



# Puerto Rico's Economy: Looking Forward

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June 10, 2016

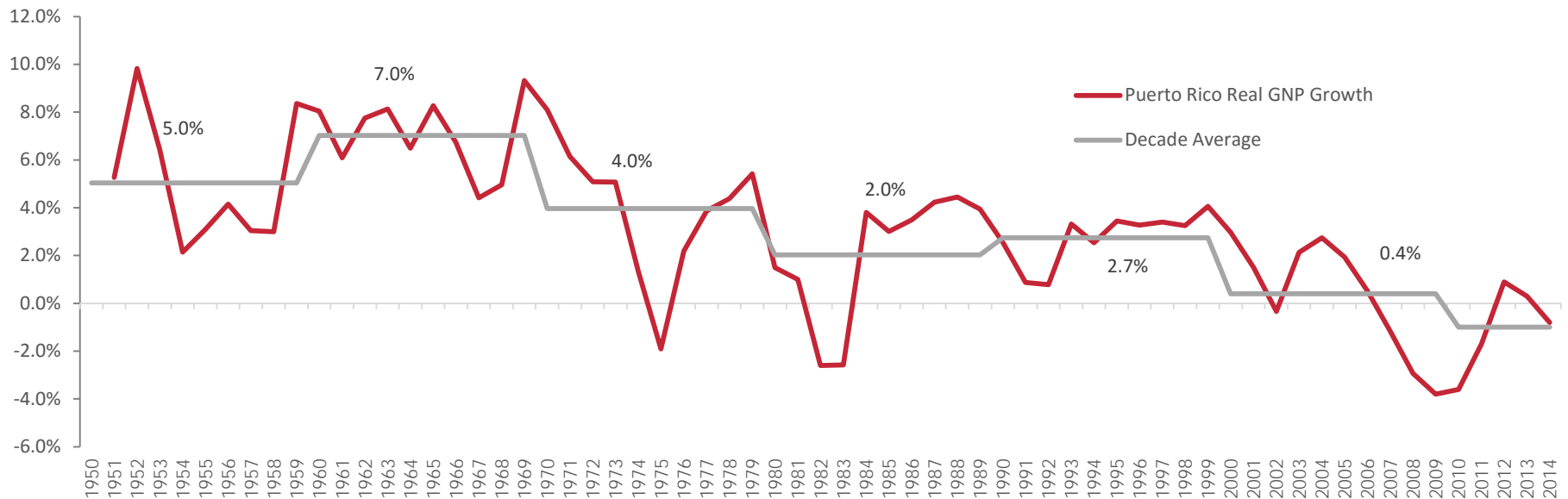
# Presentation plan



# Macro Economic Overview and Economic Prospects for Puerto Rico

# Long Term Trends

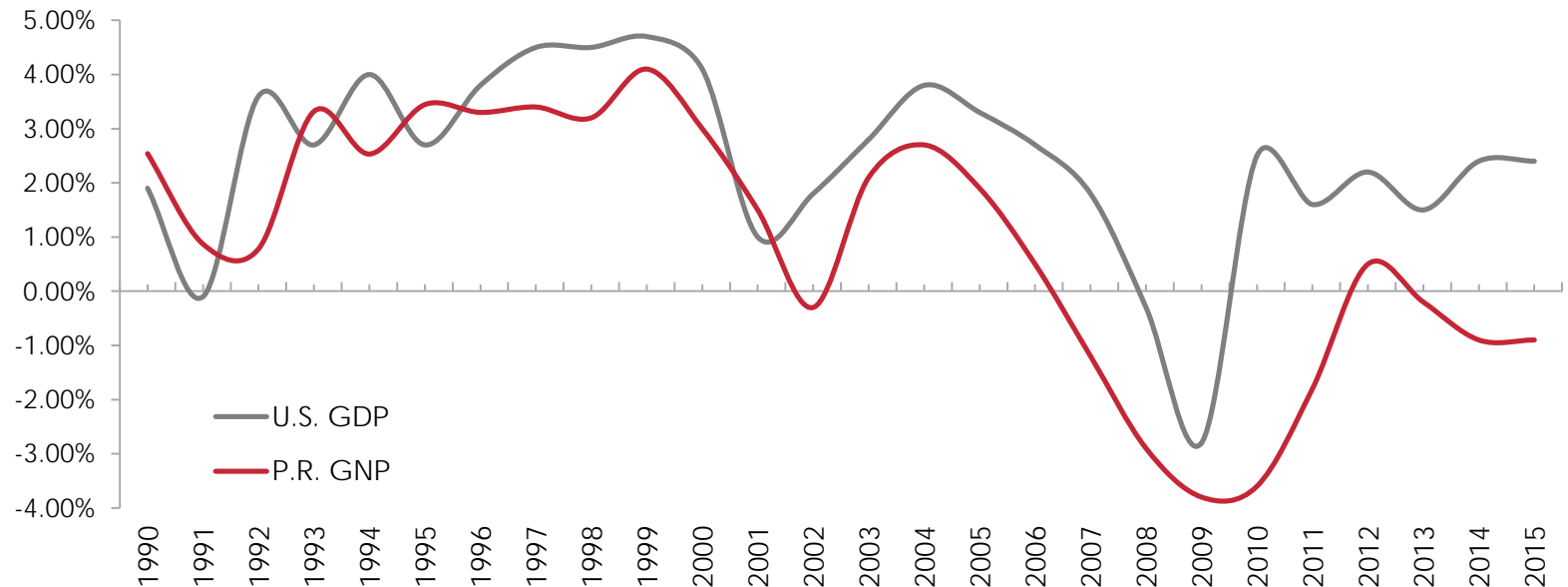
Over the past five decades: a collapse of the capacity to generate growth. The recent experience is clearly the culmination of a long process of economic decay. The following graph shows a rapidly declining rate of growth over the last six decades.



Major structural transformations have resulted making useless the traditional economic tool kit for dealing with recessions. This is precisely what the recent Plan for Fiscal and Economic Growth does and for this reason is bound to be ineffective.

