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
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...

**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

**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.

**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

**Jesús F. Méndez**
Secretary
Treasury Department
- Executive Director, Public Buildings Authority
- EVP - Operations, Government Development Bank
- Member of this Administration for 2 years

**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

*Years of experience in Financial Industry*
- 30
- 15
- 12
- 32
- 8
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...

Long lasting recession

FY 2003: 2.1%
FY 2004: 2.7%
FY 2005: 1.9%
FY 2006: 0.5%

2007: -1.2%
2008: -2.9%
2009: -4.0%
2010: -3.8%
Projection: -1.0%

Government Shutdown

-11.9 p.
A Government without expense controls, facing a $3.3 billion deficit...

Inherited Deficit FY 2009

- General Fund Revenues
- Deficit
- Budget Expenditures

Deficit: $3,306

44% of Government revenues (in $ millions)
...with Puerto Rico’s credit on the verge of JUNK status

Central Government Credit Rating (General Obligation)

- Moody’s: Baa3
- Standard & Poor’s: Baa2
- Fitch: Not Rated

JUNK
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

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

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

Timeframe:

- 2008
- 2009
- 2010-11
Fiscal Restructuring & Stabilization Board implemented the Plan and maintained government expense controls

- 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.
Agenda

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2. Understanding our Economic Architecture
3. The next Frontier: A Strong Private Sector
Puerto Rico entered an economic recession before the United States... 

- % of real GSP growth in Puerto Rico
- % of real GDP growth in the United States

Over-heating period

Period of Fiscal Imbalance

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

Projection

Government Shut Down

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**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value (in $ millions)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>$44,641</td>
<td>46%</td>
</tr>
<tr>
<td>FIRE</td>
<td>$18,862</td>
<td>20%</td>
</tr>
<tr>
<td>Services</td>
<td>$12,068</td>
<td>13%</td>
</tr>
<tr>
<td>Government</td>
<td>$8,276</td>
<td>9%</td>
</tr>
<tr>
<td>Commerce</td>
<td>$7,708</td>
<td>8%</td>
</tr>
<tr>
<td>Utilities</td>
<td>$1,944</td>
<td>2%</td>
</tr>
<tr>
<td>Construction</td>
<td>$1,658</td>
<td>2%</td>
</tr>
<tr>
<td>Transportation</td>
<td>$891</td>
<td>&lt;1%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>$553</td>
<td>&lt;1%</td>
</tr>
</tbody>
</table>


* 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

Manufacturing sector represents 25% of Puerto Rico’s GSP


* FIRE = Financial, Insurance and Real Estate.
Historical Comparison between GDP and GSP of Puerto Rico

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

$96 Bn GDP
-63 Bn GSP
$33 Bn Differential

Fiscal Year


GDP
GSP

PUERTORICO CREDIT CONFERENCE 2011
The economic base of Puerto Rico is very different from the States

- **Puerto Rico**
  - GDP: $91.2 Bn
  - GSP: $62.8 Bn
  - GDP per cápita: $22,994
  - GSP per cápita: $15,819

- **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...

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

*Cuba*

GDP: $56.0 Bn
GDP per cápita: $4,892

*Dominican Republic*

GDP: $46.7 Bn
GDP per cápita: $4,819

*Puerto Rico*

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

- Government Sector
- Other Sectors
- Effect of Corporate Tax Incentives
- Dependent on one strategy

**New Strategic Model**
Diversification reduces negative fiscal impacts

- ARRA
- Key Reforms
- Other Funds
- Promotions
- Public-Private Partnerships
- Strategic Projects
- Diversification of strategies

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 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”¹

-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.

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.

- **1950**: Sugar Cane
- **1960**: Textiles
- **1970**: Petro-chemistry
- **1980**: Electronics
- **1990-2000**: Pharmaceuticals

Future 2015: Economy based on knowledge, advanced services, exports and small and medium enterprises.
Over the decades, the manufacturing industry has become increasingly undiversified...

1950

1960

1970

1980

1990

2000

PUERTORICO CREDIT CONFERENCE 2011
Manufacturing Sector Composition

Chemicals 60%
Machinery & Equipment 30%
Food 7%
Other 3%

Pharmaceutical Industry participation: over 90%
The manufacturing sector is mainly comprised by three distinct groups:

- Pharmaceuticals
- Electronics
- Medical Devices

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

% of Jobs lost in 20 years:
US = -45%
PR = -50%
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:

