



COMMONWEALTH OF PUERTO RICO FISCAL UPDATE

August 5, 2008

Budget 2008-09 Signed into Law

Governor Aníbal Acevedo Vilá has signed the Fiscal Year 2008-09 Budget totaling \$9,483 million, which is \$4.2 million below the budget approved by the Legislature.

The Government Development Bank for Puerto Rico believes the budget signed into law addresses the needs of the Commonwealth in the context of limited resources and current economic conditions, and significantly controls government expenditures.

As the following information makes clear, despite many challenges, the Commonwealth continues to make solid progress and remains committed to assuring investors of its fiscal and financial stability.

Third Year of Sustained Controls

The signing of the fiscal 2009 budget underscores the Commonwealth's determination to control expenditures. In the 10 years through fiscal 2006, Puerto Rico's governmental spending increased 79%, to \$9.6 billion. The resulting cumulative structural deficit contributed to a fiscal crisis that required implementation of a multi-faceted program to control outlays and reform taxes beginning in 2006.

Fiscal 09's budget marks the third consecutive year that expenditures will be below those of fiscal 06, when they reached an all-time high. In fiscal 2007, expenditures were \$9,224 million, \$267 million under the prior year's budget. For fiscal 2008, which ended June 30, expenditures are estimated to come in slightly below the approved budget level of \$9,227 million.

Key to this success has been the hiring freeze that was put into effect in fiscal 05 (by law, governmental employees cannot be fired except for

cause). Combined with attrition, the freeze has resulted in 17,000 fewer government employees. This effort has been accompanied by tight expense controls and some reductions which have avoided growth of expenditures in spite of other non-discretionary cost increases.

Dealing with a Weaker Economy

While the current recession has contributed to reduced government revenues, tax reform passed two years ago by the Legislature to bring relief to the middle class has also contributed to base revenues leveling off in the \$8.4 to \$8.6 billion range since 2006. The economy was also impacted by the surge in oil prices, since Puerto Rico is wholly dependent on imports. During this recession, energy cost increases have in large part contributed directly to downward revisions in fiscal 08 GNP growth from a positive 0.8% to a negative 2.1%.

However, concerted actions are being taken to help spur economic growth:

- The Government's consolidated construction improvement program (CIP) of \$10 billion over 5 years. Plans by the Central Government and Public Corporations such as PREPA, PRHTA, and PRASA will infuse approximately \$2 billion per year of infrastructure spending into the economy.
- A housing stimulus package consisting of \$300 million in supplemental mortgage insurance, \$220 million in tax credits to home buyers, and another \$300 million to assist banks in financing affordable housing.



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- The receipt this summer of approximately \$1.2 billion by individuals under the federal government's economic stimulus program has started coursing its way through the economy.
- Aggressive steps are being taken to reduce the Island's dependence on petroleum for electric power generation from the current 74% to 50% by 2010.
- Tourism, now about 7% of GNP, is earmarked to play a bigger role as a result of efforts to build 5,000 new hotel rooms. The Island's first five-star resorts are expected to start opening in calendar 2009.
- A new Industrial Incentives Law, designed to put manufacturing in Puerto Rico on a competitive global basis, is now in effect. The Government has also committed to grow Puerto Rico's "Knowledge Economy," focused on attracting biotech firms and other high tech industries.

Fiscal 2008 Budget

While not all the figures are finalized, fiscal 08's general fund base revenues are expected to be below budget. Reduced individual and corporate income tax receipts that account for \$154 million of the anticipated \$273 million gap were brought on by the recession.

Mindful of the Commonwealth's obligation to produce a balanced budget, the difference was offset by several initiatives, including more vigorous cash management, along with a full draw down of the Government's TRANs facility and savings from the restructuring of the Commonwealth's auction rate note (ARN) debt exposure. In that connection, Puerto Rico was able to put in place a viable and effective restructuring

of its auction rate debt within 90 days of the industry-wide phenomenon by obtaining Letters of Credit and other liquidity facilities that made possible timely financial measures. The list includes total eliminations of ARNs, which at one point represented 7.5% of the portfolio, converting \$1 billion of put bonds to fixed-rate debt and VRDBs (variable rate demand bonds), and reducing floating-rate debt to 13%, from 19%. The restructuring allowed the Commonwealth to achieve budget certainty and a more conservative debt portfolio within a relatively short time frame.

Fiscal 2009 Budget

The budget for the new fiscal year 09 that started in July extends the Government's program to move towards structural balance. Although certain increases in expenditures are mandated by law (such as those for the University of Puerto Rico, the judiciary, and various municipal formula increases, and pensions), operational costs (other than payroll) are being reduced 5%. These include the Education Department, which, without sacrificing quality instruction, is cutting costs, and debt service savings.

Notably, the fiscal 09 budget also avoids what has previously been a traditional surge in election year expenditures. Increased revenues in fiscal 09 are expected to come from slightly higher corporate and individual income taxes, greater proceeds from the Sales and Use Tax, as well as alcoholic beverages and excise taxes on rum shipments.

Nonetheless, the fiscal 09 budget faces a \$1 billion shortfall, or 10.5%, of approved expenditures, similar to many States. To close the gap, Puerto Rico's Legislature has approved raising the needed resources using a structure based on existing income tax receivables. The Commonwealth currently has approximately \$2.9 million in assessed tax receivables of which approximately



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\$1.3 billion is aged 5 years or less. These are deemed by outside experts to have a high probability of collection within 5-7 years and will serve as the basis for raising funds through a marketable structure.

Another possible fundraising alternative being discussed is the sale of an Electronic Lottery concession, with the Government retaining control of the Lottery.

Forward Calendar

With the signing by President George Bush of the federal housing bill, Puerto Rico, as scheduled, marketed to strong demand on Thursday, July 31, 2008, a \$384 million long-term bond issue and \$100 million medium-term notes of Housing Financing Authority.

The balance of the present calendar is as follows (dates are approximate):

- \$150 million Puerto Rico Public Buildings Authority (Restructuring of Insured VRDBs) – Late August
- \$250 million GOs – September 1

- \$400 million Puerto Rico Municipal Financing Agency – September
- \$1 billion Puerto Rico TRANS – October

Conclusion

Despite one of the most difficult fiscal periods in its history, the Commonwealth of Puerto Rico has sustained its debt payment capacity and strengthened the credit of certain government entities such as the Aqueducts and Sewers Authority. In the face of many challenges, the Commonwealth's proven management team has moved expeditiously to develop viable plans and solutions. They include the Employee Retirement System's shift from a 19% funding ratio, to 40%, with a goal of reaching 80% or more in the near future, and the rapid conversion of all ARN debt to other, more functional modes. The introduction of several P3 (Public-Private Partnerships) initiatives is another measure expected to produce positive fiscal and economic results.

As previously stated, spending has been contained, and the focus is now on stimulating economic growth, while retaining high financial standards and assuring fiscal stability.

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