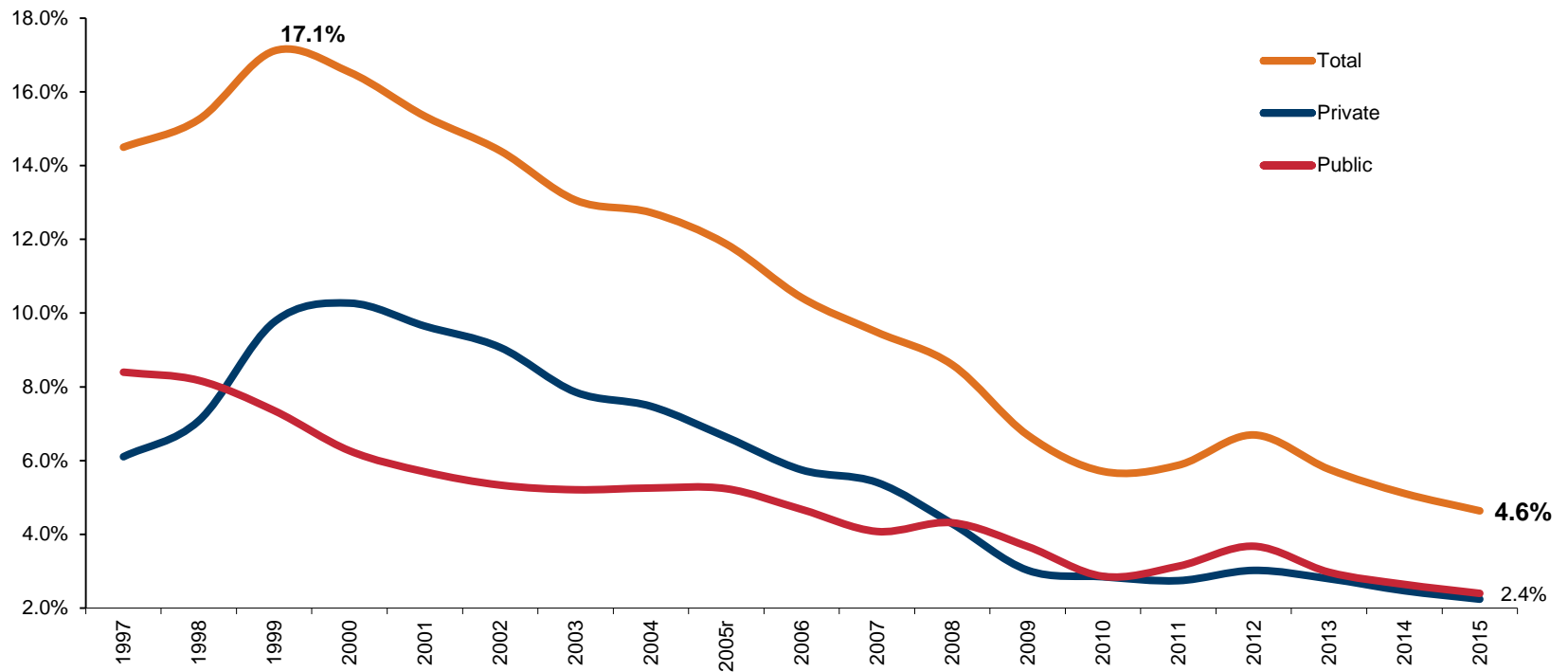
# GNP & GDP: Puerto Rico & U.S.

- The local economy has experienced secular deceleration in economic growth since the mid 1970s.
- Up to the late 1990s, the local economy's cycle was significantly correlated with the U.S business cycle.
- Since then, their growth paths have diverged.
- The underlying reasons leading to the U.S. recession in 2008 are fundamentally different from those that led to the start of the P.R recession in 2006.



Fuentes: Junta de Planificación (2015); U.S. BEA;

# Investment in Construction (I/GNP)



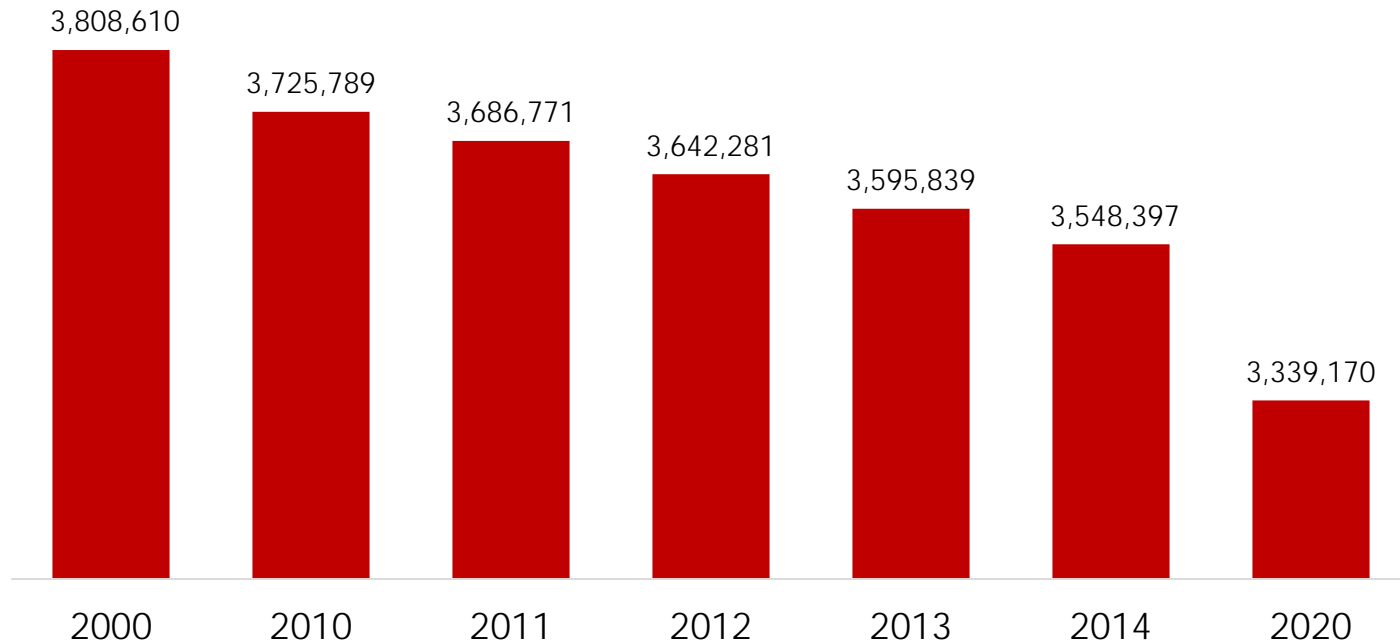
- Investment in construction fell from nearly \$7.0 billion to around \$3.4 billion.

