



PUERTORICO  
CREDIT  
CONFERENCE  
2011

# Redefining Fiscal Policy to Foster Economic Growth

*Carlos M. García*  
*Former Chairman of the Board  
and President of the Government  
Development Bank*

*April 8, 2011*

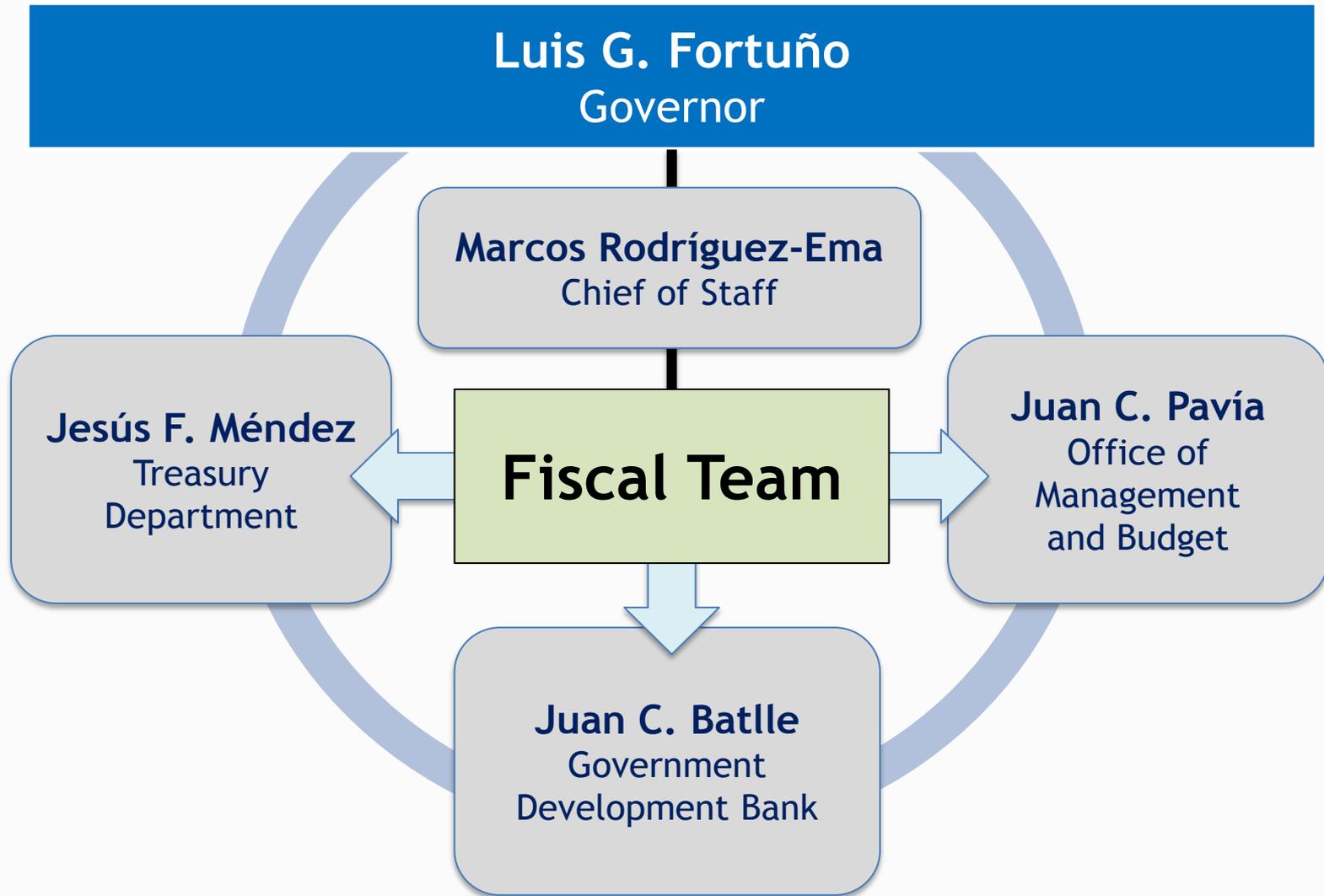


## Disclaimer

Today's presentation includes certain statements that are not historical in nature. These statements are based on the Government of Puerto Rico's current beliefs regarding future events, and are based upon a number of estimates and assumptions that are subject to significant uncertainties, many of which are outside the control of the Government of Puerto Rico, its agencies and instrumentalities. This presentation has been prepared solely for informational purposes, and should not be construed as a recommendation to buy or sell any security or to participate in any particular trading.



Fiscal team is focused on continuing the path and vision of fiscal discipline set forth by our Governor





# Experienced team formerly occupying critical roles in this Administration...

Years of experience  
in Financial Industry

**Marcos Rodríguez-Ema**  
Chief of Staff-Governor's Office  
and GDB Chairman

- GDB President from 1993-1998
- Managing Director, Chase Securities Puerto Rico
- SVP Corporate Financing - Drexel Burnham Lambert

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**Juan C. Batlle**  
President  
Government Development Bank

- Managing Director, Santander Securities Corp.
- President & CEO, Santander Asset Management
- Member of Board of Directors of several public corps.
- While at Santander, served GDB for more than 12 yrs.

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**José R. Otero**  
EVP - Financing  
Government Development Bank

- Deputy Chief of Staff, Governor's Office
- Advisor to the Governor for Economic Development
- Director of Inst. Investing, UBS Consulting Services
- Member of this Administration for 2 years

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**Jesús F. Méndez**  
Secretary  
Treasury Department

- Executive Director, Public Buildings Authority
- EVP - Operations, Government Development Bank
- Member of this Administration for 2 years

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**Juan C. Pavía**  
Director  
Office of Management and Budget

- Executive Director, Fiscal Reconstruction Board
- EVP - Fiscal Agent, Government Development Bank
- Member of this Administration for 2 years

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## Agenda

1

**Redefining Fiscal Policy**

2

Understanding our Economic Architecture

3

The next Frontier: A Strong Private Sector



# Governor Fortuño Administration Goals

## Government Principles

“We are going to awake the economic power of our private sector; put the government to work within its budgetary means; and alleviate the punitive tax burden on our working class.

These will be our first priorities, and the principles in which we will base our government.”

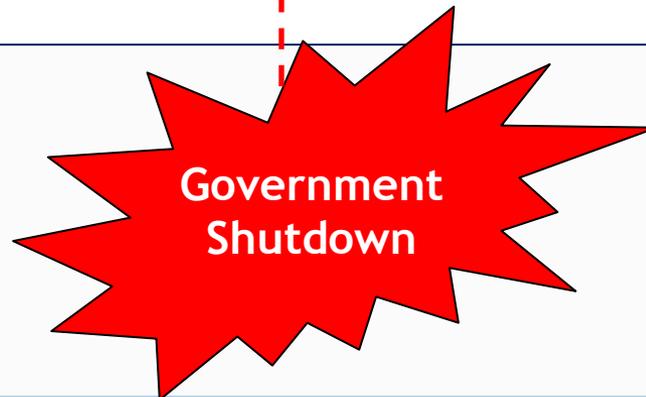
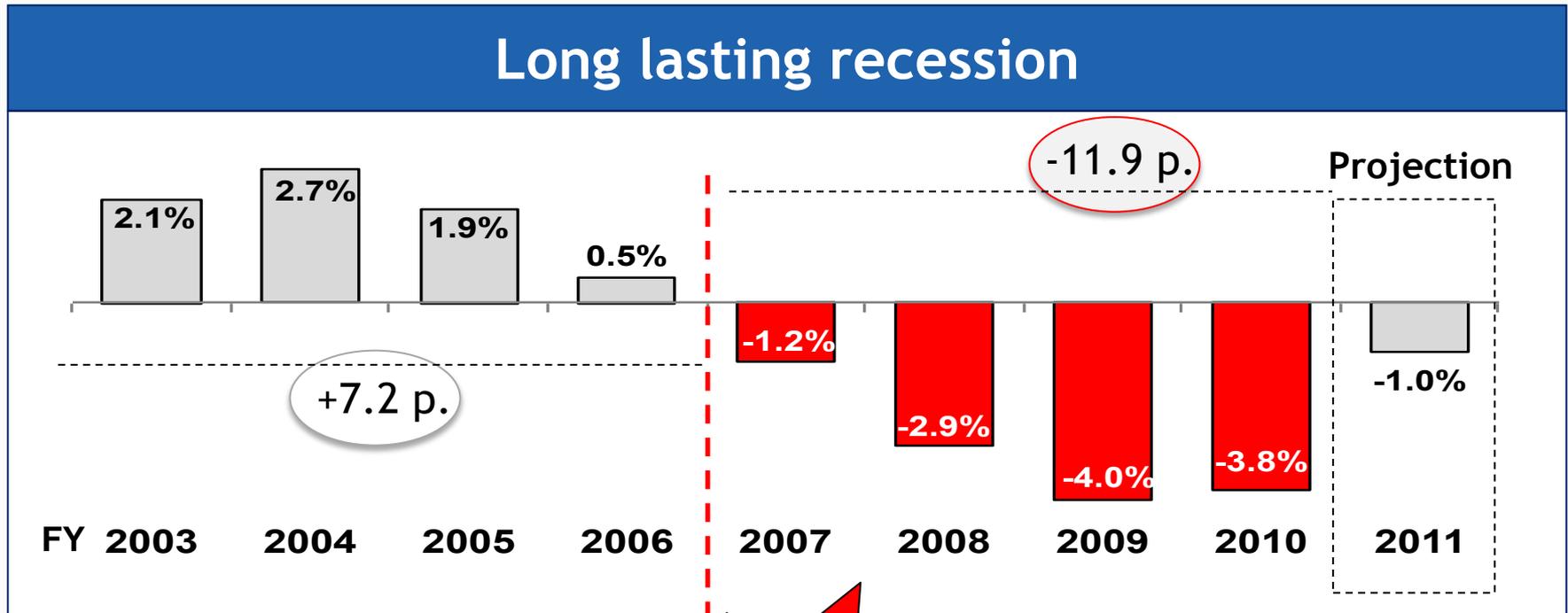
-Luis G. Fortuño



