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O SPECIAL REPORT | O FEBRUARY 2014

EcoNews A Special Report

DOWNGRADE BY S&P, MOODY'S, AND FITCH OF P.R.'S CREDIT RATING

On February 4th, Standard & Poor's Ratings Services cut its rating of Puerto Rico's general obligation debt to 'BB+' from 'BBB-', pushing it to the highest junk level status. It also downgraded the Commonwealth's appropriation secured debt and Employee Retirement System debt to 'BB,' as well as lowered various ratings on the Puerto Rico Highways and Transportation Authority to 'BB+' and the Development Bank (GDB) to 'BB.' It refrained from taking a rating action on sales tax-secured debt of the Puerto Rico Sales Tax Financing Corp. (COFINA), but maintained its negative outlook on its COFINA ratings.

Within a few days, the other credit agencies, Moody's and Fitch, followed with their own credit downgrades, as the decision by S&P, plus economic factors, notwithstanding the measures enacted by the government to manage the situation, weighted heavily in their decisions.

THE ECONOMY

These developments have serious implications for the performance of the economy, as they give more weight to

the possibilities of a more pronounced contraction than originally estimated for fiscal years 2014 and 2015.

The outlook for the economy in the case of GNP growth becomes more negative, considering also the observation made by S&P (2014) that "The Commonwealth may

also potentially need monthly cash flow financing in fiscal 2015, following use of a \$1.2 billion of credit line draws for cash flow purposes in fiscal 2014."

Moreover, recently Moody's, for instance, estimated that "if Puerto Rico's credit were downgraded, it faced \$1.0 billion

Credit History of Puerto Rico

Moody's Ratings			Standard & Poor's Ratings		
	Outlook	Classification		Outlook	Classification
January 1976	Stable	Baa1	October 1983	Stable	A
October 1983	Stable	Baa2	October 2001	Negative outlook	A
October 2001	Stable	Baa1	May 2002	Classification down to A- with stable outlook	A-
June 2002	Stable	Baa1	April 2003	Perspective moved from stable to negative	A-
April 2003	Stable	Baa1	September 2004	Negative perspective maintained	A-
September 2004	Down to negative	Baa1	January 2005	Negative outlook and rating maintained	A-
January 2005	Negative outlook and rating maintained	Baa1	May 2005	Negative outlook maintained and rating down	BBB
May 2005	Negative outlook maintained and credit rating down	Baa2	February 2006	On CreditWatch with negative implications	BBB
February 2006	Under observation for possible revision; negative outlook maintained	Baa2	May 2007	GO debt rating lowered but outlook is upgraded to stable	BBB-
May 2006	Downgrade of Commonwealth's G.O. bonds with negative outlook	Baa3	July 2009	Debt rating and outlook maintained,	BBB-
May 2007	Maintains rating and negative outlook for pending issues of \$2.0 billion of public improvement bonds	Baa3	November 2010	Outlook from stable to positive	BBB-
November 2007	Maintains rating and stable outlook,	Baa3	March 7, 2011	Stable	BBB
April 2010	Revised up to A3 with a stable outlook	A3	June 6, 2012	Negative outlook	BBB
August 10, 2010	Outlook changed to negative	A3	March 13, 2013	Negative outlook maintained and credit rating down	BBB-
August 8, 2011	Negative outlook	Baa1	October 24, 2013	Negative outlook maintained	BBB-
December 13, 2012	Negative outlook maintained and credit rating down	Baa3	February 4, 2014*	Credit rating down and negative outlook maintained	BB+
October 3, 2013	Negative outlook maintained	Baa3			
February 7, 2014*	Negative outlook maintained and credit rating down two notches	Ba2			

Fitch		
	Outlook	Classification
August 8, 2011	Stable	BBB+
March, 2013	Negative outlook and credit rating down	BBB-
November 13, 2013	Negative watch	BBB-
February 11, 2014*	Credit rating down and negative outlook maintained	BB

Sources: Government Development Bank; Rating agencies.

Note: As of February 14, 2014.

* The ratings for several public corporations and COFINA was also downgraded.

in short-term costs due to collateral calls on loans that are contingent on P.R.'s debt not being rated junk."