# Private Investment in Construction

## Construction Investment - Private

	2005	2009	2010	2015	Change 2015-2005
Housing	\$2,062.80	\$1,099.40	\$996.10	\$571.40	-\$1,491.40
Other	\$1,578.30	\$823.50	\$834.50	\$1,316.50	-\$261.80
Total	\$3,641.10	\$1,922.90	\$1,830.60	\$1,887.90	-\$1,753.20

# Population



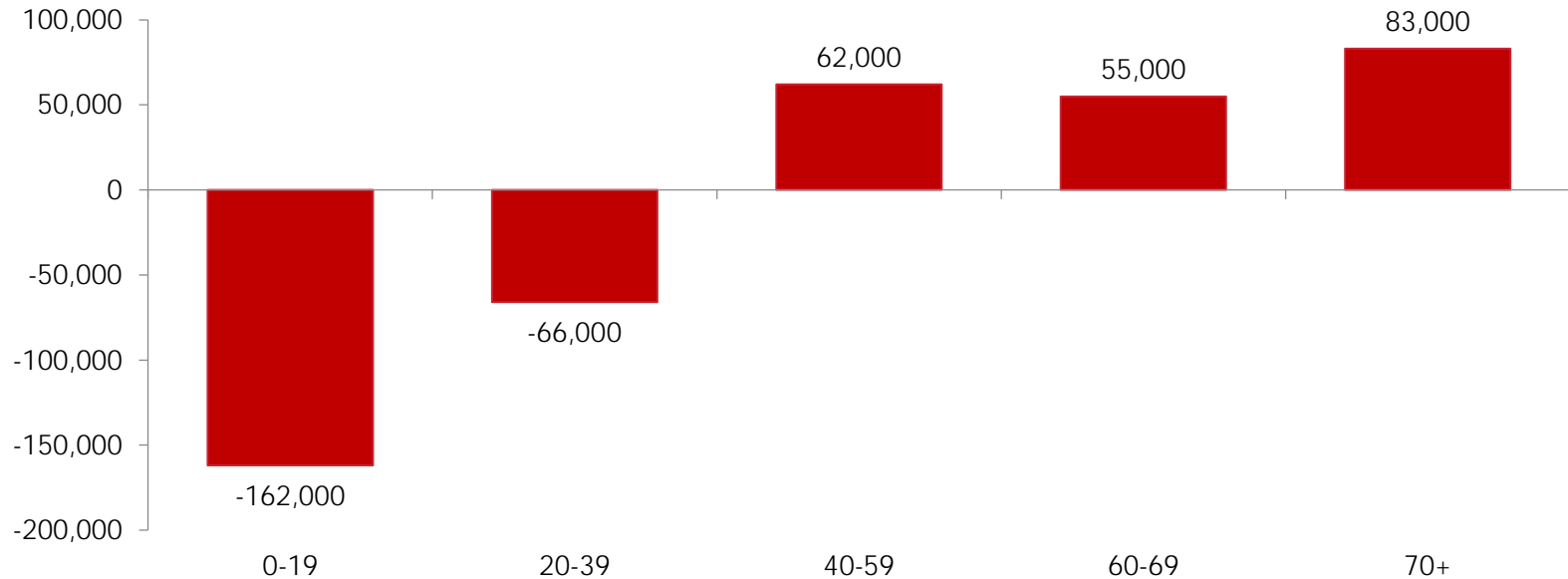
Sources: U.S. Census Bureau.

- According to the 2016 Community Survey, every municipality lost population with the exception of Gurabo (3.7%) and Toa Alta (0.1%).



# Population

Change in population by cohort 2010-2020



Source: U.S. Census Bureau.

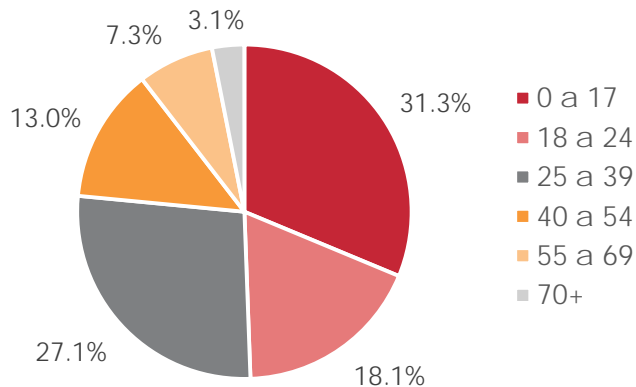
It is expected that the total population in **2020** will be 3.3 million

# Migration is more prevalent among younger populations

## Migrant Profile

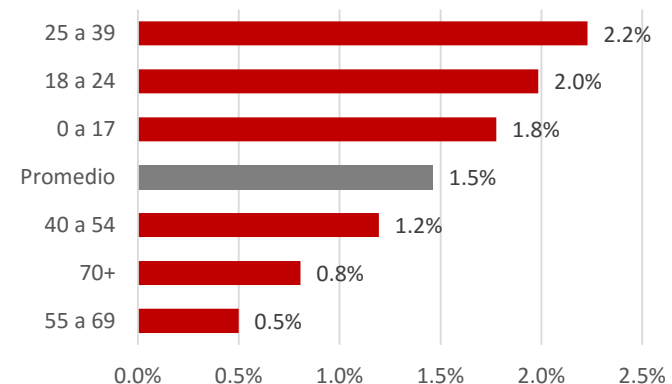
- Out of all immigrants, 49% are less than 24 years old.
- The probability of a young person migrating is twice that of someone 40 to 54 years old.