**What you face... can change  
your plans, but not your goals**



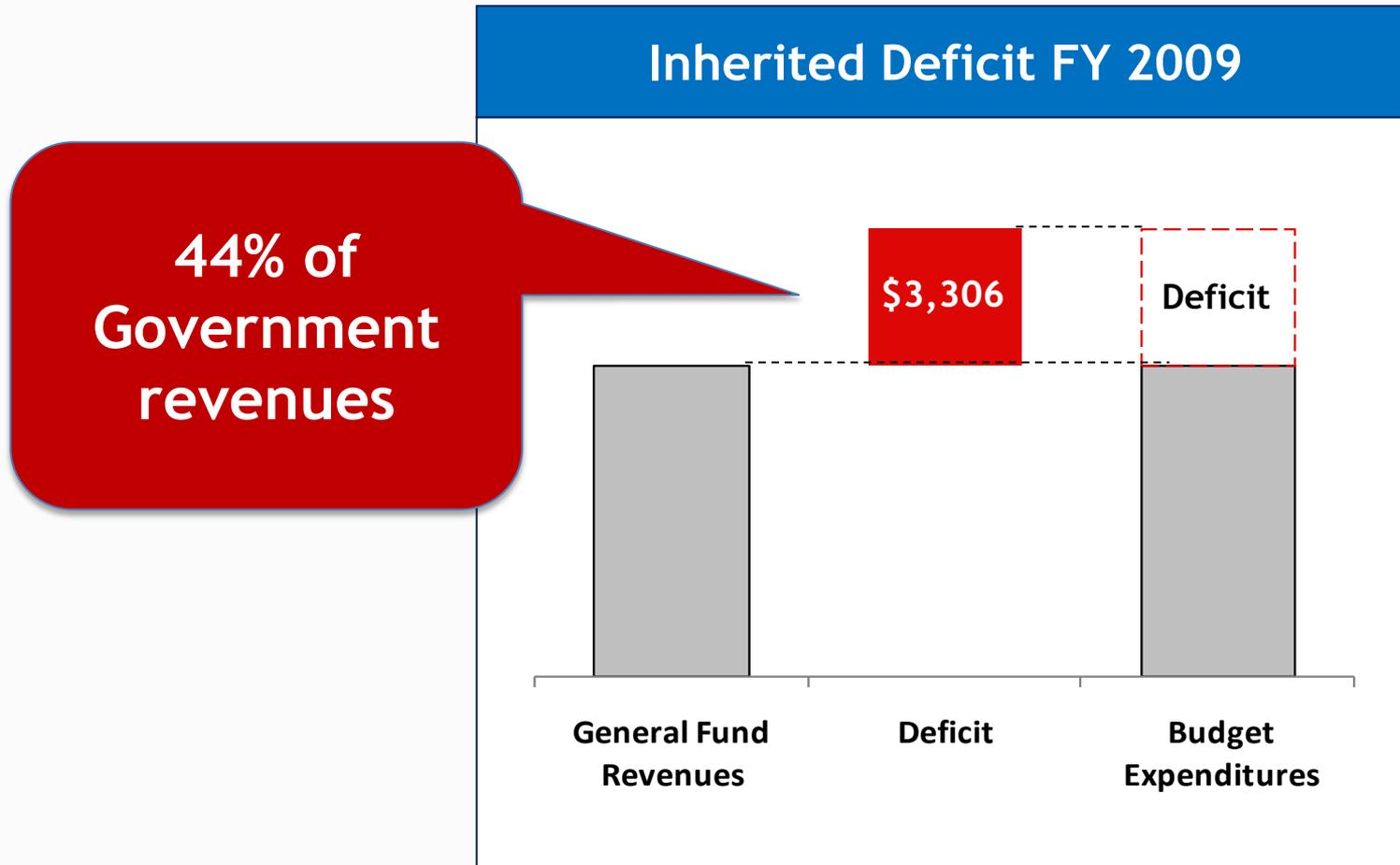
# Unattended recession that resulted in a “Lost Decade” of no growth...





# A Government without expense controls, facing a \$3.3 billion deficit...

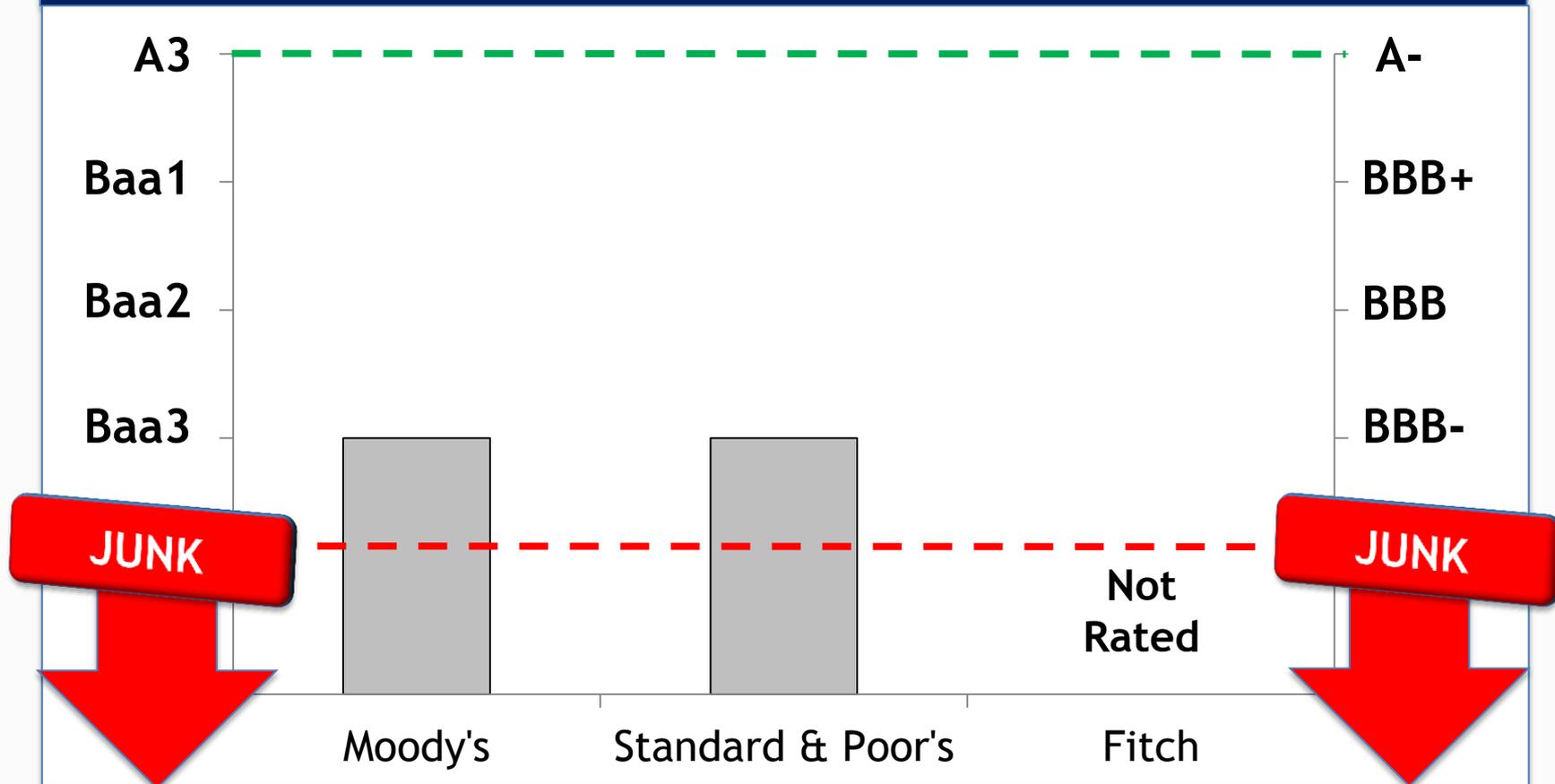
(in \$ millions)





# ...with Puerto Rico's credit on the verge of JUNK status

## Central Government Credit Rating (General Obligation)





# What we did...To address the Problem

## Pre-government Inauguration

Governor elected;  
Names Private Sector  
Advisory Council

Advisory Council  
Report; public and  
media out-reach about  
the crisis

Rating Agencies Visited

Inauguration

Nov

Dec

Jan

## Planning and Legislation

Executive Order #1: Declares  
State of Fiscal Emergency

Approval of 4 laws to reestablish  
cash for central government

Fiscal and Economic  
Reconstruction Plan  
designed

Fiscal Emergency  
Act approved

Jan

Feb

Mar

## Implementation

Establishment of Fiscal  
Restructuring and  
Stabilization Board

Government workforce  
reduction by 21,000  
employees

Moody's upgrades to A3

S&P assigns  
positive outlook  
and then  
upgrades to BBB

Mar

Sept

Apr

Nov

Mar

2008

2009

2010-11



# Fiscal Restructuring & Stabilization Board implemented the Plan and maintained government expense controls



## Fiscal Restructuring & Stabilization Board

- The Board was composed by:
  - President of Government Development Bank (**Chairman**)
  - Secretary of Treasury
  - Director of Office of Management and Budget
  - Secretary of Department of Labor and Human Resources
  - Secretary of Economic Development and Commerce Department
- Its main purpose was leading the cost reduction initiatives to in Government expenses
- The Board maintains constant meetings to monitor expense control measures at the central government level



# How we cut government expenses?

- 10% pay cut for the Governor and 5% for agency heads
- 10% cut in operating expenses, including official vehicles, cell phones and credit cards
- 30% reduction in political job appointees
- Freeze on all salaries and all economic clauses in collective bargaining agreements for two years
- 15% cut in contracts for consulting, legal services and lease contracts
- Shrank government employee ranks by 21,000 through an orderly voluntary and mandatory process
- Fund but maintain closed-out defined benefit pension plan and move to a performance based defined contribution plan for new government employees



# Once you have your arms around the problem... How do you effect change?

## Applied Principles:

- 1** Unyielding political commitment, execution capabilities and continuous follow-up are as important as the plan itself for its success
- 2** The implementation of long-lasting transformational reforms requires leadership and teamwork between the executive and legislative power
- 3** Focus first on tackling competitive disadvantages while caring for socio-economic needs
- 4** Tax burden reduction is the fastest way to implement income re-distribution and capital deployment when you are in a deep recession
- 5** Dare to do things differently and break with established and unchallenged long standing policy