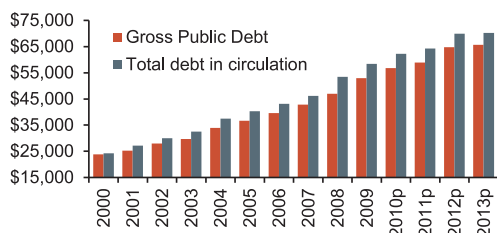
An additional downside risk is the effect of the downgrade on the financial system. Recently, S&P lowered the ratings of three financial institutions (Santander, FirstBank and Popular Bank), on the basis of a weak economy that can deteriorate lending activity, affecting the profitability of several of these institutions, plus the exposure of some to government loans.

The analysis of past, and recent trends of the selected economic indicators, up to the last quarter of 2013 shows that the local economy continued to face growth challenges. Employment, retail sales, bankruptcies, delinquency rates and cement sales point to an economy that suffered a contraction during fiscal 2014, above that announced by the Puerto Rico Planning Board last October. The situation is expected to deteriorate as a result of the most recent S&P's downgrade to junk level by S&P of P.R.'s general obligation debt to 'BB+' from 'BBB-'.⁴

THE DEBT IN NUMBERS

As of fiscal 2013, it is estimated that the total circulating public debt of Puerto Rico amounted to \$70.2 billion, of which \$65.7 billion corresponded to the gross debt of the central government, corporations, municipal, constitutional and extra-constitutional, and COFINA (which account for 24.5% of the debt, and public corporations 47.0%). As an indicator of high public indebtedness, gross

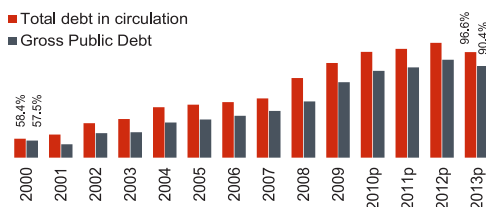
Gross Public Debt and Total Circulating Public Debt



Sources: Planning Board (2013); Government Development Bank (2013). * In the case of gross public debt corresponds to debt of central government (including COFINA), public corporations, and municipalities. p = Preliminary

public debt represented 90.4% of the island's GNP (nominal), from 58.4% in fiscal 2000, edging down from 93.2% in fiscal 2012. Total circulating debt represented 97.0%, from 100.7% in fiscal 2012.

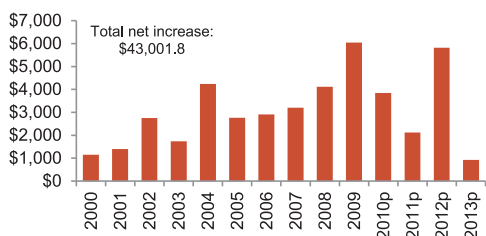
Ratio of Total Gross Debt in Circulation and Gross Public Debt to GNP



Sources: Office of Management and Budget (2013); Planning Board (2013); Government Development Bank (2013).

To have an idea of how the situation deteriorated, between fiscal years 2001 and 2013, the net increase in the gross public debt amounted to \$43.0 billion, of which \$31.7 billion was incurred during the period 2005-2013. This accounted for 74.0% of the increase in net indebtedness during the period. The net increase in the debt of COFINA accounted for 39.0% of the \$31.7 billion increase, debt that was issued, in essence, to cover current and recurrent spending.

Annual Increases of Gross Public Debt

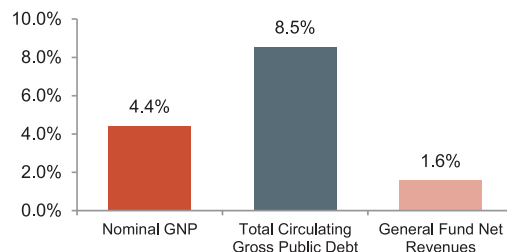


Sources: Planning Board (2013); Government Development Bank (2013). * Corresponds to debt of central government (including COFINA), public corporations, and municipalities. p = Preliminary

Thus, while during the years 2000-2013, the economy (production) expanded at a nominal rate of growth of 4.4%, and government revenues (net) barely increased, by 1.6%, the size of the public debt increased 8.5% annually.

Annual Growth of Nominal GNP, General Fund Net Revenues, and Total Gross Public Debt

Fiscal Years 2000-2013*



Sources: Planning Board (2013); Government Development Bank (2013). * Compound annual rate of growth.