Net Migration  
By Age Group



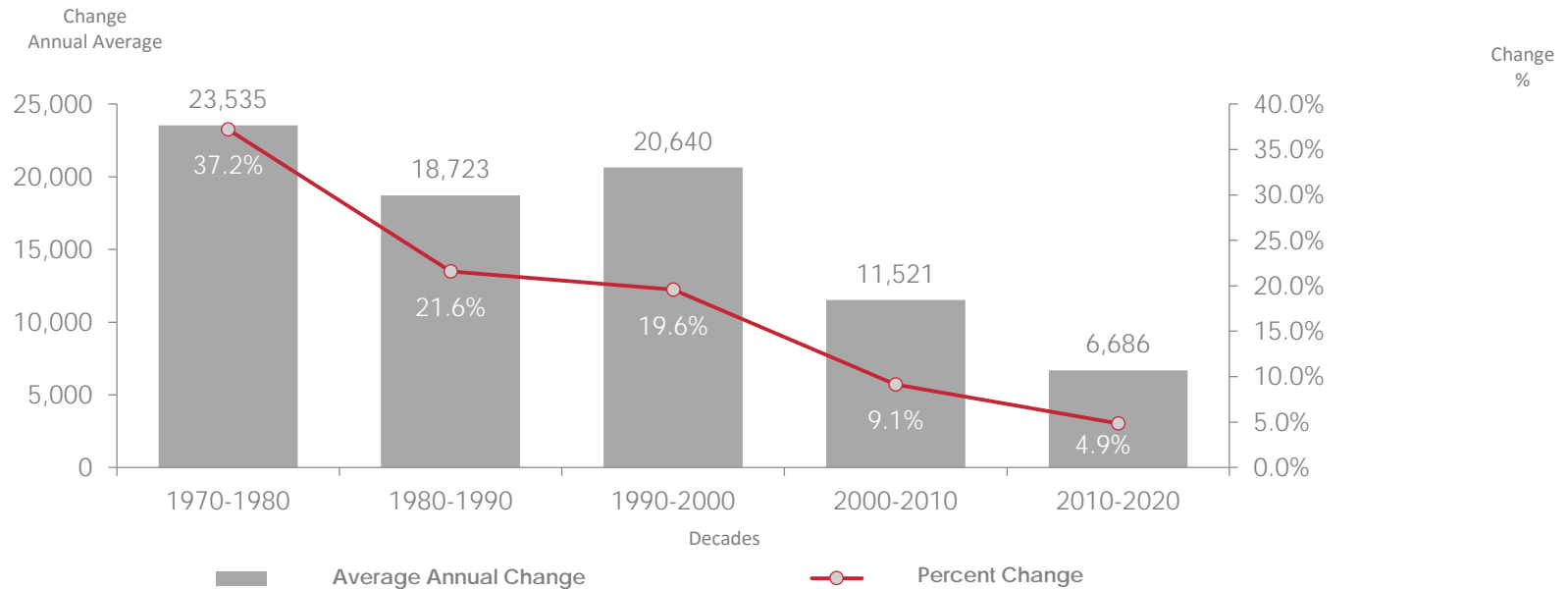
Source: Perfil del Migrante 2013, Puerto Rico Statistics Institute.

Probability by Age Group



# Population and Households

## Annual Household Formation 1970-2010 Historical



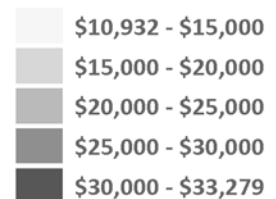
Sources: US Census Bureau 1970 - 2010. Estudios Técnicos, Inc. estimates for 2010-2020.

# Median Household Income, 2010

Highest incomes in suburban municipalities around San Juan



## Median Income

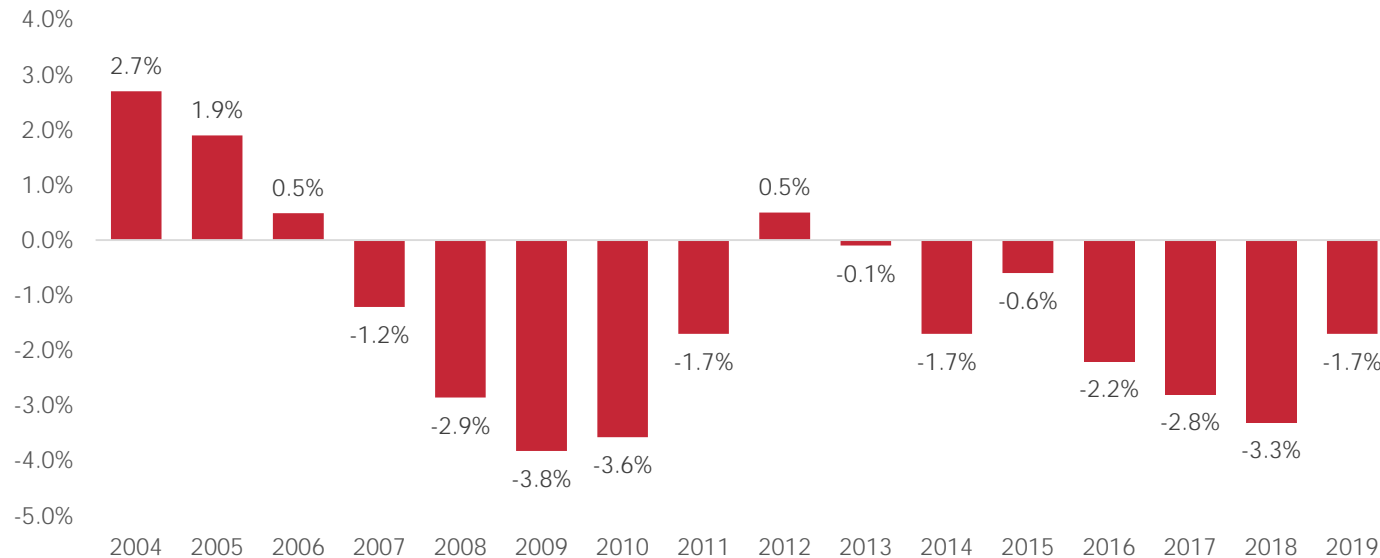


- San Juan Metro Area has the highest median household income.
- Guaynabo is the most affluent community.
- Inequality in income distribution is both a social and geographic problem.