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**Understanding our Economic Architecture**

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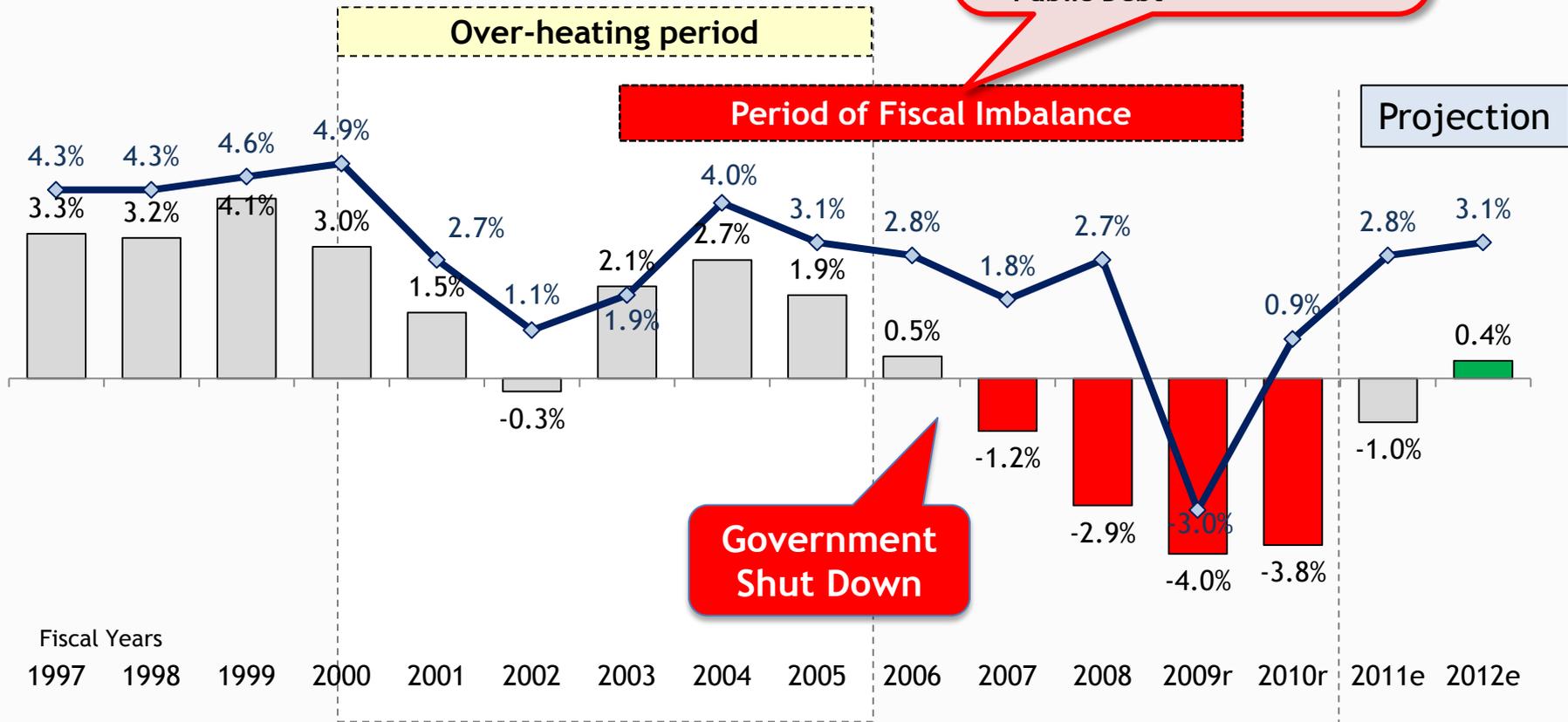
The next Frontier: A Strong Private Sector



# Puerto Rico entered an economic recession before the United States...

□ % of real GDP growth in Puerto Rico  
 — % of real GDP growth in the United States

- Government expenses increased 8% while revenues increased only 2%
- Accelerated increase in Public Debt



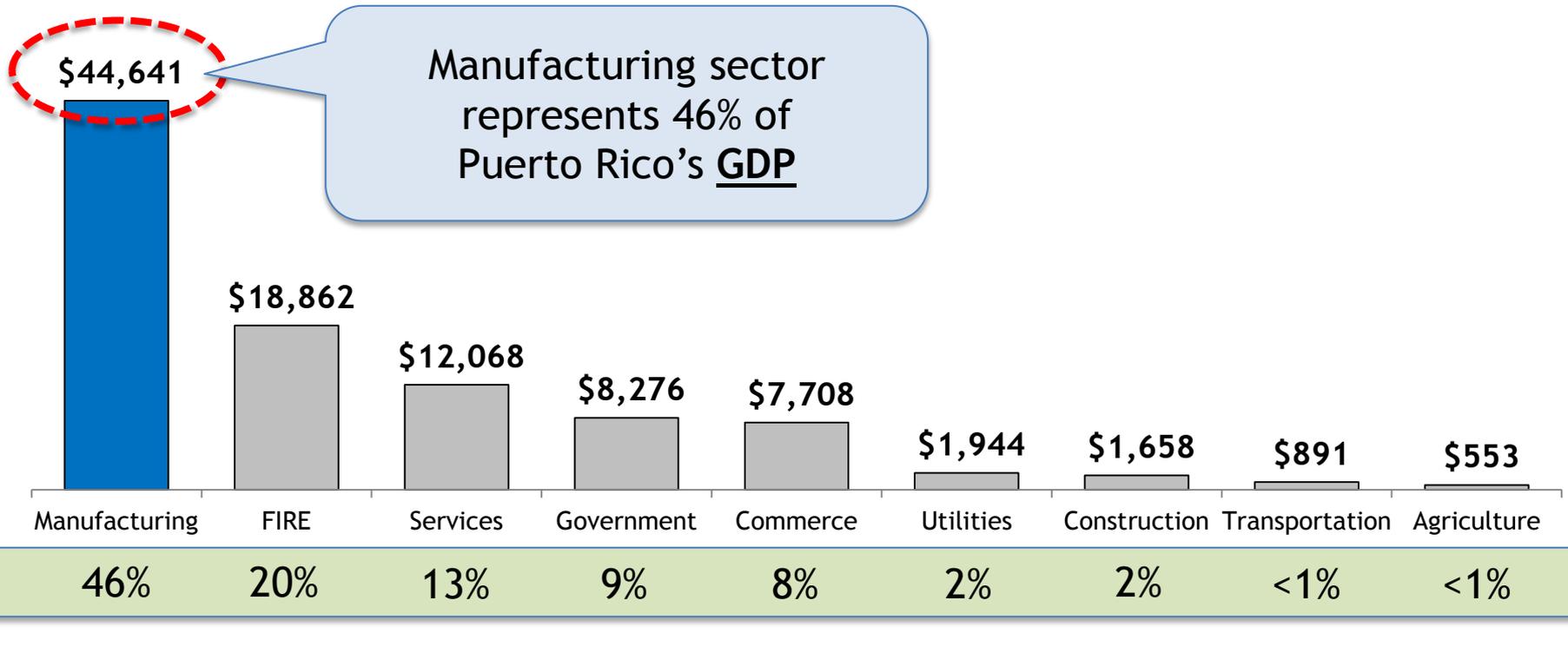
Source: Puerto Rico Planning Board



# Our manufacturing sector is an important component when considering Puerto Rico's Gross Domestic Product...

## FY2010 Gross Domestic Product \$96.3 Bn

(in \$ millions)



Source: PR Planning Board, March 2010, Economic Report to Governor 2010.

\* FIRE = Financial, Insurance and Real Estate.

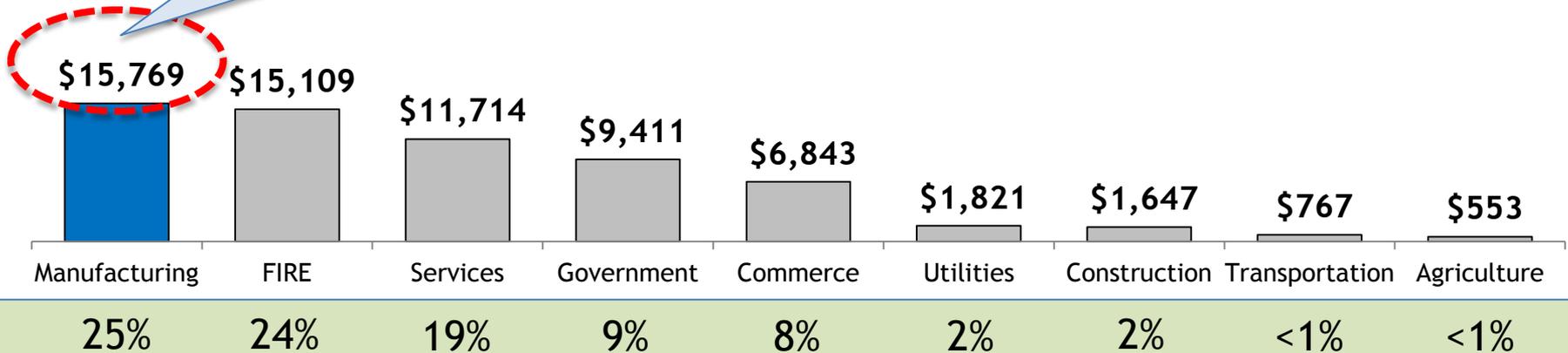


...however, income repatriation and price transfer strategies used by multi-national groups are reflected in our significantly lower Gross State Product

## FY 2010 Gross State Product - \$63.3 Bn

(in \$ millions)