AFTER THE DOWNGRADES

Expectations in the short and medium term will be influenced by the downgrades that, although expected, will nevertheless have its impact on consumers, businesses, and through the fiscal situation of the government, on public spending and investment. GNP growth will thus face strong downside risks during fiscal years 2015 and 2016.

In the wake of Standard & Poor's decision to cut Puerto Rico's credit rating to junk, the governor announced on February 5th several measures to cut the budget deficit. The Bill, E-14-0093, submitted to the Legislature, included several proposals, among them an amendment to the current budget (Fiscal year 2014) to reduce the deficit by \$170 million without laying-off public employees, and requiring 2.0% expense cuts by central government agencies, except the Education Department. This is coupled with the efforts already implemented to reduce spending, including public payroll.

At the same time, the government will continue to negotiate loans whose payments have been accelerated by S&P's decision — \$575 million in 90 days and \$375 million in less than six months — and in financing alternatives to provide greater liquidity to the GDB.

On the revenue side, the administration has indicated that it is completing the revised revenue projections without new taxes for

the next fiscal year, taking into account the economic growth projection and income measures already legislated, together with the efforts to control tax evasion.

On the economic side, the government has identified \$800 million in public and private investment in infrastructure projects that it will push aggressively.

Nevertheless, the negative economic impact will be strong, at least in the short and medium term. The expected contraction in public spending and investment will lower economic growth perspectives. For incoming fiscal 2015, the government has already announced a reduction of \$820.0 million in spending in order to eliminate the deficit.

On the other hand, of the new GO issue contemplated for next month for \$3.5 billion, most of it will go to pay old debt (\$2.0 billion), an amount that would not provide monies further than 2015 and none for investment. The proceeds are also to be used to terminate interest-rate swaps, fill a \$245.0 million hole in the current fiscal year's budget, and bolster the liquidity of the Government Development Bank. Interestingly, some analysts are of the opinion that despite the risk, there is demand for fresh debt from Puerto Rico, especially among sophisticated investors seeking high returns. Hedge funds and other alternative asset managers believe they see ways of protecting themselves in the face of an increasing risk that Puerto Rico's other debt will have to be restructured at some point.

The impact on the manufacturing sector of the downgrades is somewhat more difficult to pinpoint. Obviously, those sub-sectors related to construction will be impacted, as will those that produce for the local market. To the extent that it produces for export, the direct impact should be minimal. Any impacts will be in the mid and long terms, through a more restrictive tax environment and costly infrastructure services. Expanding exports from both the manufacturing and service sectors is essential for stimulating economic growth since local markets will remain weak for at least the next three to four years. The main implication of the current crisis is the

need for Puerto Rico to adopt an outward orientation in its economic initiatives.

REAL GNP GROWTH

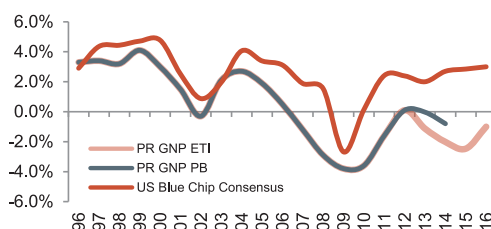
In the case of real GNP growth, our revised forecasts take into consideration the potential effects of the rating downgrade by S&P, for the balance of current fiscal 2014, but its impact will be also felt in coming fiscal 2015.

The contraction will extend into fiscal years 2014 through 2016, as the economy is estimated to have contracted by -2.0% this fiscal year, and -2.5% in fiscal 2015, slowing down still in fiscal 2016 by -1.0%. As a result of the expected limitations in revenues and deficit financing, public spending is expected to contract at an accumulated rate of 4.3% during fiscal years 2014 and 2015, and public investment by 29.7%, as its main source of funds, debt, will be heavily constrained.

The most recent downgrade by Fitch on February 17th of PRSA's credit rating and of the PRPA's to junk level, following Moody's decision on February 10th, will simply make it more difficult (and costly) for these two key public corporations to entertain an expansion in their investment.