# Annual Real GNP Growth for PR and its Forecast

(2004-2019)

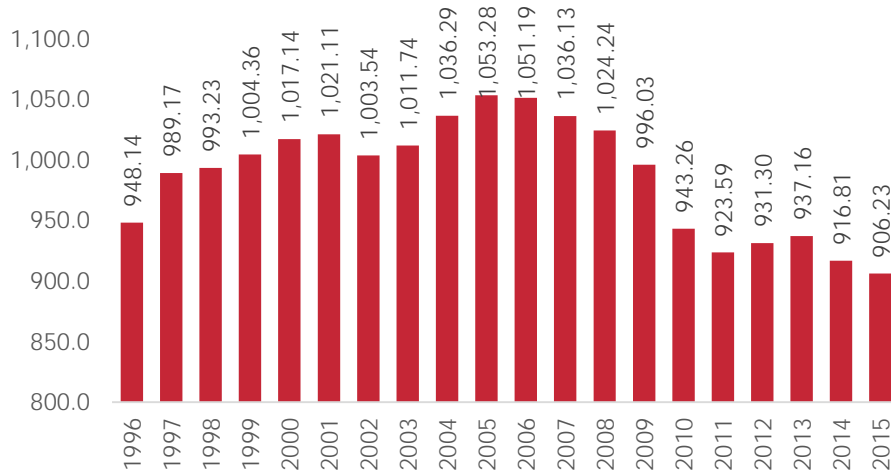
- The Government's role is no longer that of stimulating the economy. Its recent actions lead the economy in the opposite direction. The International Monetary Fund (IMF) projects contractions in the economy until 2021.



# Recent Trends

# Employment

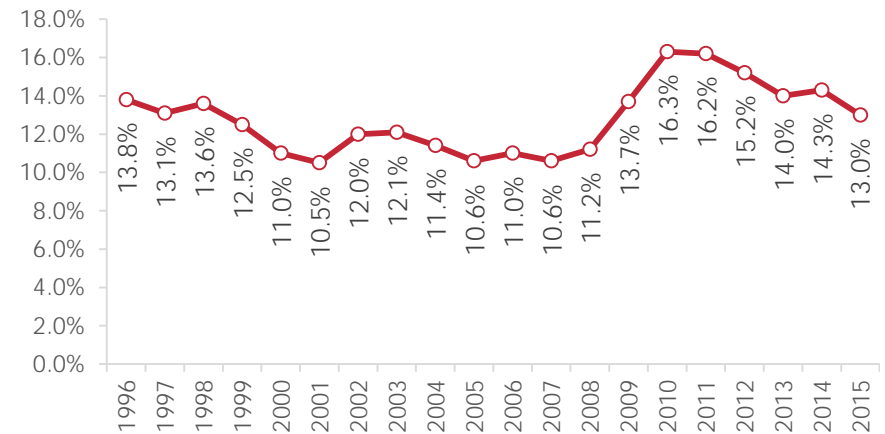
**Non Farm Salaried Employment**  
Total, 1996-2015 (in thousand)



Source: Negociado Estadísticas del Trabajo. División Estadísticas sobre Empleo

In April 2016, Non Farm Salaried Employment in Puerto Rico was 894,300.

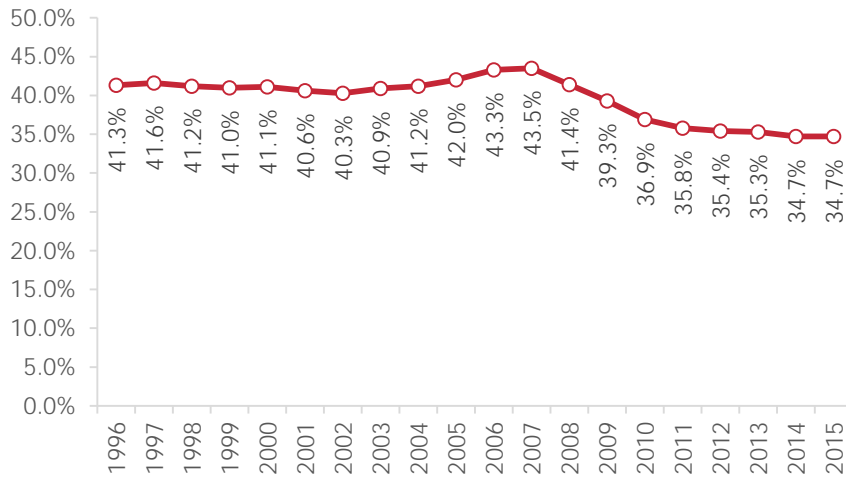
**Unemployment Rate**  
1996-2015



The unemployment rate in April 2016 was 11.4%.