Manufacturing sector represents 25% of Puerto Rico's GSP



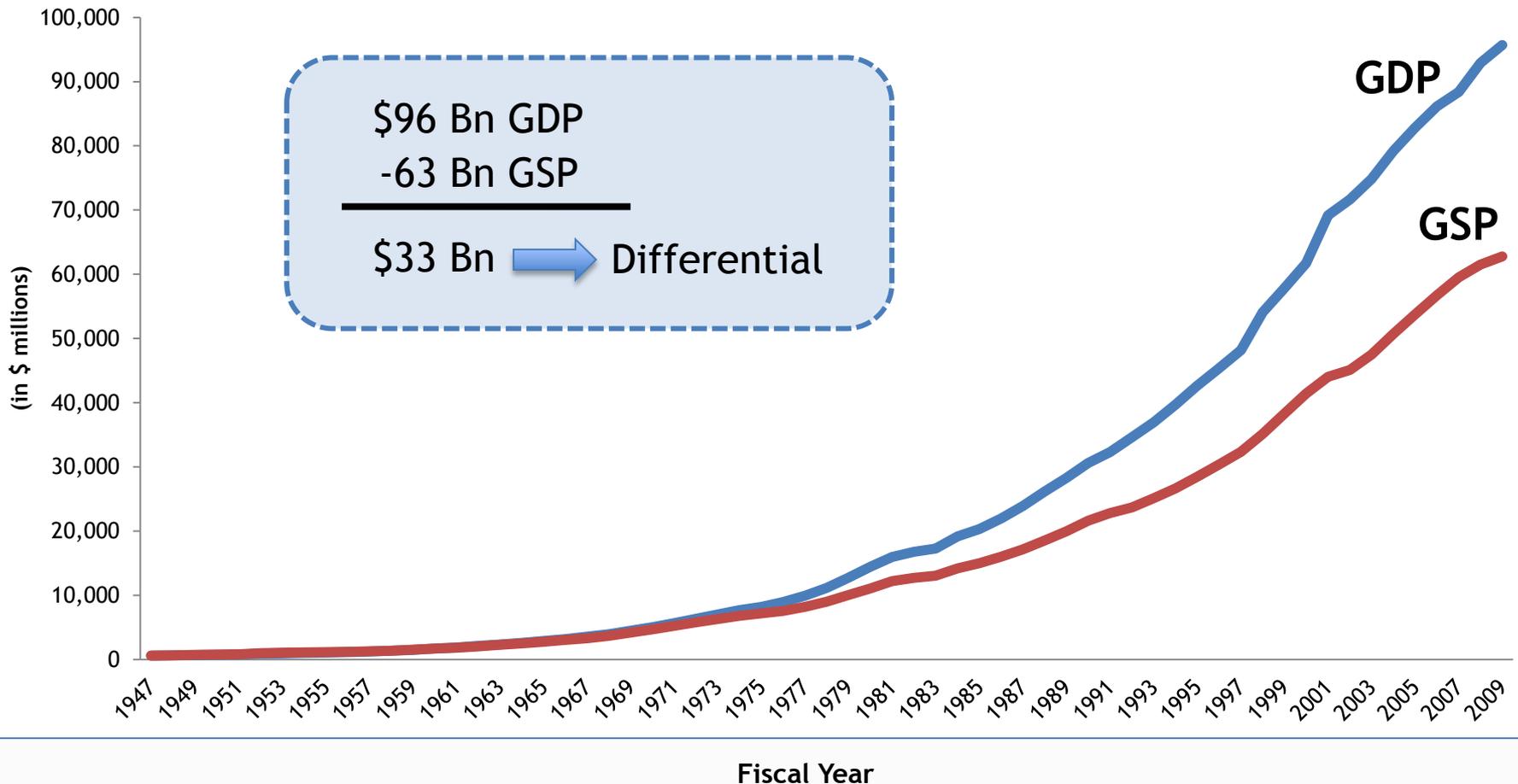
Source: PR Planning Board, March 2010, Economic Report to Governor 2010.

\* FIRE = Financial, Insurance and Real Estate.



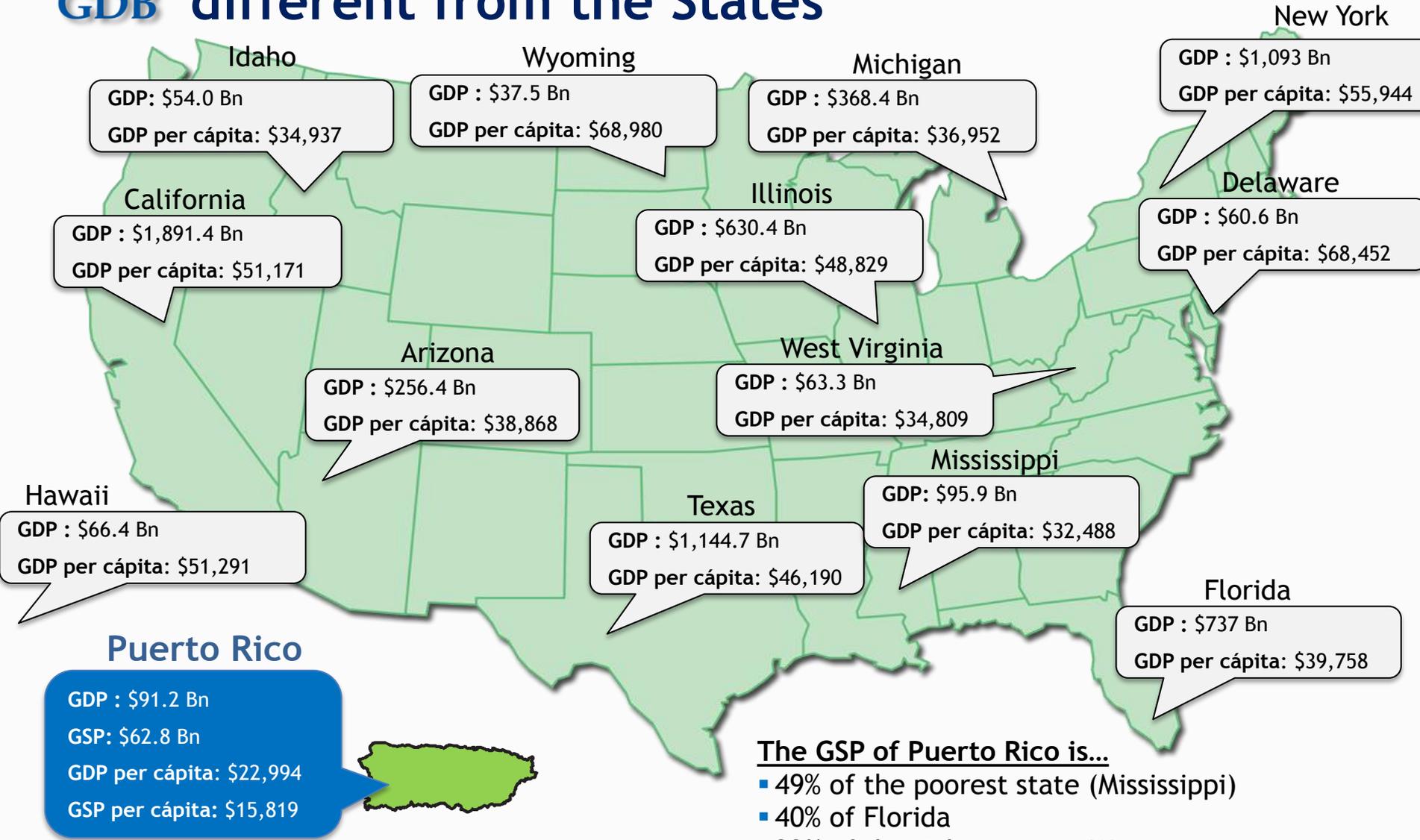
# Jurisdictions such as Puerto Rico, which are highly dependent on foreign investment, tend to have larger GDP than GSP

## Historical Comparison between GDP and GSP of Puerto Rico





# The economic base of Puerto Rico is very different from the States



- The GSP of Puerto Rico is...**
- 49% of the poorest state (Mississippi)
  - 40% of Florida
  - 23% of the richest state (Wyoming)

\* Data 2009, Bureau of Economic Analysis



# However, Puerto Rico has a superior economic base when compared to neighboring countries in the Caribbean...

Cuba

GDP: \$56.0 Bn  
GDP per cápita: \$4,892

Dominican Republic

GDP : \$46.7 Bn  
GDP per cápita: \$4,819

**Puerto Rico**

GDP : \$91.2 Bn  
GSP: \$62.8 Bn  
GDP per cápita: \$22,994  
GSP per cápita: \$15,819

Mexico

GDP : \$874.8 Bn  
GDP per cápita: \$7,865

Jamaica

GDP : \$12.6 Bn  
GDP per cápita: \$4,473

Colombia

GDP : \$232.4 Bn  
GDP per cápita: \$5,320

Venezuela

GDP : \$325.7 Bn  
GDP per cápita: \$12,146

Costa Rica

GDP : \$29.3 Bn  
GDP per cápita: \$6,580

Panama

GDP : \$24.9 Bn  
GDP per cápita: \$7,395

Brazil

GDP: \$1,574.0 Bn  
GDP per cápita: \$7,918

\* Data 2009, Central Intelligence Agency



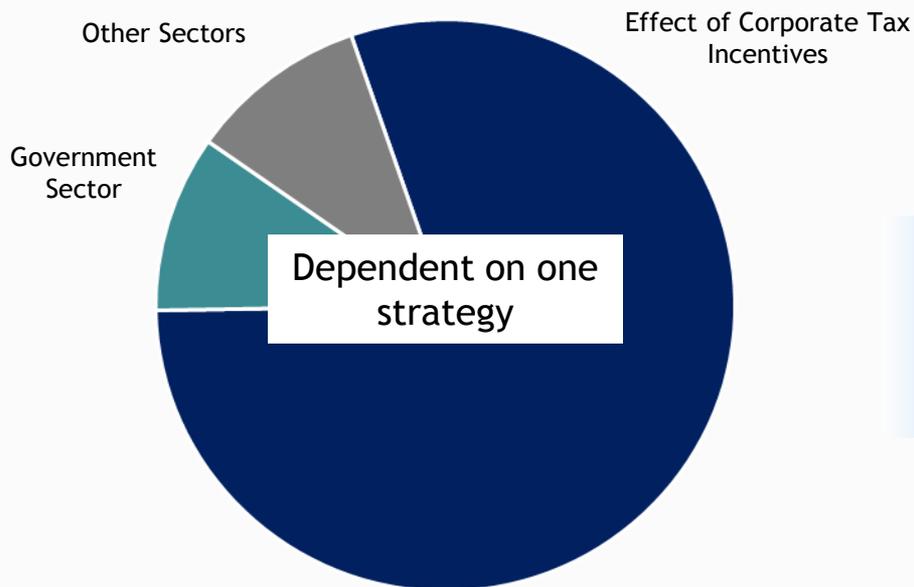
**For years, Puerto Rico has relied on an economic model that does not evolve, with no will to implement the necessary measures to change our course...**



# We are diversifying our economy, modifying the existing, obsolete model while promoting exportation and in doing so, increasing foreign investment...