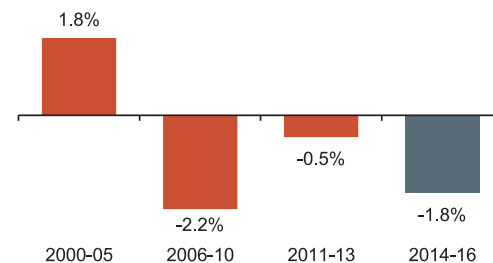
Private investment in construction will continue to be on the downside, led by a housing sector still in the doldrums, and a scarcity of public funds for investment. It is estimated that it will contract at an accumulated rate of 27.8% during fiscal years 2014 and 2015, with fiscal 2016 still on the negative side, -6.4%.

Annual Growth Rates: Historic and Forecasts 1996-2016



Sources: PR Planning Board (2013); Estudios Técnicos (2014); U.S. BEA; Blue Chip Consensus (February 10, 2014). *US data on PR's fiscal year basis. Note: Shaded area indicates contraction period in PR.

Annual Growth Rates: Historic and Forecasts 1996-2016



Sources: PR Planning Board (2013); Estudios Técnicos (2014).

On balance, expect the next three fiscal years to continue on a contraction mode, slightly more pronounced on average than in the previous three years.

PUBLIC MEASURES STEPS IN THE RIGHT DIRECTION?

The government has initiated or enacted a series of measures to restore fiscal balance, liquidity to the GDB, and the proposed revision of the tax system, submit a real balanced budget for fiscal 2015, are steps in the right direction. Nevertheless, they entail spending cuts, less money for investment, and again raising revenues, which in essence will be of taxes, and user fees for services.

All, one way or the other, will impact consumers and businesses, eroding domestic demand. And none of these options are too appealing.

There is still the issue of the proposed reform to the Teachers Retirement System, whose implementation is pending on a decision by the local Supreme Court. An unfavorable one would send the wrong signals to the bond market and investors.

In the short and medium term, the measures proposed or to be enacted will help to regain credit standing and confidence, but they will take time. Immediately, and into next fiscal year, the situation will be quite constrained, as explained before.

Projections through 2016 are presented in the following table:

Real GNP: Historical and Forecast Growth Rates

	Fiscal Years											
	Annual Growth Rate											
	Historic								Forecast (a)			
	2005	2006	2007	2008	2009	2010	2011	2012p	2013	2014	2015	2016
Real GNP	1.9%	0.5%	-1.2%	-2.9%	-3.8%	-3.6%	-1.6%	0.1%	-1.1%	-2.0%	-2.5%	-1.0%
Personal consumption expenditures	3.4%	2.2%	3.5%	-1.2%	-2.9%	1.4%	0.7%	3.0%	1.2%	1.0%	1.1%	1.5%
Public spending	4.2%	0.1%	-1.5%	-4.7%	2.5%	-3.4%	-4.7%	-0.7%	-0.6%	-1.5%	-2.8%	-1.2%
Gross domestic investment	-4.0%	2.2%	-6.3%	-7.9%	-12.5%	-7.8%	12.8%	4.4%	-7.7%	-8.3%	-10.5%	-5.3%
Construction	-6.9%	-10.9%	-7.6%	-9.4%	-22.2%	-14.1%	2.0%	11.0%	-13.1%	-13.5%	-15.1%	-7.4%
Private	-11.3%	-12.1%	-4.5%	-20.8%	-29.5%	-5.1%	-4.1%	-3.0%	-12.0%	-13.3%	-14.5%	-6.4%
Public	-0.5%	-9.4%	-11.5%	5.7%	-15.0%	-21.5%	8.1%	23.3%	-14.6%	-13.8%	-15.9%	-8.9%
Exports	2.7%	0.7%	-7.9%	-1.3%	-3.6%	-3.9%	1.7%	-4.1%	-1.9%	-2.4%	0.7%	3.8%
Imports	2.7%	1.9%	-4.5%	-1.7%	-3.2%	-0.5%	3.0%	0.5%	-0.5%	-0.6%	0.9%	2.8%

