compliance measures, reduction of tax incentives and credits, and an excise tax on multinational affiliates.

There is also a special window, in effect until April 15, for declaring nonreported revenue.

### **SPECIAL EXCISE TAX ON MULTINATIONALS**

Starting this year, there is an expansion of the source-income rule to determine the adequate amount of the income derived from multinational companies that should be allocated to Puerto Rico. A temporary excise tax of 4% will apply to certain multinational corporations in 2011.

The special excise tax is expected to collect \$700 million during what remains of the current fiscal year, meaning from Jan. 1 to June 30.

### **MEASURES TO CURTAIL TAX EVASION**

The administration will continue to take steps to avoid tax evasion, and implement tax compliance, by requiring financial institutions to submit financial information to the Treasury Department for clients that apply for loans over \$250,000 or residential loans over \$500,000; personal and criminal liability will be imposed on corporate executives that withhold taxes but do not remit such taxes to the Treasury Department, and a limit has been imposed on the amount of the deduction for home-mortgage interest reduction.

### **SALES & USE TAX [IVU] COLLECTIONS TO INCREASE IN 2011 WITH A STATEWIDE IVU-LOTO**

The Treasury Department is well along in implementing technology to further enhance the IVU collections through a lottery system. An island-wide implementation of the system is slated for the first quarter of 2011. A pilot program was launched Nov. 15, 2010 in Ponce.

"The IVU-Loto is expected to capture an additional \$400 million in transactions, of which \$100 million will be in FY 2011 and another \$200 million in FY 2012, and by FY

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2013 we will be able to capture the full base of \$400 million, or the target amount for this program," García said.

#### **GOVERNMENT REORGANIZATION WILL CONTINUE**

The reorganization of the executive branch of the central government will continue in 2011 and will almost certainly see a large number of agencies restructured under the government reform plan. Obviously, these laws will take time to implement and won't have an immediate impact.

The government reform aims to eliminate 30% of the island's 134 government agencies.

"We need to devote more resources to the growth of our economy," García said. "If you have a government that pays 70% of its revenue to payroll, you don't have enough to invest in economic development."

It is reasonable to expect approval of the Tax Reform and the start of the process to revamp the government retirement system this year. Progress on labor and legislative reform is not likely to be significant, however.

#### **GOVERNMENT REVENUE, CASH FLOW AND FURTHER REDUCTION OF EXPENSES IN 2011**

"Revenue to the government's general fund has stabilized and is gradually beginning to make modest but sustained gains," Lara said. "These are encouraging indicators that a turnaround is in the offing."

García said that the central government has reduced expenses by \$935 million or 17% of total payroll and this trend will continue through 2011. It will continue to strictly monitor all services retained by the government to maintain tight controls on the expenses, because "there is no alternative," he said.

"We continue to operate under very challenging circumstances, but I'm convinced that we are ahead of the curve as compared to most states in doing what needs to happen to bring back economic recovery and fiscal responsibility," García said. "We have established strong and predictable cash-flow management and we have ended in a positive cash benefit for every quarter of fiscal 2010 and the first quarter of FY 2011. Expect further reductions in the budget gap

[revenue vs. expenses]. The gap is approximately 11% down from 44% two years ago.

"We will continue containing costs and strengthening our collection efforts as well."

The GDB will continue monitoring the expenses of major agencies such as the Health and Education departments. Government financial statements for FY 2010 are slated to be ready by March 31.

#### **IMPLEMENTATION OF NEW PERMITTING PROCESS**

In December 2010, a total overhaul of the permitting process took hold and is expected to commence full operation this year. Permitting agencies have been merged and 26 regulations have been done away with. To facilitate business and job creation, there will be only one regulation that will cover this area, considered a fundamental obstacle to investment in the past.

While the new permits system provides a 90-day deadline for permits, it will take time for it to achieve full and effective operation.

#### **GOVERNMENT-EMPLOYEES PENSION SYSTEM**

The legislative process to fix the government-pension-system's unfunded liabilities will start in 2011.

The government retirement system has available assets to cover obligations only until FY 2019, making it an item that will be handled with urgency this year.

Consensus legislation will be prepared to tackle the unfunded liability focused on three areas: implementing an additional employer/employee contribution needed to reach the annual required contribution and improve the funding ratio, the impact of the different special laws, and the impact of personal-loan portfolios on the system's cash flow.

#### **INCREASED FUNDING FOR HEALTHCARE**

Last year, the administration embarked on refurbishing the local healthcare plan and was successful in securing additional funding from the federal Medicaid program.