## Past Model

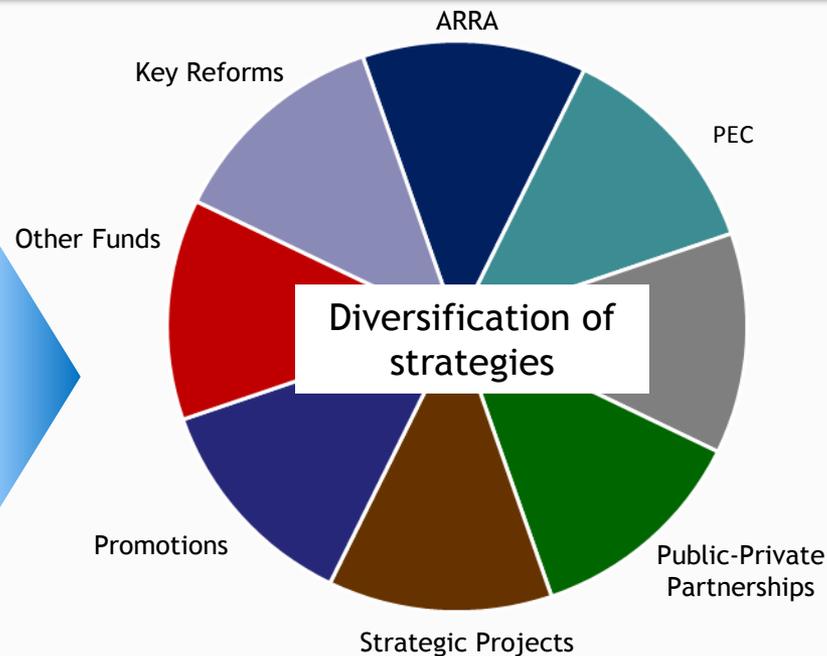
One Dominating Component



Model based on one primary strategy; corporate tax incentives; no diversification; high risk for negative future impact; a dominant government sector to compensate for the lack of working strategies

## New Strategic Model

Diversification reduces negative fiscal impacts



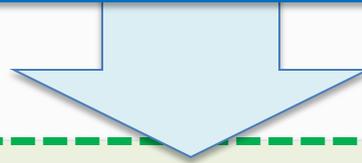
New model of diverse strategies and actions; distributed risk; smaller government participation and increased private sector involvement leads to dynamic economy; fiscal stabilization and better public policy implementation



# The prestigious Brookings Institution indicated the following in a study in 2006...

“Much of what is recorded as production in Puerto Rico is a simple paper transaction in which income is transferred to Puerto Rico and then taken back out as dividend payments to mainland corporations”<sup>1</sup>

-Barry Bosworth y Susan Collins (Brookings Institution)



A detailed analysis conducted by the Brookings Institution revealed that from 1987 to 2001, the proportion of return on capital to workers' compensation in the chemical sector averaged 10.5 in Puerto Rico versus 2.1 in the mainland.

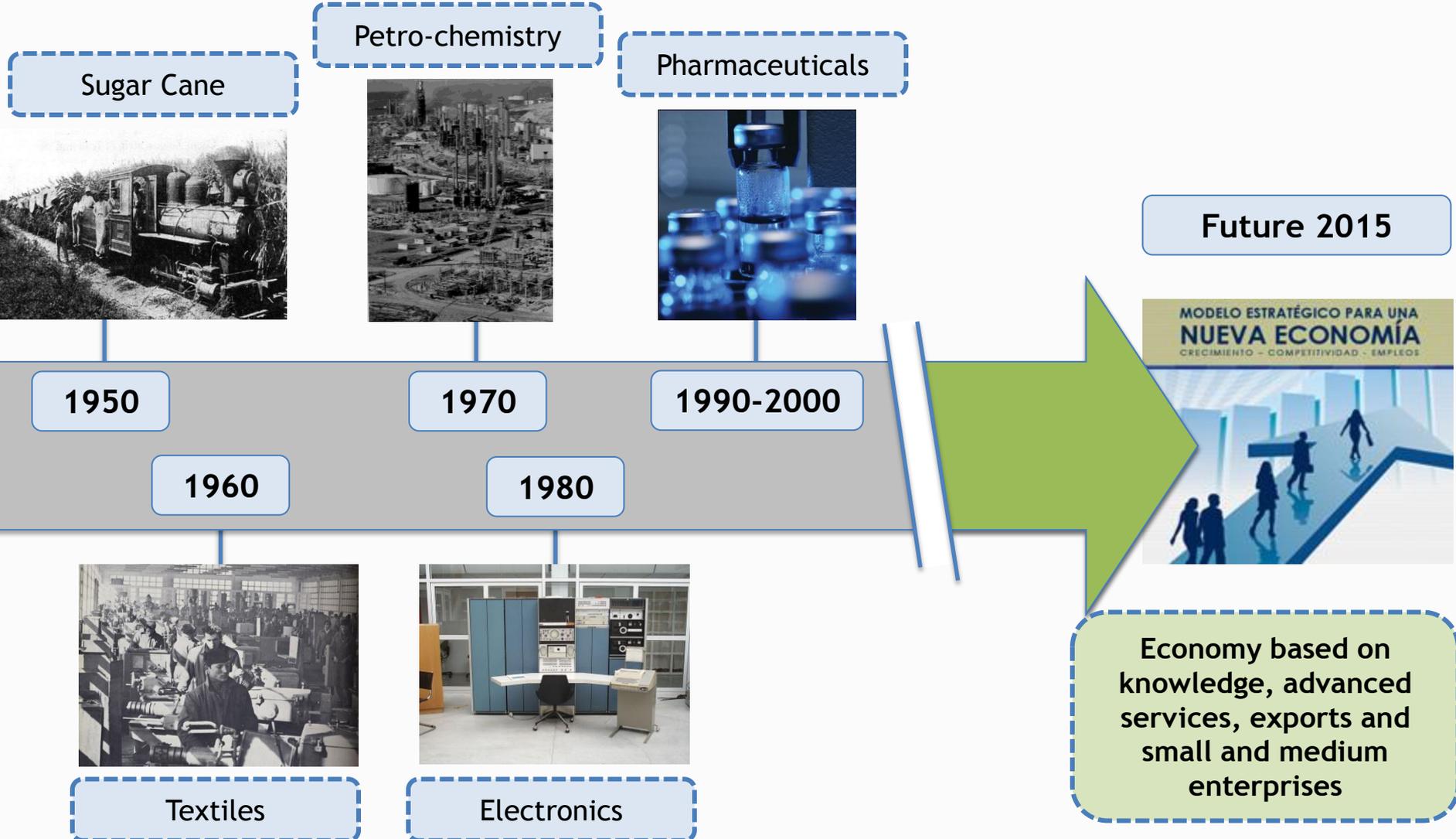
<sup>1</sup> Barry Bosworth and Susan Collins, “Economic Growth”, in *The Economy of Puerto Rico: Restoring Growth*, Susan M. Collins, Barry P. Bosworth, and Miguel Soto Class, eds., (Brookings Institution Press: Washington, DC, 2006), p. 28.



**To change a course you have  
to change your strategy and  
you must understand where  
every sector is in the  
economic life cycle...**



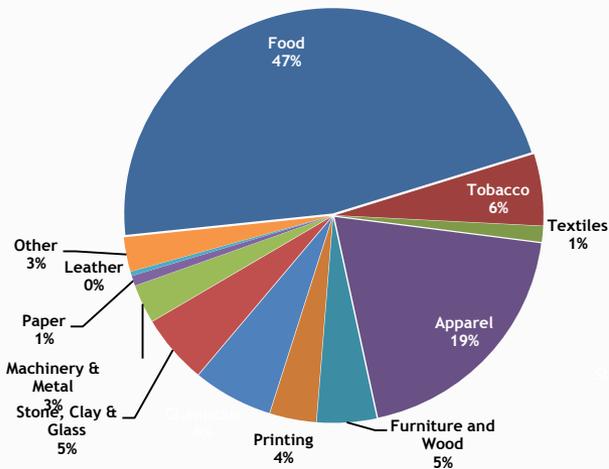
# Manufacturing sector in Puerto Rico has continuously evolved over the past 50 years