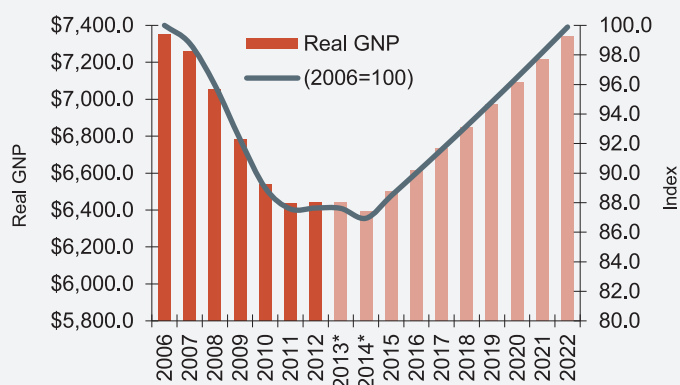
Sources: PR Planning Board (2013). *Statistical Appendix 2012*; Estudios Técnicos, Inc. (February 20, 2014). P = Preliminary (a) Subject to revisions.

Long-term Economic Challenge

The economic growth challenges are daunting and long-term, as seen in our risk scenarios. Adopting an alternative base line approach, which assumes a conservative annual growth rate of 1.75% for 2015 and afterwards, which is slightly higher than the historic average for fiscal years 2000-2006 (1.61%), and the revised forecasts by the Planning Board for fiscal years 2013 and 2014, it would not be until fiscal year 2022 when Puerto Rico's real GNP would arrive to its pre-contraction level of 2006.

How Much Does P.R. Has To Grow to Achieve 2006 Levels

(Assuming an annual rate of 1.75% for 2015 - 2022)



Sources: PR Planning Board; Estudios Técnicos, Inc. * Revised forecasts

Notes:

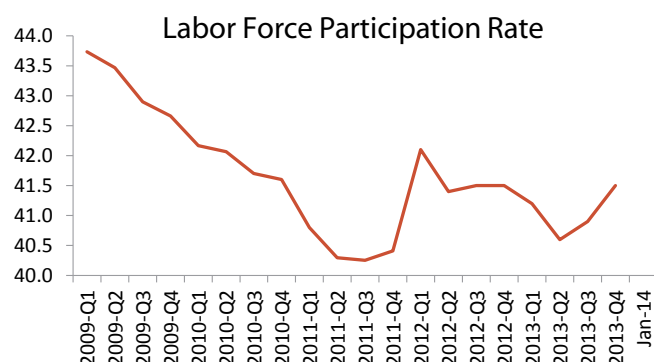
- Standard & Poor's Rating Services (2014). Puerto Rico GO Rating Lowered To 'BB+'; Remains on Watch Negative, Rating Direct (February 4). At: www.standardandpoors.com/ratingsdirect.
- There is a question about what might happen with Moody's Investors Service and Fitch Ratings following S&P's downgrade. That might force selling by investors who have mandates preventing them from holding junk-rated debt. On February 7th Moody's downgraded two notches its ratings to Baa2 from Baa3 with outlook negative. See Moody's Investor Services (2014). <http://recend.apextech.netdna-cdn.com/docs/editor/InformeMoody.pdf>. On February 11th Fitch did the same with a downgrade to 'BB' from 'BBB-' with negative outlook. See Fitch Ratings (2014). https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=820231&origin=home&cm_sp=homepage-Featured_Content_Archive-Fitch%20Downgrades%20Puerto%20Rico%20to%20%27BB%27.
- Standard & Poor's Rating Services (2014), p. 3.
- Cnbc.com (2014). "Why Puerto Rico Needs to Borrow Money - Soon," (January 24). At: <http://www.cnbc.com/>
- The legislation seeks to amend Articles 3 and 8 of Law 45-2013. This Law created in 2013 the Fiscal Reconstruction Fund, under the custody of the Department of the Treasury, and authorized the Government Development Bank to transfer to the Fund \$245.0 million to finance the administration's economic development plan known as the "Jobs Now Act".
- M. Williams and M. Corkery (2014). "Puerto Rico Wants to Incur More Debt to Regain Financial Footing," DealBKK (February 18). At: <http://mobile.nytimes.com/blogs/dealbook/2014/02/18/puerto-rico-wants-to-incur-more-debt-to-regain-financial-footing/?smid=fb-share>.
- The estimates are subject to revision, once the Planning Board publishes its macroeconomic estimates for fiscal 2013, and revised 2012, expected in March, and the annual benchmark revisions of nonfarm employment data that will be available in March from the U.S. BLS.
- Fitch Ratings (2014). Fitch Downgrades Puerto Rico Aqueduct & Sewer Authority Senior Revs to 'BB+'; Outlook Remains Negative (February 18). At: https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=820922; Fitch Downgrades Puerto Rico Electric Power Auth's Revs to 'BB+'; Outlook to Negative (February 18). At: https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=820918.
- Some analysts believe that it will take Puerto Rico within five years to regain its investment grade rating from S&P. See S. O'Leary and M. Shellhorn (2014). What Does Below Investment Grade Mean for Puerto Rico?, Nuveen Asset Management (February), p. 4. At: <http://www.nuveen.com/Home/Documents/Default.aspx?field=61768>.