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Pfizer</td>
<td>Lipitor</td>
<td>2011 / 2012</td>
<td>$12,401</td>
</tr>
<tr>
<td>Bristol Myers</td>
<td>Plavix</td>
<td>2012 / 2013</td>
<td>$5,603</td>
</tr>
<tr>
<td>Eli Lilly</td>
<td>Zyprexa</td>
<td>2011</td>
<td>$4,696</td>
</tr>
<tr>
<td>Abbott</td>
<td>Humira</td>
<td>2016</td>
<td>$4,521</td>
</tr>
<tr>
<td>Wyeth (Pfizer)</td>
<td>Effexor/Effexor XR</td>
<td>2009 / 2010</td>
<td>$3,928</td>
</tr>
<tr>
<td>Amgen</td>
<td>Enbrel</td>
<td>2012</td>
<td>$3,598</td>
</tr>
<tr>
<td>Merck</td>
<td>Cozaar/Hyzaar</td>
<td>2009 / 2010</td>
<td>$3,558</td>
</tr>
<tr>
<td>Amgen</td>
<td>Neulasta</td>
<td>2015</td>
<td>$3,318</td>
</tr>
<tr>
<td>Eli Lilly</td>
<td>Cymbalta</td>
<td>2013 / 2014</td>
<td>$2,697</td>
</tr>
<tr>
<td>Pfizer</td>
<td>Lyrica</td>
<td>2013</td>
<td>$2,573</td>
</tr>
</tbody>
</table>

Source: PRIDCO y market analyst report
Pharmaceutical companies have addressed their impending reduction in revenues by implementing cost cutting measures and looking at acquisitions with product development opportunities.

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

- **2006**
  - Closure of Pfizer plant in Barceloneta (Cruce Dávila)
  - Closure of Schering–Plough plant in Manatí
  - Closure of IVAX plant in Cidra

- **2007**
  - GlaxoSmithKline announces closure of plant in Cidra
  - Bristol-Myers Squibb announces closure of plant
  - Pfizer announces the termination of 40 jobs

- **2010**
  - Pfizer announces closure of Caguas, Guayama and Carolina plants
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:

<table>
<thead>
<tr>
<th></th>
<th>Marginal</th>
<th>Effective</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regular Corporations</strong></td>
<td>41%</td>
<td>34%</td>
<td>20,146</td>
</tr>
<tr>
<td><strong>Exempt Multinational Corporations</strong></td>
<td>0-4%</td>
<td>1.4%*</td>
<td>58**</td>
</tr>
</tbody>
</table>

* 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...

<table>
<thead>
<tr>
<th></th>
<th># of Controlled Groups</th>
<th>Worldwide Sales</th>
<th>Puerto Rico Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmaceuticals</td>
<td>10</td>
<td>$309</td>
<td>$45</td>
</tr>
<tr>
<td>Electronics</td>
<td>11</td>
<td>447</td>
<td>12</td>
</tr>
<tr>
<td>Medical Devices</td>
<td>10</td>
<td>58</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
<td>19</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36</strong></td>
<td><strong>$833</strong></td>
<td><strong>$64</strong></td>
</tr>
</tbody>
</table>

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
1. Redefining Fiscal Policy
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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

Source: WSJ
Almost a year after the FDIC assisted transactions, the banking system has deleveraged.

<table>
<thead>
<tr>
<th>Category</th>
<th>YOY % Change</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Banks</td>
<td>-33%</td>
<td>3</td>
</tr>
<tr>
<td>Branches</td>
<td>-11%</td>
<td>54</td>
</tr>
<tr>
<td>Brokered Deposits</td>
<td>-45%</td>
<td>-$10.0 BN</td>
</tr>
<tr>
<td>Construction Loans</td>
<td>-47%</td>
<td>-$2.6 BN</td>
</tr>
<tr>
<td>Commercial Loans</td>
<td>-19%</td>
<td>-$2.4 BN</td>
</tr>
<tr>
<td>Residential Mortgages</td>
<td>-4%</td>
<td>-$739 MM</td>
</tr>
<tr>
<td>Personal Loans</td>
<td>-18%</td>
<td>-$361 MM</td>
</tr>
</tbody>
</table>

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.

**Assets**

<table>
<thead>
<tr>
<th>Dec-09</th>
<th>Reduction</th>
<th>Dec-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>$89.6</td>
<td>(in $ billions)</td>
<td>$14.0</td>
</tr>
<tr>
<td>$75.6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

-16%

**Capital / Total Assets**

<table>
<thead>
<tr>
<th>Dec-09</th>
<th>Dec-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.8%</td>
<td>9.0%</td>
</tr>
</tbody>
</table>

Stable capital position of $6.8 billion

Response: **YES**

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

“Better times ahead”
April 2, 2011

Key Reforms in place

- Public Private Partnerships Authority
- Permits Reform
- Energy Reform
- Health Reform
- Tax Reform

Reconstruction Plan enacted

Reform Dates:
- March 2009
- December 2009
- July 2010
- August 2010
- January 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...
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