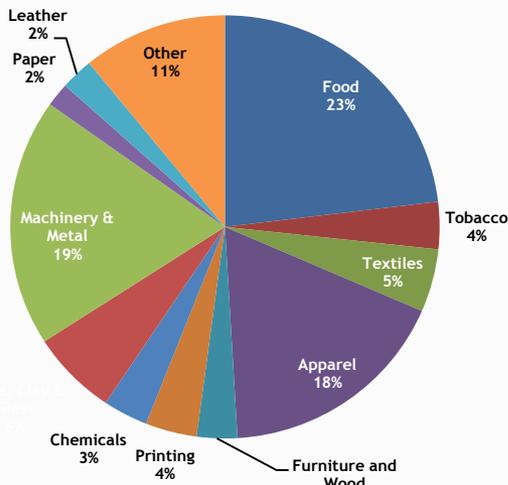


# Over the decades, the manufacturing industry has become increasingly undiversified...

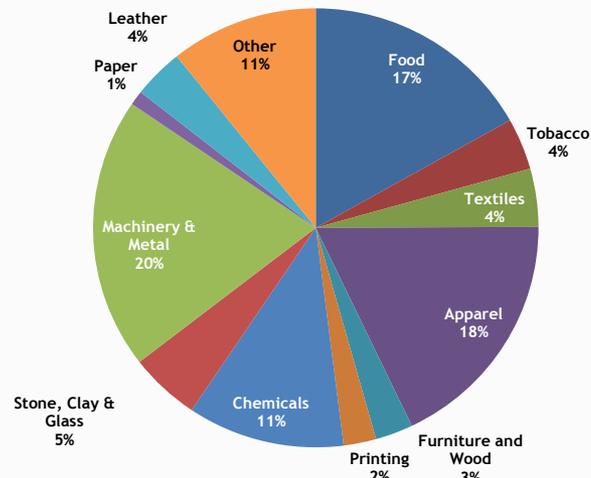
1950



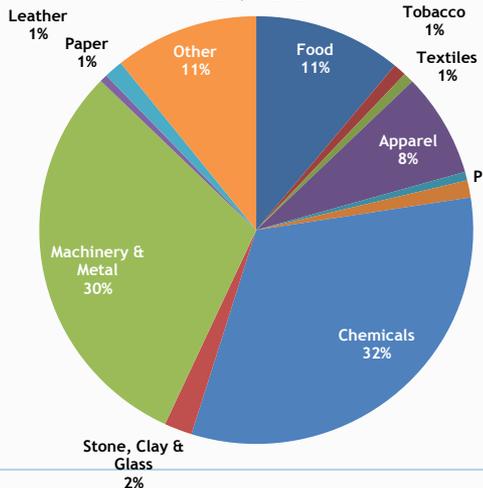
1960



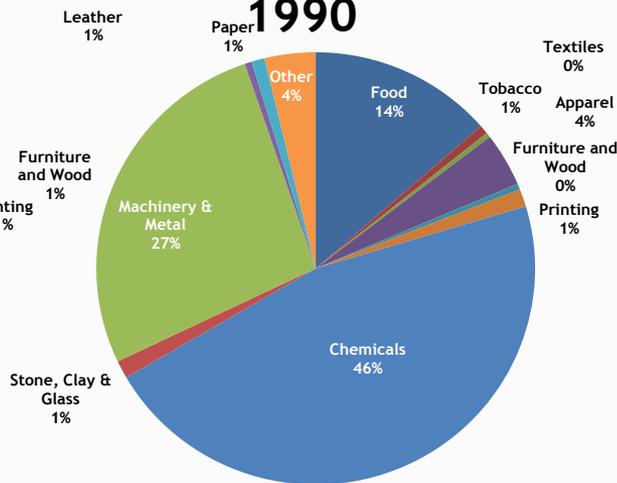
1970



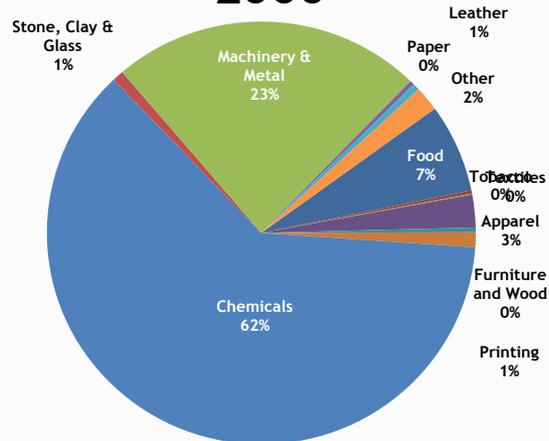
1980



1990



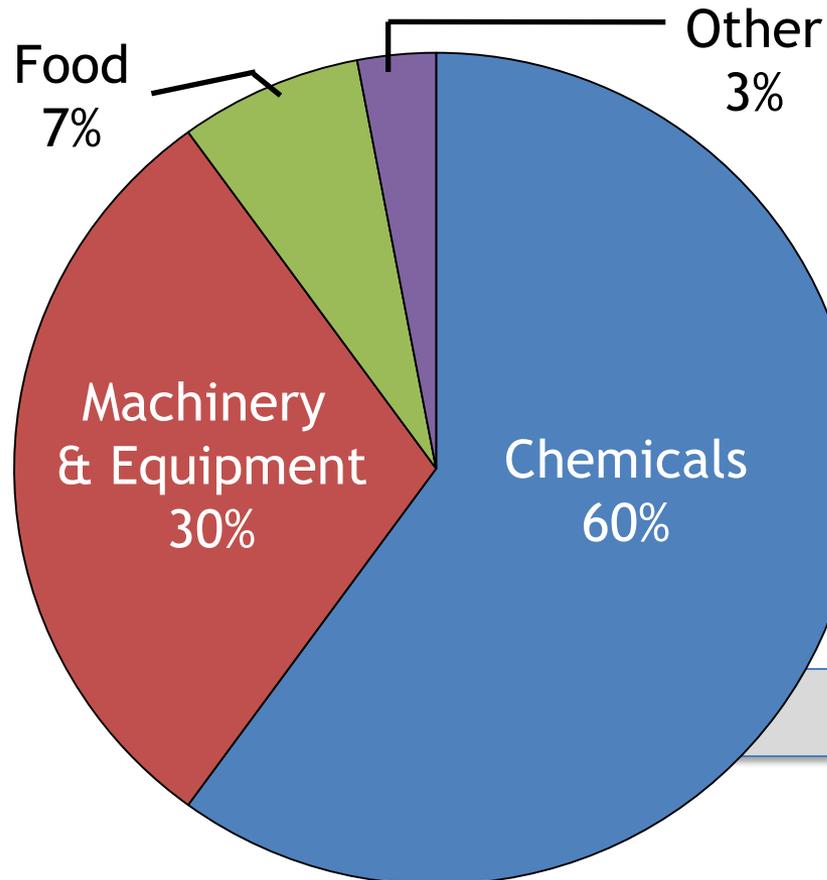
2000





Presently, our manufacturing sector is 90% comprised of pharmaceuticals and device production

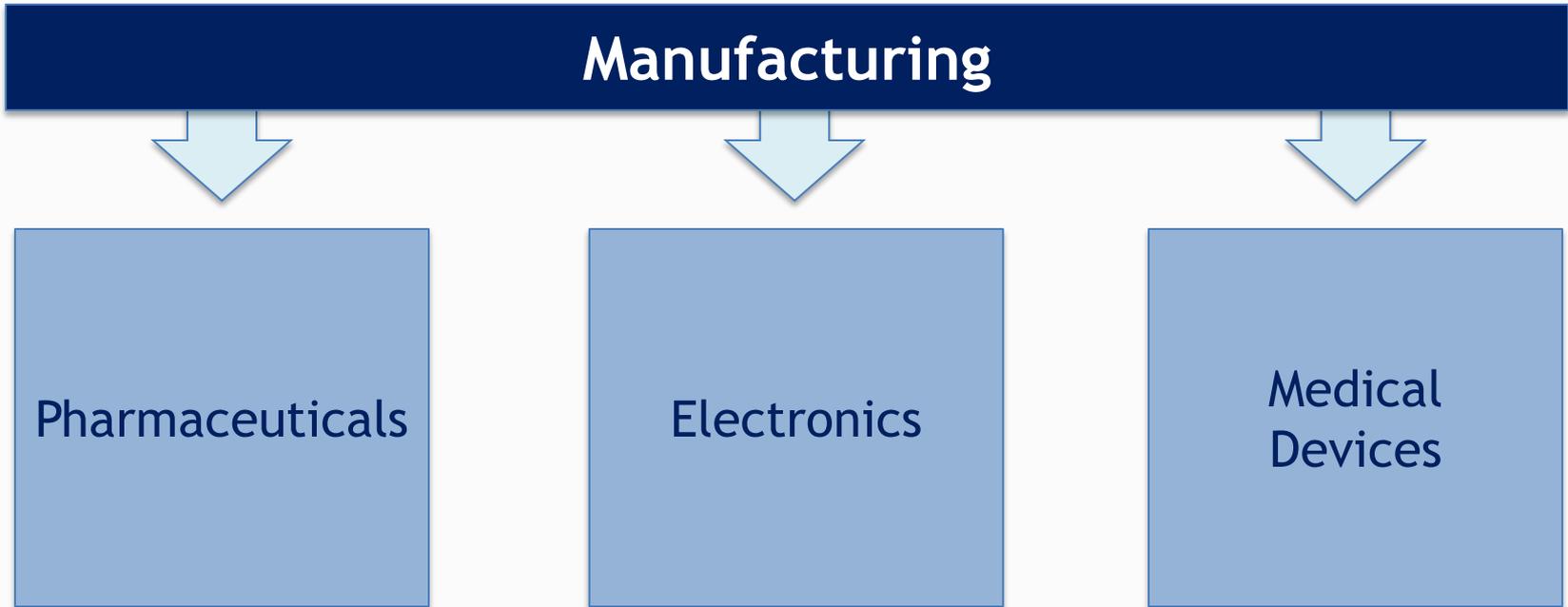
## Manufacturing Sector Composition



Pharmaceutical Industry participation: over 90%



The manufacturing sector is mainly comprised by three distinct groups:



Other segments:

