June 2005

Uncertainty is the order of the day in the economic sphere as we approach the midpoint of the year. First, the geopolitical situation remains extremely fluid. Insurgents in Iraq have managed to tie up coalition resources that could have been used for the economic reconstruction of the country. Afghanistan is not doing much better. Meanwhile the showdown between the U.S and North Korea regarding nuclear weapons continues and Iran, for its part, has indicated it will continue pursuing its own nuclear program, in the face of European and U.S. opposition. A crisis involving either North Korea or Iran could escalate to dangerous levels fairly rapidly and would have significant negative effects in world markets.

Second, the price of oil hovers above $53 a barrel due to a number of structural factors, such as high demand in China, low refining capacity in the United States, the failure of Iraqi oil fields to come on line and political turmoil in Venezuela, none of which will disappear overnight.

Third, growth in the Euro zone has all but stalled, with the European Commission cutting its second quarter growth forecast to 0.3 percent from an already anemic 0.4 percent. The rejection of the European constitution by French and Dutch voters has increased uncertainty about the process of economic and political integration in Europe. As a consequence the Euro is trading at a seven month low against the dollar.

Finally, the United States economy continues to move along an unsustainable path. The U.S. government closed fiscal year 2004 with a budget deficit of $412 billion and is expected to finish the current fiscal year with a shortfall of around $400 billion. In addition, American consumers have been buying far more from the rest of the world than they have been able to sell. Therefore, the U.S. is facing record (in nominal terms) trade and current account deficits.

This spending binge has been financed in large part by foreign creditors, mostly Asian central banks, which have been willing to buy dollars and dollar-denominated assets in record numbers. For example, the central bank of China has been purchasing dollars at the rate of $200 billion a year. According to Nouriel Roubini, an economist at NYU's Stern School of Business, if China cut back its purchases of U.S. dollar assets by half, long-term interest rates in the United States could rise over 200 basis points over a few months. Such a jolt in interest rates—mortgage rates could increase from 5.09% to over 7.00%—would translate into higher borrowing costs for the government, business and consumers and could trigger a mild recession in the short term.

THE UNITED STATES ECONOMY

The United States economy keeps sending mixed signals. In late May the Bureau of Economic Analysis announced that GDP growth for the first quarter of 2005 was revised upward from 3.1% to 3.5%. However, the revised growth rate was below the 3.8% registered during the last quarter of 2004.

The manufacturing sector continues to show weakness across the board. The industrial production index, a measure of the physical output of U.S. factories, fell 0.2% in April. Furthermore, the Institute of Supply Management reported that U.S. manufacturing growth slowed in May for the sixth straight month, reflecting fewer orders, less production and a decline in factory employment.

On the positive side, we note that U.S. housing starts, a monthly snapshot of new residential construction, increased 11% in April to 2.038 million units on an annualized basis. This increase exceeded consensus expectations of an increase of 2.0 million annualized units. On a yearly basis, the increase came in at a sound 3.6%.

Also on the positive side, we observed jobless claims fall by 20,000 to 321,000 for the week ending May 14th, lower than consensus estimates. According to Economy.com, the current pattern in jobless claims is consistent with a healthy labor market and with monthly employment gains of 200,000.

The actions of the U.S. Federal Reserve remain by far the biggest wild card over the short term horizon. The Fed has raised its key short-term rate eight times, in quarter-point increments, since June 2004. It appears that the Federal Open Market Committee's concern about rising price pressures was the main justification for these increases. However, recent evidence that the economy is not growing quickly enough to spark faster inflation and declining rates in the long end of the yield curve, could be a signal that the pricing pressures may be subsiding relative to what the Fed perceived in previous months.

Further rate increases by the Fed may complicate the operations of major U.S. banks, as the spread between the short and long ends of the yield curve continues to shrink. In late May, the difference in yields between the two and the ten year notes was 46 basis points. This gap was 210 basis points a year ago. This means that banks will have to work harder to make money in their core lending business. Right now, according to most analysts, there is a risk of the Fed overshooting its inflation target, which could result in a significant economic slowdown over the short term. The next Fed meeting will be a key determinant of the growth of the U.S. economy over the short term.

THE PUERTO RICAN ECONOMY

The Puerto Rican economy is not immune to the uncertainty that permeates the world and U.S. economies. Recent data releases indicate that the local economy is growing at a slow, steady pace. Total employment, as measured by the household survey, increased a paltry 0.3% in March when compared to the previous month. On a yearly basis, total employment was reported at 1.231 million, an increase of 1.1% when compared with same month in 2004. The unemployment rate, however, increased to 11.4% in March from 10.0% in February. The

Puerto Rico Labor Department indicated that this increase was explained mostly by a sharp increase in the labor force, as 20,000 persons joined the labor force in March of the current year.

Retail sales increased 3.0% in March when compared to the previous month. On a year-over-year basis, retail sales increased 5.2% and reported a 5.8% leap in the first quarter of 2005 when compared with the same period of 2004. Car sales also remain strong. The absolute number of new vehicles sold reached 11,436 in April, up 3.6%, from the 11,035 sold in March. On an annual basis, the number of new vehicles sold increased 13.3%.