# Employment

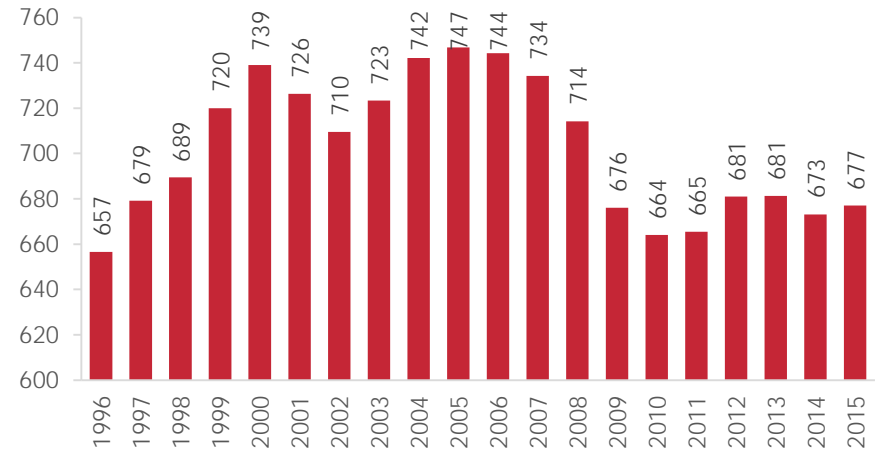
**Employment Rate**  
1996-2015



Source: Negociado Estadísticas del Trabajo. División Estadísticas sobre Empleo

In April 2016 the employment rate was 35.9.

**Private Employment**  
1996-2015 - thousands

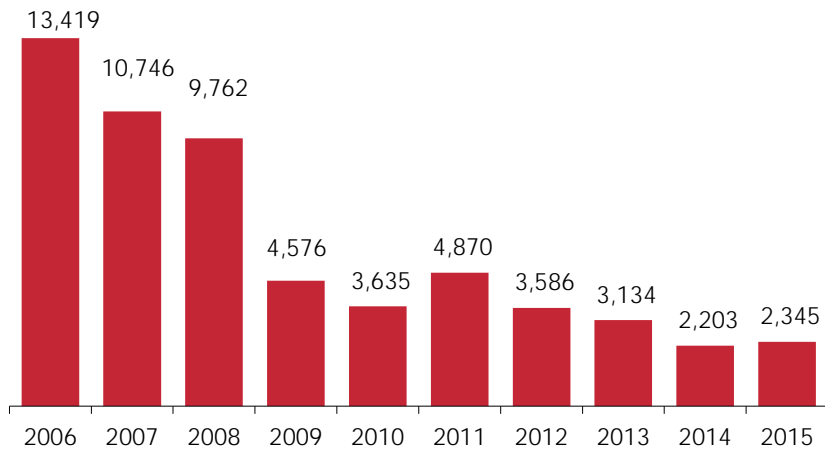


Private employment in April 2016 was 661,800.



# Sales of New Housing Units

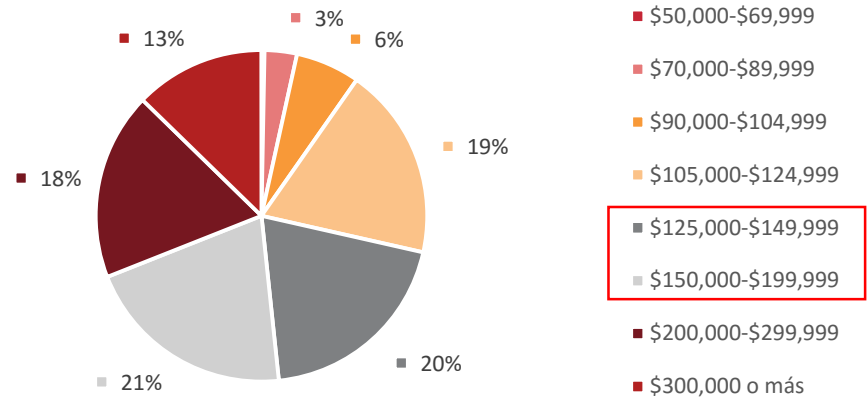
Number of Units



Fuente: CSAR, Estudios Técnicos, Inc.

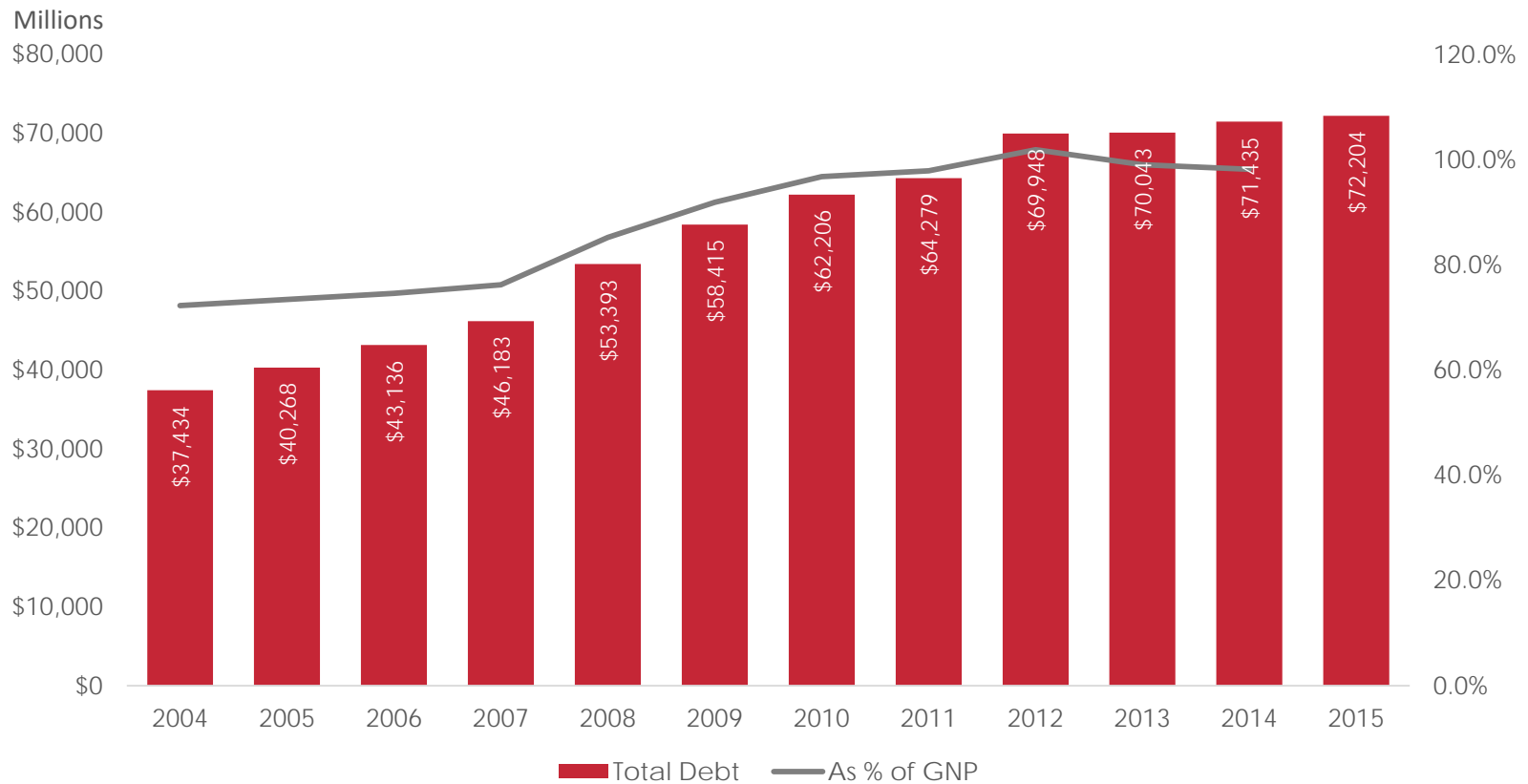
Sales in the first five months of 2016 averaged 200 units per month.