Economic Indicators

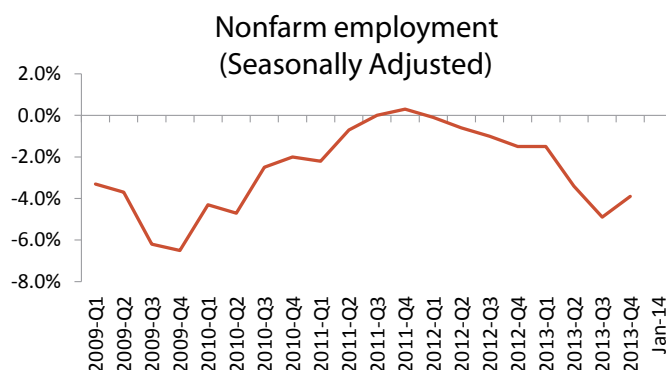
A Special Report



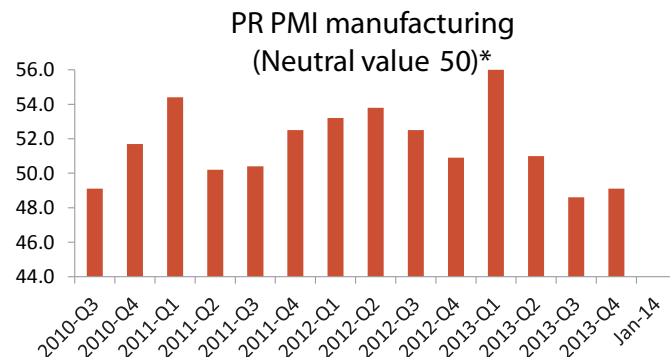
Source: P.R. Department of Labor



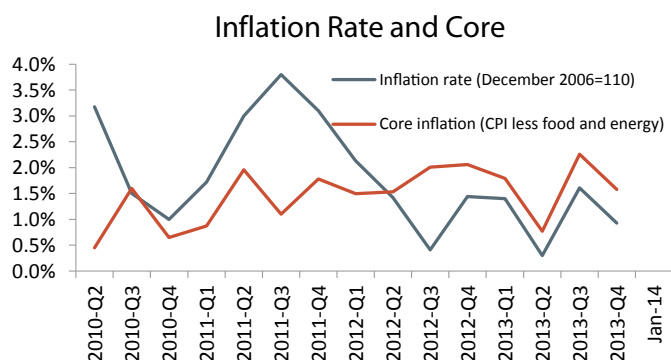
Source: P.R. Department of Labor



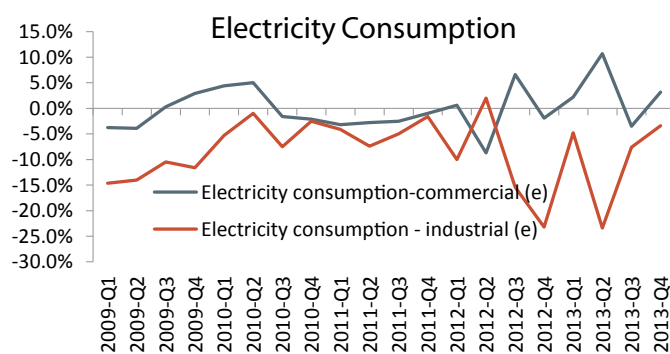
Source: Bureau of Labor



Source: Puerto Rico Statistics Institute. * Introduced in December 2010. Average for the quarter.



Source: PR Statistics Institute. Estudios Técnicos Inc.