On the negative side, the construction sector remains sluggish. The number of construction permits remained virtually unchanged in March at 853 when compared to 852 in February. However, on an annualized basis, the number of construction permits has declined 9.4% from March 2004. In addition, the value of new construction has declined 1.2%, when calculated on a year-over-year basis, and 6.2%, when calculated on a quarterly basis.

Energy consumption, which is strongly correlated with economic activity, also remains stagnant. According to PREPA total consumption for the July 2004-February 2005 period was 13,439 million kwh when compared with 13,581 million kwh during the same period for the previous fiscal year, a reduction of 1.0%. Part of this decline could be explained by seasonal factors, as January usually marks the lowest point of electricity consumption. We should expect to see an increase in electricity consumption as we approach July, which is typically the peak month in terms of load for PREPA. It remains to be seen, however, whether PREPA will be able to meet its peak time demand in July with the new urban train in operation.

There are also several new developments that may affect Puerto Rico's economic performance over the short term. In this category we find the following:

- **Puerto Rico Credit Downgraded by Moodys and S&P** – According to the rating agencies, the downgrade reflects (1) the Commonwealth's deteriorating General Fund financial conditions for fiscal years 2004 and 2005, both of which have seen large operating deficits financed with borrowing; (2) a greater than expected decline in the GDBs net liquidity position during 2005, and (3) a significant increase in the Commonwealth's outstanding tax-supported debt, now approaching 60% of personal income, as a result of the deficit financing in the past two years as well as borrowing for government capital projects. The downgrade will affect the Commonwealth's borrowing costs and may affect the cost of capital of Puerto Rican companies to the extent that Puerto Rico is perceived as a more risky place to do business. However, we should bear in mind that Puerto Rico's bonds are still considered investment grade and they continue to offer triple tax exemption, a feature that is very attractive to bondholders. Looking forward, there are three things we need to keep in mind as we begin to extricate ourselves from this fiscal mess. First, the downgrade, while bad, is limited to the government sector and does not reflect the status of the productive sector of the economy. In other words, Puerto Rico is not in a recession. Second, it is evident that credit analysts were expecting more cooperation between the executive and legislative branches. Shared government for them is not an empty slogan; rather, it is an expectation of responsible behavior on both sides. In essence, it means accepting that neither the governor nor the legislature will get 100% of what it wants and that all

parties should be willing to negotiate fairly in order to reach a compromise. Third, Puerto Rico needs to implement a series of short-term measures to stabilize the fiscal situation and, once that is done, implement a long-term structural reform plan.

- **Fiscal 2006 Budget** – As of this writing, the governor and the legislature are engaged in a tug of war over the government budget for fiscal year 2006. The budget problem, in our view, should be fairly easy to solve. The Puerto Rico government has three main sources of income: the general fund, income generated by public corporations and federal funds. Of these three, only the general fund is subject to the direct control of the central government. The budget presented by the Governor proposes an increase of 16.6% in general fund expenditures. The legislature is proposing a $1.3 billion, or 15.6%, cut in overall expenditures, the bulk of which we assume will come from the general fund. In our view neither proposal is reasonable. A good compromise is to limit the growth in general fund expenditures to the growth rate in nominal GNP. The Planning Board forecasts nominal growth for fiscal year 2006 to be 5.9%. Thus, if total income for Puerto Rico is increasing by 5.9% we propose, following IMF guidelines, that growth in government expenditures be set at that level too.
- **Tax Reform** – The governor appointed a special committee to evaluate a thorough tax reform to be implemented in Puerto Rico. The committee issued a report full of rather ill-defined recommendations. The main proposal is to tax income, both at the individual and corporate level, at 10% and to implement a general sales tax also at a rate of 10%. The report contains no economic projections or forecasts. In our view tax reform is necessary, but it has to be undertaken in a rational way and taking into account the fact that tax systems are designed to achieve multiple objectives. The first objective is to raise the revenues necessary to finance government expenditures and to ensure the growth of government revenues is adequate to fund these expenditure requirements over time. Second, the tax system should be simple, both to comply with and to administer. Simplicity is essential to enable transactors in the Puerto Rican economy to accurately determine the tax consequences of their business and investment decisions, without incurring excessive costs to determine their fiscal obligation. Third, a properly designed tax system distributes the taxation burden in a way that satisfies a given society's notions of equity and fairness. Equity in a fiscal context is usually defined in terms of the ability to pay. In general, those with equal ability should pay the same taxes; while those with greater ability to pay should pay more taxes. Finally, promoting efficiency is also an important objective. Efficiency in this context means minimizing the costs incurred by economic actors in order to avoid or reduce the payment of taxes. The problem is that almost all taxes affect the decisions of individuals and firms, often leading them to undertake actions they would not otherwise have taken. A thoughtfully designed tax reform should take into consideration the broader policy objectives set forth above. In our view, the administration's proposals so far do not satisfy this test.