By Price  
CSAR 2015



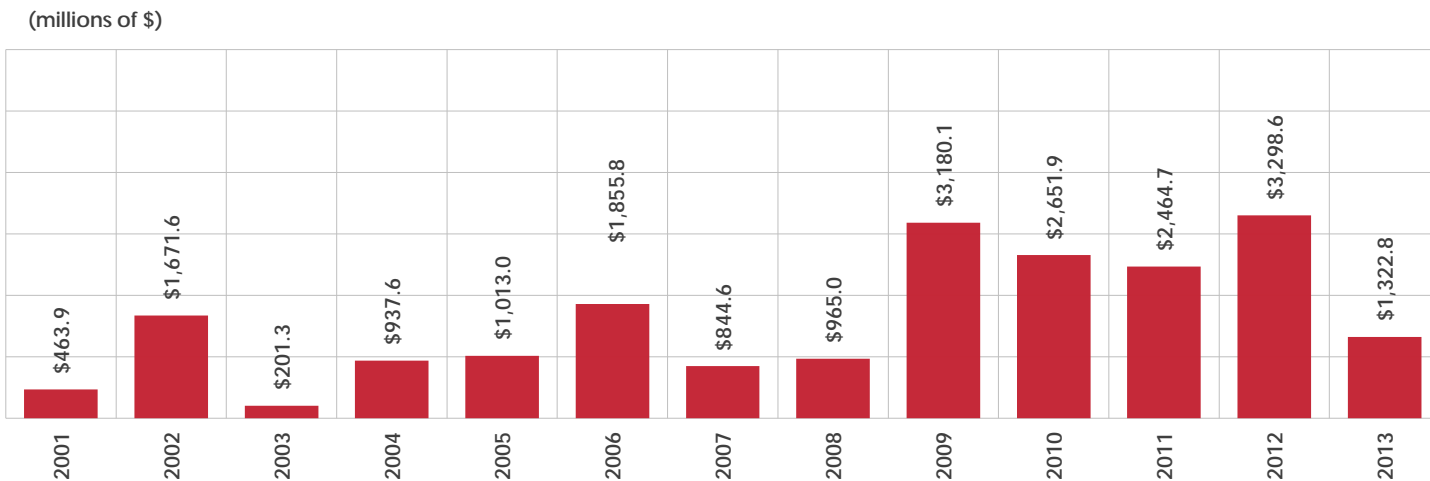
# Fiscal Issues

# Total Government Debt and as % of GNP



# Fiscal Deficits

Fiscal Years -- 2001 to 2013



Sources: Office of Management and Budget (2015). *Budget Petition (various years)*. Office of Management and Budget (2015). *Approved Budget Fiscal 2015*. The fiscal 2015 statistic corresponds to the estimated cash flow deficit upon the fiscal year's closing (May 20, 2015).

From 2001 to 2013, accumulated Budget deficits exceeded \$20 billion, during this same period \$42 billion in debt was issued, half of which went to cover budget deficits.

# Why the fiscal crisis?

- Upcoming debt service payments in July, 2016 of \$2.0 billion. Default is almost inevitable.
- Puerto Rico's economy stopped having endogenous capacity to promote growth in the seventies.
- Four factors covered up this condition: federal transfers, Section 936, a large underground economy and government expenditures.
- Between 2001 and 2012, \$42 billion in new debt was issued and this permitted the Administrations to "kick the can down the road" ...until we came to a dead end in 2013.
- By 2001, S&P had already signaled concerned and Moody's in 2004, both with negative outlooks.

# What could have been done differently?

Since January 2013, not acting quickly has made a difference and has greatly reduced the Government's room for maneuver.

## **Some specifics**

The GDB loan to ACT for \$2.0 billion was clearly a problem in January 2013, yet the Bill to deal with the problem was submitted in November, 2014 when the GDB's liquidity situation had deteriorated significantly.

The tax reform process that should have begun in 2013, did not commence until mid-2014 and was not ready until early in 2015.

Dealing with the debt issue and the financial markets did not begin in earnest until 2015, although some initial initiatives did take place.

The local Financial Supervisory Board, created by Law last year, should have been put in place much earlier and, in fact, the Governor announced its creation a number of months before submitting the needed legislation.

# Options for the debt issue

## Moratorium on principal payments

GO bondholders have offered to postpone principal payments for five years and make an investment of \$750 million. COFINA bondholders proposed that during fiscal 2017 no IVU/IVA receipts need be deposited in the COFINA Trust, generating in excess of \$500 million in cash flow and reduced payments until 2021. A group of Cooperatives has made a proposal with some of the above conditions and using the point of entry price not faced value for negotiations.