Although Puerto Rico doesn't fully participate in the federal program, with additional Medicaid funding it has been able to cover additional participants in the Mi Salud program



(which late in 2010 replaced the 17-year-old island Health Reform system) in 2011. Funding for the next fiscal year will be \$372 million above the \$492 million in current funding.

#### **HOUSING-SECTOR STIMULUS WILL BE EXPANDED IN 2011**

In order to stimulate the economy, an additional stimulus package for the housing sector will be put in place in 2011 to reduce banks' housing inventory as well as stimulate the construction of new housing.

Last year, the administration implemented a program that included closing-cost bonus programs as well as second-mortgage programs that allowed participants to buy second homes at a reduced rate.

For 2011, the program has been expanded into the areas of enhanced mortgage insurance, rental-market stimulus and housing stimulus. In the enhanced-mortgage-insurance area, the government will offer 105% loan-to-value, which provides for loans to be made without a down payment. In the rental-market stimulus area, the program provides for a 100% tax exemption on net rental income for a 10-year period.

In addition, it provides for a 100% exemption on capital-gains tax at the time of the resale of new properties, as well as a 100% exemption on fees,

stamps and vouchers, a 100% exemption on temporary property tax and a five-year exemption on property taxes.

"There is a 50% exemption on the capital gains for properties that are resold, but if you are the seller you still get 100% exemption in order to stimulate the sale of these properties," García said. "You get a 50% exemption for fees, stamps and vouchers on a second home. We also have increased the deduction of up to \$5,000 for up to 15 years against ordinary income for capital loss on sales of existing homes if the transaction is conducted during this window [which closes April 15]."

The GDB president said 2011 will be a pivotal year in turning the island economy around, as policies designed to go to the root of the island's structural economic deficiencies begin to take effect.

"There is still a lot to get done, but there is no doubt that we have changed the course of Puerto Rico's future," García said. "We are forging ahead and are staying the course, both on the fiscal side and on the economic-development side."

"We took unprecedented steps that needed to be taken so that we could bring Puerto Rico back to solvency and avoid a deeper economic depression." ■



# Private sector cautiously optimistic about 2011

BY CB STAFF

After enduring a five-year recession, the consensus among private-sector executives in Puerto Rico's most important industries interviewed by CARIBBEAN BUSINESS is one of cautious optimism for 2011.

## ADVERTISING

In 2011, the numbers look even brighter than last year, when advertising investments increased to \$1.2 billion. This year, they are expected to reach \$1.3 billion.

Brands are thrown at consumers every day. This is why it is essential for companies to not only create awareness of their brands, but also to build a relationship between the brand and the consumer. For businesses to grab the attention of potential buyers, they must market to their target audience in an effective way. Currently, marketing decisions are being made carefully and with more attention to budget and to what the consumer wants and needs. In 2011, the advertising industry is not only offering great campaign ideas, but more long-term business-marketing solutions as well.

## AUTOS

After facing its most challenging year on record in 2009—as the local economy experienced its third-straight year of economic downturn—the Puerto Rico auto industry bounced back in remarkable fashion in 2010, selling nearly 90,000 units, up 16%.

The dozens of auto-sale fairs the top automotive brands held collectively and individually at local stadiums, dealerships, parking lots, and inside malls throughout the island, plus an upswing in fleet sales, generated a new level of excitement among customers and dealer showrooms not seen in a very long time.

Most industry observers agree there is still room for growth in the local automotive market, as many vehicle owners and companies that

replaced their personal cars or fleets in 2004, 2005 and 2006 are on track to replace them again this year.

“We estimate the industry is going to sell approximately 98,000 units this year, with Toyota, Scion and Lexus selling a combined 26,500 units,” said Mario Dávila, president of local distributor Toyota de Puerto Rico.

For Carlos López-Lay, president of the United Group of Automotive Importers (GUIA by its Spanish acronym), the market's 2010 showing was still below the industry's potential, estimated to be 123,000 new units a year.

“2010 was better than 2009, and we expect 2011 to be even better than last year,” López-Lay said. “I don't think we will reach the record numbers of 2005, when the industry sold 140,400 units, for a long while. Nevertheless, we see the banks' credit issues being resolved, and financial institutions are now more aggressive and actively participating in the auto industry. Ultimately, that is what sells cars.”

RayLugo, general manager of local Chrysler Group (Chrysler, Dodge, Jeep & Ram) distributor Chrysler Group International Services LLC (CGIS) noted the U.S. automaker closed 2010 with a bang, registering a whopping 70.2% increase during

December with 1,120 units sold—its best month since 2005.