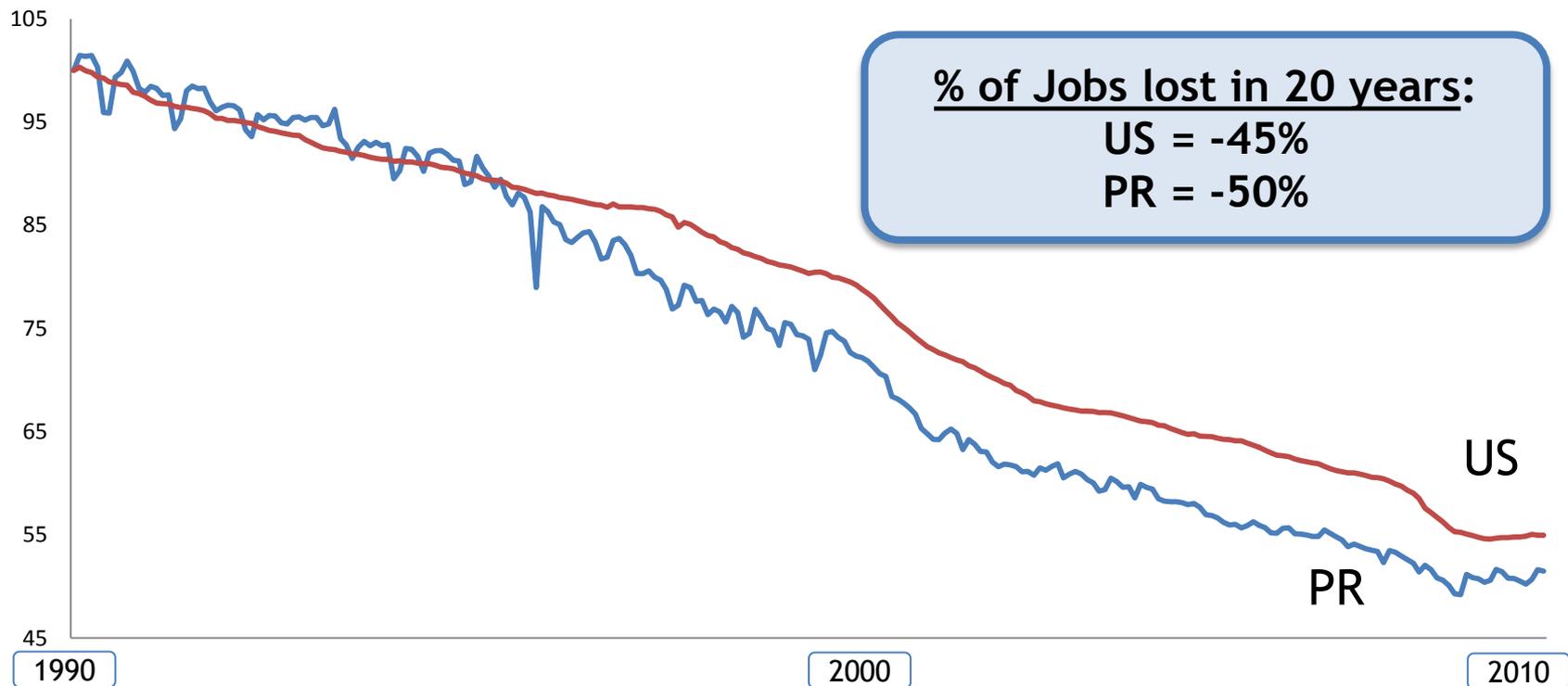
Food

Metals/ Plastics



Employment in the manufacturing sector has been in a steady decline over the past 20 years, both in the US and Puerto Rico

## Manufacturing Employment Index





# Pharmaceutical industry continues to face significant challenges and global contraction that has also affected the local Puerto Rico economy

- According to rating agencies and other research analysts, the industry perspective is **NEGATIVE**. This is due to the fact that companies face expiring patents on their most important drugs:

\$ in millions

Company	Drug	Expiring Patent	Worldwide sales (2008)
Pfizer	Lipitor	2011 / 2012	\$12,401
Bristol Myers	Plavix	2012 / 2013	\$5,603
Eli Lilly	Zyprexa	2011	\$4,696
Abbott	Humira	2016	\$4,521
Wyeth (Pfizer)	Effexor/Effexor XR	2009 / 2010	\$3,928
Amgen	Enbrel	2012	\$3,598
Merck	Cozaar/Hyzaar	2009 / 2010	\$3,558
Amgen	Neulasta	2015	\$3,318
Eli Lilly	Cymbalta	2013 / 2014	\$2,697
Pfizer	Lyrica	2013	\$2,573



# Pharmaceutical companies have addressed their impending reduction in revenues by implementing cost cutting measures and looking at acquisitions with product development opportunities

Announced termination of 6,000 employees of which 1,500 were in PR

10/2009

Pfizer

\$68 Bn

Wyeth

03/2009

Roche

\$46 Bn

Genentech

11/2009

Merck

\$41 Bn

Schering-Plough

Sanofi-Aventis

\$19 Bn

Genzyme

Transaction has not yet closed

10/2010

Pfizer

\$4 Bn

King Pharmaceutical

Consolidation activity in the pharmaceutical industry has resulted in the shutdown of production plants and worldwide layoffs. In Puerto Rico, we have been impacted by this change as 8 plants have shut down in the past 4 years.



# ...the contraction of pharmaceuticals in PR





It is common practice for some exempt companies to periodically revise their tax decrees as their financial position and compliance with previous agreements change...

Decree # 1234

Company A

Decree contains minimum employee requirement clause



Unable to comply with the minimum employee requirement, a request for a decree revision is submitted

The company decides to close production lines or undergoes consolidation of several plants and are forced to layoff employees

Lengthy process that has unfortunately become common practice in the industry



# Corporate Tax Burden Imbalance in Puerto Rico...

## Corporate Income Tax Rates:

	<u>Marginal</u>	<u>Effective</u>	<u>Number of Companies</u>
<b>Regular Corporations</b>	41%	34%	20,146
<b>Exempt Multinational Corporations</b>	0-4%	1.4%*	58**

\* Including royalty tax (approximately 5%)

\*\* Concentrated in 36 multi-national corporate groups



## Multi-national sector is contributing to push Puerto Rico out of its recession...

(\$ in Billions)

	# of Controlled Groups	Worldwide Sales	Puerto Rico Sales
Pharmaceuticals	10	\$309	\$45
Electronics	11	447	12
Medical Devices	10	58	3
Other	5	19	4
<b>Total</b>	<b>36</b>	<b>\$833</b>	<b>\$64</b>

Net impact of the temporary excise tax in multi-national companies is significantly reduced by local and federal credits

**Excise Tax  
Estimate CY 2011:  
\$1.4 billion**



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**The next Frontier: A Strong Private Sector**



## Growth is paramount for economic recovery...

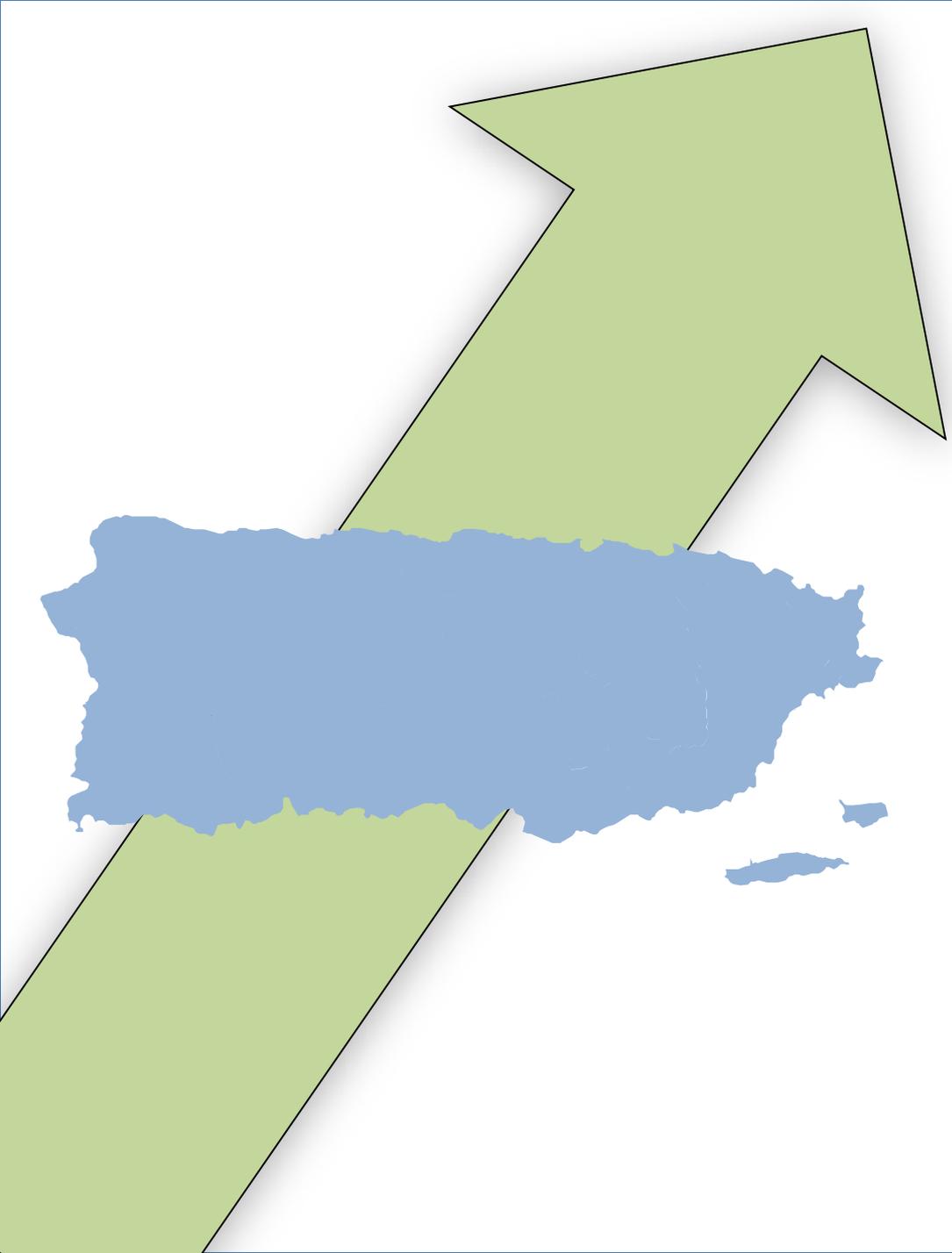
Puerto Rico is following the right economic strategy...