## Superbond

GDB has proposed issuing a new bond to substitute for existing debt with a haircut of 40%, extended maturities and including some specific conditions for local bondholders.

# HR 5278

- The Bill approved by the House Committee on Natural Resources has yet to be adopted by the full House. If approved it will then move to the Senate. Amendments are certain to be made before full approval by Congress. Full approval before July 1st. is doubtful.
- If it were approved and becomes Law before that date, the July 1st. default would not be avoided, but no litigation would occur against the government.
- HR 5278 was unavoidable given the incompetent management of Puerto Rico's finances for many years. It could have been avoided if:
  - Early in 2013 the debt and liquidity problem had been addressed
  - A well designed tax reform put in place in early 2014
  - The Gross Receipts Tax not been eliminated in December, 2014
  - The Administration hadn't waited almost two years to submit legislation on the PRHTA loan from GDB
  - The Legislature had approved the Bill as submitted, making it possible to deal with the GDB's liquidity problem
  - The possibility for a moratorium on principal payments had not been discarded outright.



# HR 5278 (cont.)

- The Fiscal Control Board has one primary objective and that is to assure payment of the Government's bonds. This means almost certainly a severe austerity program that will push back Puerto Rico's economic recovery and could stimulate further out-migration by impacting social programs.
- The debt restructuring process is so cumbersome and requires that so many conditions be met, that it is unlikely that it will occur within the time framework outlined in the Bill.
- Title III, Section 314 includes the conditions necessary for an adjustment of government debt. It makes clear that the Plan of Adjustment must be "in the best interest of the creditors...". Only the Board is authorized to put together a Plan of Adjustment, and submit the Plan to the Federal District Court.
- There is no local "Plan B" for the various distinct variations in results that the Board's orientation could generate.

Looking Forward

# The Restructuring Process

## Some Numbers



No one expects housing to reach the same level of sales that it enjoyed in 2006, **13,000** new units. Likely levels will be nearer the 2014 level of some 2,200 units for the foreseeable future.



Much of the construction industry, for example, is not only **smaller**, but has disappeared completely. Reviving the industry will require major structural measures not marginal ones.



The banking sector now has roughly **40% fewer** assets than in its peak year of 2005, although it is now profitable.



**250,000** jobs **lost** since 2005 and major shifts in the labor market have taken place.



A major impact of a **shrinking population** and economy is on physical infrastructure planning, with excess capacity developing in some of the major infrastructures, PREPA, for example, but also the Department of Education.

# Long term prospects

- Obviously, moving the economy back to a path of high growth rates will not be easy given the erosion of human, economic, financial and social capital and the need to reconstitute an institutional framework that is not functional with present and prospective economic and social needs.
- Economic culture has become a defensive culture related to the fact that the economy has become a market share economy.
- In the public sphere, the political system has become what Acemoglu and Robinson (*Why Nations Fail*) call an “extractive” political system, one in which maintaining itself in power takes precedence over resolving society’s problems. Further the political system has become an economic sector and the political class an economic class.
- Turning around the cultural context reflected in the above, particularly with respect to the political system, will take time and leadership, most likely from Civil Society.
- An open economy that has shrunk and in which its institutional framework has been severely weakened faces greater risks from external shocks. This requires that risk management assume a central role in economic policymaking.

# Long term prospects (cont.)

- There is a need to focus on those structures that can be transformed in a relatively short period and that can be instrumental in breaking the negative spiral that has characterized the economy.
- Puerto Rico's approach to development policies has been characterized for decades by a short term operational bias. Given the risk environment for the Island, the absence of resources and the structural deficiencies that have resulted from the prolonged and deep economic contraction, the change to a strategy and risk based decision-making approach is essential in order to minimize the Island's risk profile and advance medium and long term economic perspectives.

# Long term prospects (cont.)

Major structural ruptures have resulted in the Island's demographics (including size, age composition and geographic distribution), its economic structure, labor markets, government and even the spatial distribution of economic activities.

Even culture, understood as the set of norms that regulates everyday life, including economic aspects, will have been impacted.

Reconstructing the various "infrastructures" (physical, institutional, social, cultural, etc.) that have been impacted by the prolonged interplay of a shrinking economy and population is a much more difficult task than putting in place market correction initiatives.

# What can we expect?

- The U. S. Economy will grow but at a slower rate in the next two years.
- It is reasonable to assume that austerity will prevail over stimulus and that certain programs will be eliminated or downsized.
- The Global economy will reflect mixed performance with the advanced economies growing at modest rates in the next two years and the BRICS slowing down. Latin America's growth will almost certainly continue but at much slower rates. Brazil, the largest regional economy is in a deep recession and faces increased turmoil.
- Overall, oil prices will remain at historically low levels for this and the following year, but a modest increase is to be expected.
- China's economic presence will partially substitute that of the U.S. in the Middle East, Africa and Latin America, although its recent difficulties will impact Chinese expansion abroad.
- The practice of U.S. firms finding better tax environments will continue, but legal efforts to stop the "inversion" process will almost certainly be adopted. The CFC's are threatened by proposed changes to the U.S. tax code.
- The risk of an increase in the Fed's interest rate has been reduced by recent performance of the labor market.

# What can we expect?

## In Puerto Rico:

- Continued fiscal difficulties with the threat of a major default in July, 2016, now almost certain, without HR5278.
- A prolonged period of litigation is foreseen, with one case already in Federal court questioning the legality of the “clawback”. The GDB has still to present a truly new negotiating position, preferring the “superbond” offer with minor recent modifications.
- PDP candidate for Governor, David Bernier, has presented a proposal for a five year moratorium on principal payments, guarantying the payment of interest. The rationale for the measure is that it will permit a sufficient timeframe for negotiating a permanent agreement on the public debt.
- With respect to the tax system, a suspension of the VAT has been legislated, as well as freezing the B2B tax on services at 4.0%.
- High energy costs will remain for the foreseeable future, even with low petroleum prices, and may increase as a result of debt negotiations and expected petroleum price increases.
- The 2016 elections will take precedence in defining policy initiatives.



# Thank you!



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