## BANKING

As the banking industry begins 2011, it continues to face the same challenging environment it encountered throughout 2010: a weak local economy in its fifth year of negative growth, a decline in real-estate values and an excess inventory of new unsold homes, and the effects of the consolidation in the local banking industry.

On April 30, 2010, the Federal Deposit Insurance Corp. (FDIC) failed local banks Westernbank Puerto Rico, R-G Premier Bank and Eurobank, which were acquired by Banco Popular, Scotiabank de Puerto Rico and Oriental Financial Group, respectively, through an FDIC-assisted transaction.

Nonetheless, industry observers point out there are important economic indicators in the mainland U.S. that suggest 2011 should be better than 2010 for the banking sector, both locally and nationally. Such is the case of interest rates, which remain at historically low levels.

“In addition, banks last year recognized a considerable amount of loan losses and the devaluation of their assets. When you look at the adjustments banks made to

property values in their balance sheets, we should see those values entering a stabilization stage,” said FirstBank Puerto Rico President & CEO Aurelio Alemán. “We expect the reduction in the price of housing units, combined with the government's housing-stimulus program, should continue to help move the island's inventory of existing and new housing units.”

For Alfredo Padilla, the Puerto Rico Financial Institutions Commissioner, nonperforming construction and commercial real-estate loans will continue to impact the balance sheet of local financial institutions during this year, as over 50% of construction-project loans are nonperforming.

“This is complicated and will take time, but you are already noticing that it has gone past being a decision process and banks are becoming more aggressive when addressing these problems,” Padilla said. “You see more legal actions being taken, so in 2011 this will have to be defined and banks will have to take the losses that need to be taken, because the system can't take any more.”

## CONSTRUCTION

Local chapter members of the





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Associated General Contractors of America (AGC) expect 2011 to be more active in terms of construction projects than the previous two years, as the government tries to reactivate the sector with a slew of infrastructure projects headed by the \$796 million Schools for the 21st Century modernization program.

"We are already feeling the sector's reactivation with the school-modernization program," local AGC chapter President José Nolla said. "The Infrastructure Finance Authority has already awarded \$130 million in contracts and work has already begun on 27 schools throughout the island. They have a hectic schedule and the goal is to impact 100 schools. We will be recommending the government allocate more funds to this program, because it has really revived a construction industry that was depressed."

Nolla also noted the \$400 million Vía Verde natural-gas pipeline project is important for contractors and for the island's economy, as it will not only require many human resources in many fields, but will also cut greenhouse emissions and reduce our petroleum dependence.

"It is vital that we stand behind and back this project once it gets all the necessary state and federal permits," Nolla added.

Meanwhile, housing developers remain focused on reducing their excess inventory of unsold new dwellings by promoting their development projects and the government's housing-stimulus program.

During the last four months of 2010, the housing-stimulus program moved \$900 million worth of mortgage closings, or 6,000 units, of new and existing homes, up \$200 million from the same period in 2009. In addition, the Housing Finance Authority's COMBO Program originated \$1.56 billion in housing sales or 11,620 units with an average price of \$134,000.

"Last year, there was a lot of movement of existing homes, which was good, because it needed to happen to promote the move-up market," said Hans Moll, president of the Puerto Rico Homebuilders Association. "We are aware there



has to be growth in employment, and we can help the population grow through job growth."

Another concern is that while real-estate values have gone down, construction costs continue to go up. The issue is further compounded by a newly enacted energy-construction code that will drive up the costs of building the next generation of housing even more.

### HEALTHCARE

Government statistics have shown Washington currently spends \$7 per senior citizen, while it spends only \$1 per child.

Louis Sullivan, who served as U.S. Health Secretary under former President George H.W. Bush Sr. said, during a recent visit to the island, "We are living in an age in which we are witnessing the changing face of the United States due to demographic changes that are reshaping this nation in relation to racial diversity."

The population in Puerto Rico, as well as in the mainland U.S., is living longer, reproducing less and developing chronic conditions that are costing the government millions of dollars.

Approved this past March, the Affordable Care Act (ACA), puts in place comprehensive health-insurance reforms that will hold insurance companies more accountable, lower healthcare

costs, guarantee more healthcare choices and enhance the quality of healthcare for all Americans.

Through Medicaid and ACA, Puerto Rico will be receiving \$6 billion dollars through 2019 via the federal health reform, which will support changes in the local healthcare system.

### INSURANCE

Ramón M. Ruiz-Comas, President & CEO of Triple-S Management Corp., said the local insurance industry's main challenges this year will have to do with the slow economic recovery.

"This will obligate companies to innovate and look for new ways to grow," Ruiz-Comas said.