The tax policy is **PRO GROWTH**, and balances the source of growth between domestic production and the efforts of large multinational firms

Research has shown that fiscal consolidation is most successful when  
**SPENDING IS CUT** and **TAXES ARE KEPT LOW**

The tax policy is coupled with an **ENERGY REFORM** that provides corporations with significant savings

**PUERTO RICO IS IMPROVING ITS VALUE PROPOSITION**

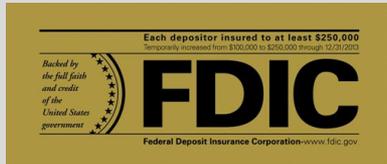


We are rebuilding  
the Economic  
Structure of Puerto  
Rico through  
several key reforms

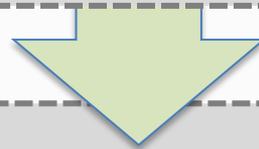


# A re-capitalized banking sector and an improving real estate market are key components of the recovery

- Joint efforts between FDIC, OFIC and GDB resulted in a successful holistic approach and a three bank simultaneous consolidation in April 2010



**\$5.28 billion** in loss-sharing agreements between FDIC and the acquiring banks



**Over \$2 billion** of combined capital raised by local banks

**Total: Over \$7 billion**



# Almost a year after the FDIC assisted transactions, the banking system has deleveraged

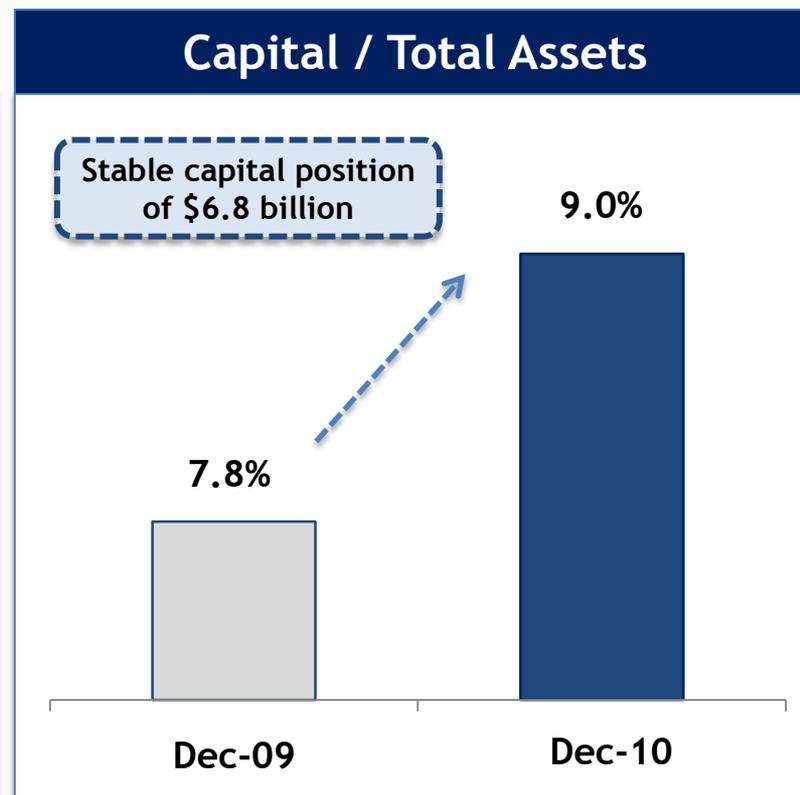
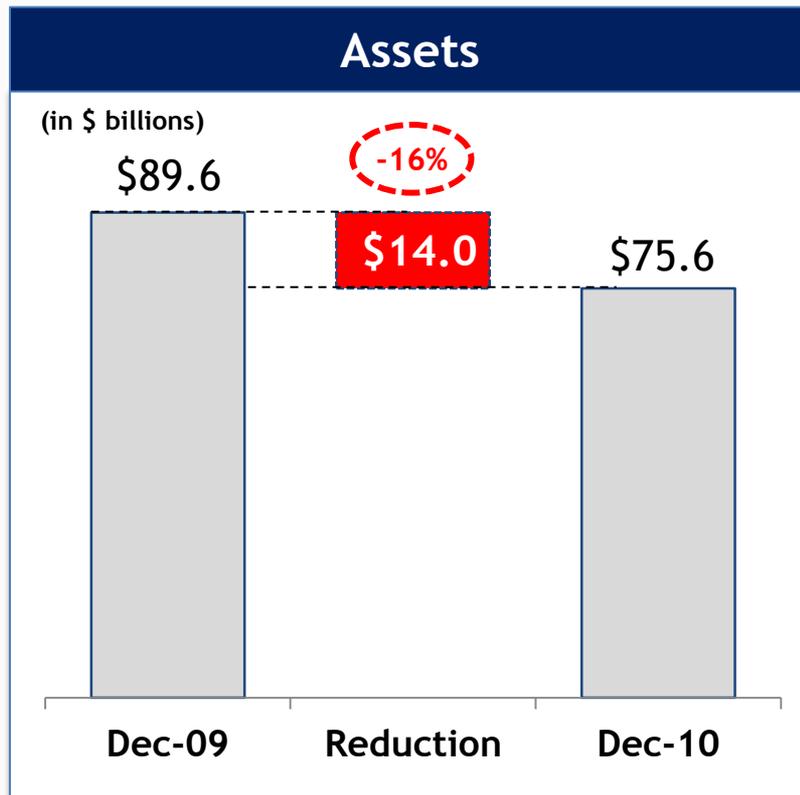
	YOY % Change	Amount
Total Banks	-33%	3
Branches	-11%	54
Brokered Deposits	-45%	-\$10.0 BN
Construction Loans	-47%	-\$2.6 BN
Commercial Loans	-19%	-\$2.4 BN
Residential Mortgages	-4%	-\$739 MM
Personal Loans	-18%	-\$361 MM

Source: Office of the Commissioner of Financial Institutions, data as of December 31, 2010



# Are Puerto Rico banks able to lend and support growth?

Significant deleveraging has improved the Banks' balance sheet and their capital position



Response

YES ✓

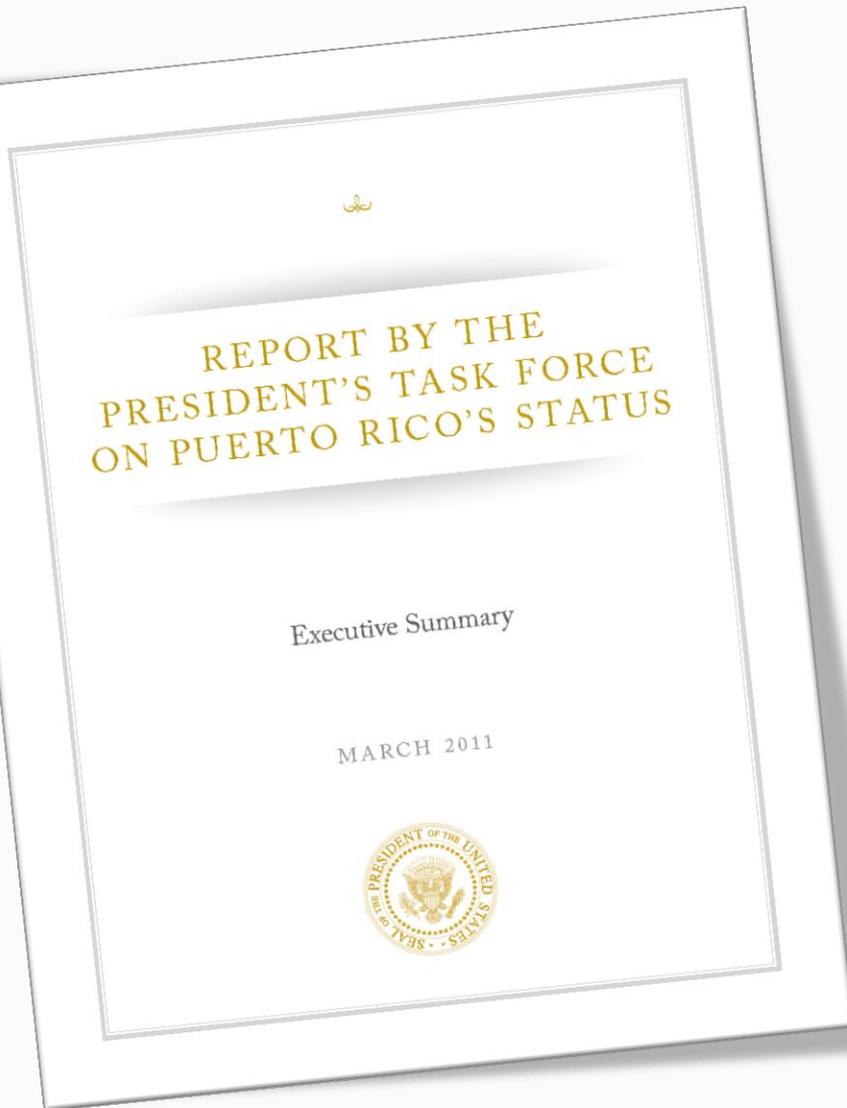


## The Obama Administration has taken a special interest in Puerto Rico socio-economic issues

President Barack Obama - March 11, 2011

“For over a century, the people of Puerto Rico and the United States have woven a lasting political, economic, social and cultural relationship. Today, this relationship is strengthened and renewed by the more than four million U.S. citizens who call Puerto Rico home and the nearly equal number of Puerto Ricans living on the mainland...

I am encouraged that the Task Force took a serious look at a range of Puerto Rico’s economic challenges and developed important recommendations for building competitive industries, investing in a modern renewable energy infrastructure, enhancing economic development, and improving the health and well-being of its citizens.”





# White House Task Force most relevant Recommendations on Economic Development and Building Competitive Industries

- Economic Empowerment Zones
- Developing Puerto Rico as a Model for Clean Energy (renewable energy, Caribbean electrical grid and energy efficiency)
- Promoting Puerto Rico as an Economic and Tourism Hub and Gateway to the Caribbean and Latin America (airport, tourism, exports, port)
- Creating the Caribbean's Health Science and Research Center in Puerto Rico



Puerto Rico's reconstruction path has been challenging but we are committed to continue addressing critical issues to reestablish sustainable economic growth

**Key Reforms  
in place**

Public Private Partnerships Authority

Permits Reform

Energy Reform

Health Reform

Tax Reform

Reconstruction Plan enacted

March 2009

December 2009

July 2010

August 2010

January 2011

**"Better times ahead"**  
April 2, 2011





## The Private Sector is the next frontier...

Government Reforms have taken down the principals barriers to growth

### The private sector must be the engine of JOB CREATION



Emphasis on small and medium size businesses



Exports initiatives



Creating opportunities in health sciences, tourism, banking, film industry, insurance, education and others



A strengthened banking and financial sector leading the way...



**It is a great time to be  
and invest in  
Puerto Rico...**



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