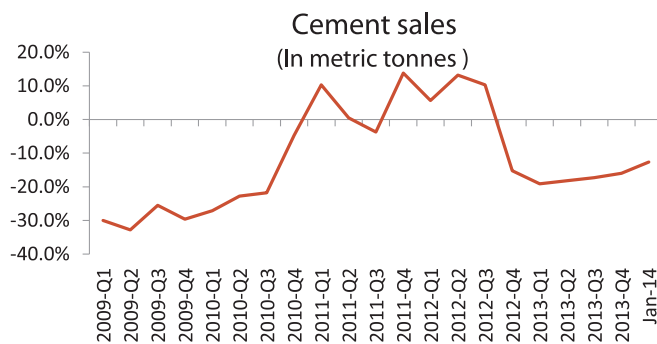
Source: P.R. Planning Board

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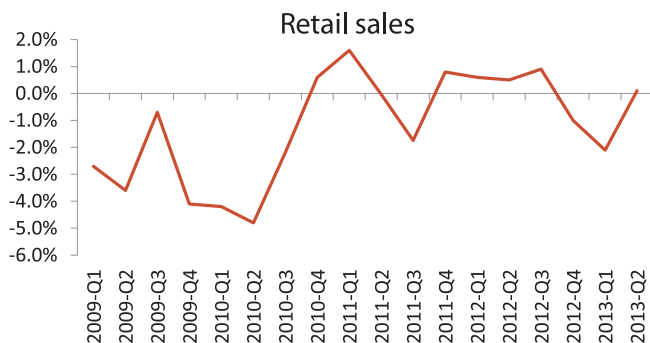
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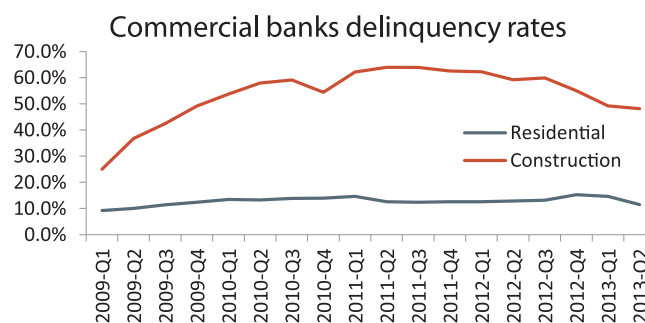
Source: P.R. Department of Labor



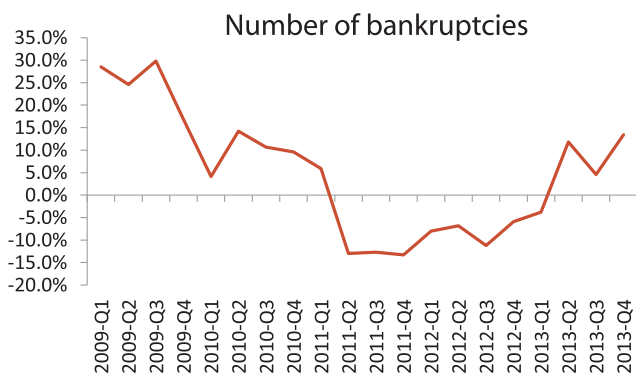
Source: P.R. Planning Board.



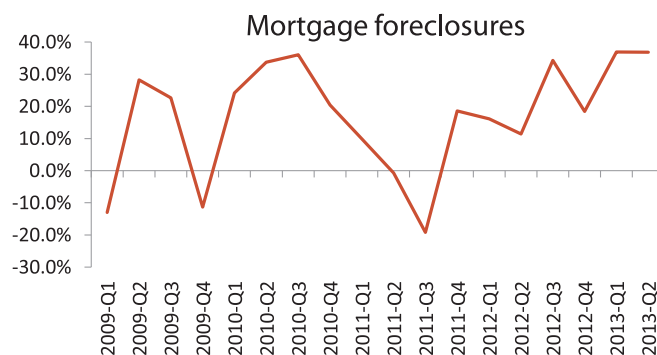
Source: PR Trade and Export Company



Source: P.R. Office of the Commissioner of Financial Institutions.



Source: Boletín Comercial de Puerto Rico.



Source: P.R. Office of the Commissioner of Financial Institutions.