In addition, Juan Terrassa, chairman of the board & CEO of Puerto Rico Medical Defense Insurance Co. said the tendency of the insurance industry will be to continue reacting to the excess of capital capacity of reinsurance companies on a global level.

"This will benefit consumers, because there will be increased supply and a reduced demand due to the contraction of the global economy," he said, adding that Puerto Rico will profit because the cost of property insurance, the principal component of subscribed premiums in the market, is highly competitive.

### MANUFACTURING

It is still uncertain how manufacturers, particularly multinational pharmaceutical and medical-device operations on the island, will change their business practices in reaction to Law 154's excise tax on production sold to offshore affiliated companies. While executives from drug- and medical-device makers have remained quiet, U.S. and local trade organizations representing these corporations say several have put their island expansion plans on hold to evaluate the excise tax's costs. They are also waiting for a U.S. Internal Revenue Service ruling on whether the excise tax qualifies as a creditable foreign tax for U.S. federal income-tax purposes, which had not been issued as of press time.

Nevertheless, the Treasury Department has reported that several corporations are applying for commonwealth tax credits included in Law 154 regulations that can be applied against the excise tax if such corporations meet certain conditions involving gross-sales receipts, taxable acquisitions, purchases from local suppliers and investments in research & development. Trade groups have acknowledged that the credits mitigate the impact of the tax somewhat, but they maintain that the commonwealth's credibility has been damaged by the backhanded

Continued on page 24



Continued from page 23

way the tax was approved and that will weigh on investment decisions in 2011 and beyond.

### TRANSPORTATION

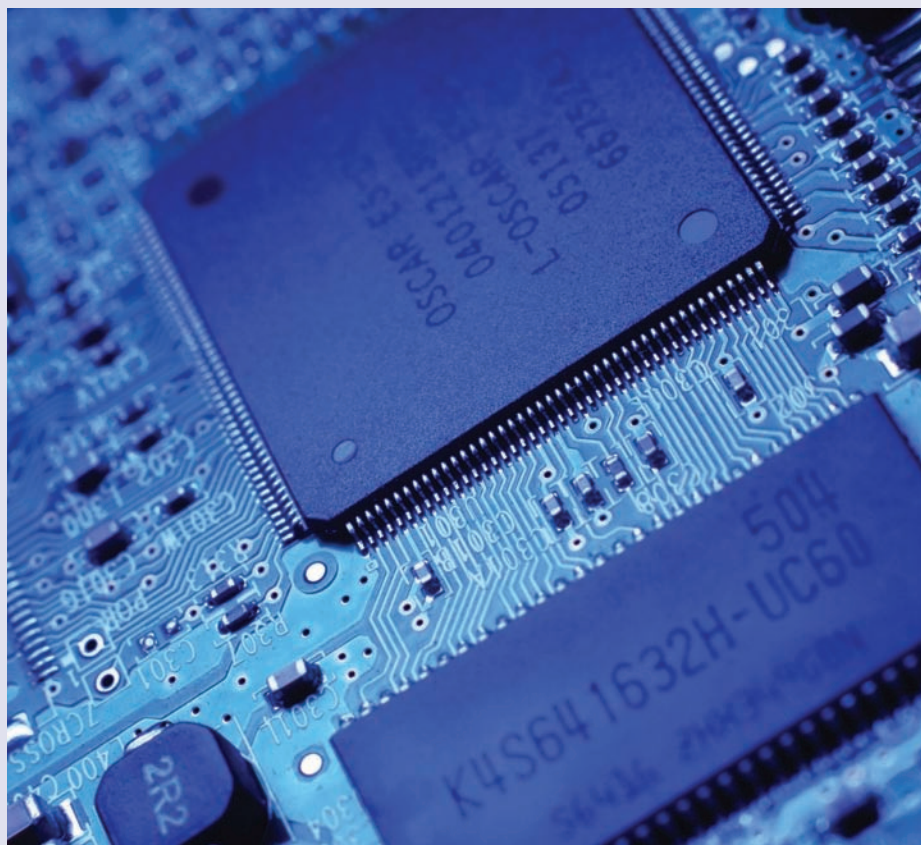
Despite a fairly positive 2010 for the transportation industry in terms of volume, which reflected a small increase, opinions differ in the industry about what to expect in 2011.

"We are expecting a small increase next year over 2010," Hernán Ayala, president of the Puerto Rico Shippers Association (PRSA) said. "We are waiting to include the volume numbers of the last three months of this year to our economic model, and will have a better picture by February."

Many in the industry are under the impression that last year's small volume increase was the result of inventories going too low because companies stopped purchasing during 2009 and had to replenish during 2010. Most don't see those circumstances applying this year.

### RETAIL

Unlike some economic sectors, executives from the island's retail and commerce industry are looking ahead with cautious optimism. Such guarded optimism is attributed to the recent arrival of stores like Pet Smart, TJ Maxx and CVS, soon to be followed by the opening of Target and P.F. Chang's, among others. Economic Development & Commerce Secretary José R. Pérez-Riera said this speaks to the administration's tough economic decisions made during the past two years, which have put the island's retail and commerce sector on the right track for economic recovery. Existing top retailers including Walmart, Walgreens and Puerto Rico's own Pitusa, as well as the island's top shopping centers like Plaza Las Américas, Plaza del Sol and Barceloneta's Premium Outlets, are confident they will remain at last year's levels or slightly improve in 2011. If their projections materialize, Puerto Rico's retail industry will remain at the \$35 billion mark despite the fact that the economy is not yet showing the degree of improvement they'd like to see.



Meanwhile, proposed shopping developments from stateside developer Taubman (Plaza Internacional) and Venezuela's Sambil conglomerate, with a regional mall slated for the Guaynabo market, promise to shake things up for the island's top regional mall, Plaza Las Américas.

"We are already seeing pockets of improvement in reported retail sales with a consistent upward trend," Pérez-Riera said. "Also, many of the economic-development reforms that have been accomplished—from tax reform to economic-development incentives—give Puerto Rico the right kind of economic infrastructure that enables us to go out to our mainland U.S. counterpart, as well as global markets, to promote the advantages of investing and doing business on the island."

The Economic Development & Commerce secretary is the first to admit that Puerto Rico's economy, while showing signs of improvement, faces another difficult year.

### TECHNOLOGY AND TELECOMMUNICATIONS

The quality and reach of broadband Internet service on the island will get a big boost this year with the recent Federal Communications Commission ruling allowing broadband service to be defined

as telecommunications for the purpose of receiving universal-access funding to subsidize service to low-income customers and those living in remote areas. Much faster broadband will be available locally as carriers hook up to a new fiber-optic cable link to Miami that was recently completed by island-based Critical Hub Networks, which last year received a \$25.7-million grant from the American Recovery & Reinvestment Act (ARRA) broadband-access program for this project.

Improvement in broadband service will support new smartphone and tablet technologies expected to arrive to the local market this year, as wireless carriers continue to target new and old customers for upgrades to the increasingly sophisticated devices merging telecommunications and personal computing. AT&T plans to follow T-Mobile's lead and launch fourth-generation (4G) service with the introduction of Motorola's Atrix, touted as the world's most powerful smartphone. Motorola's Android-powered Xoom tablet computer will also arrive early this year, along with several other tablets that seek to dethrone Apple's iPad.

### TOURISM

A long, cold winter for the U.S. mainland—where nearly 80% of

visitors to Puerto Rico come from—has helped jumpstart the year for the local tourism industry. The industry, which roughly accounts for 6% of the island's GDP, is positioned to benefit from the Tourism Co.'s strategic initiatives geared to spark demand and increase room occupancy, said Mario González Lafuente, executive director of the Puerto Rico Tourism Co. (PRTC), who said he feels optimistic about the direction in which the industry is moving.

"In addition to an early jumpstart with the winter season, ongoing efforts in boosting our airlift and overall access to our destination are beginning to pay off as we expand not only the number and frequency of flights from the mainland to Puerto Rico, but also attract new international airlines interested in Puerto Rico's strategic location as an important entry point into the U.S. market," he said. "Overall, the Tourism Co. expects 12 new flights will begin operating this year between the island and core mainland U.S. markets, along with new airlines from Colombia, México and Germany, as well as expansion from Puerto Rico's top European market, Spain, with two flights from Barcelona to the Aguadilla airport.

Moreover, the tourism chief said that from a development standpoint, the island's high-end luxury segment is officially underway with the opening of such prestigious new properties as the St. Regis Bahía Beach, the W Retreat Vieques Island, the Vanderbilt in Condado, slated to open this fall, and the 2012 opening of the Ritz Carlton Reserve, the first of its kind in the Americas.

"All of this comes at a time when new hotel construction is at a near standstill in most Caribbean destinations," González Lafuente said, while acknowledging that 2011 will be another challenging year for tourism, as it will be for all the other island economic sectors. "However, our marketing and promotional efforts are beginning to pay off by sparking market demand, which in turn helps local hotels increase room rates and move away from a price-driven position, which usually causes profit drain." ■