

The background of the slide is a faded, light blue image of a city skyline and harbor. In the foreground, there are several boats and yachts in the water. In the background, there are numerous high-rise buildings and apartment complexes. The sky is a pale blue.

# 1<sup>st</sup> PROMESA Conference

AMAZON PLATE  
**August 31, 2016**

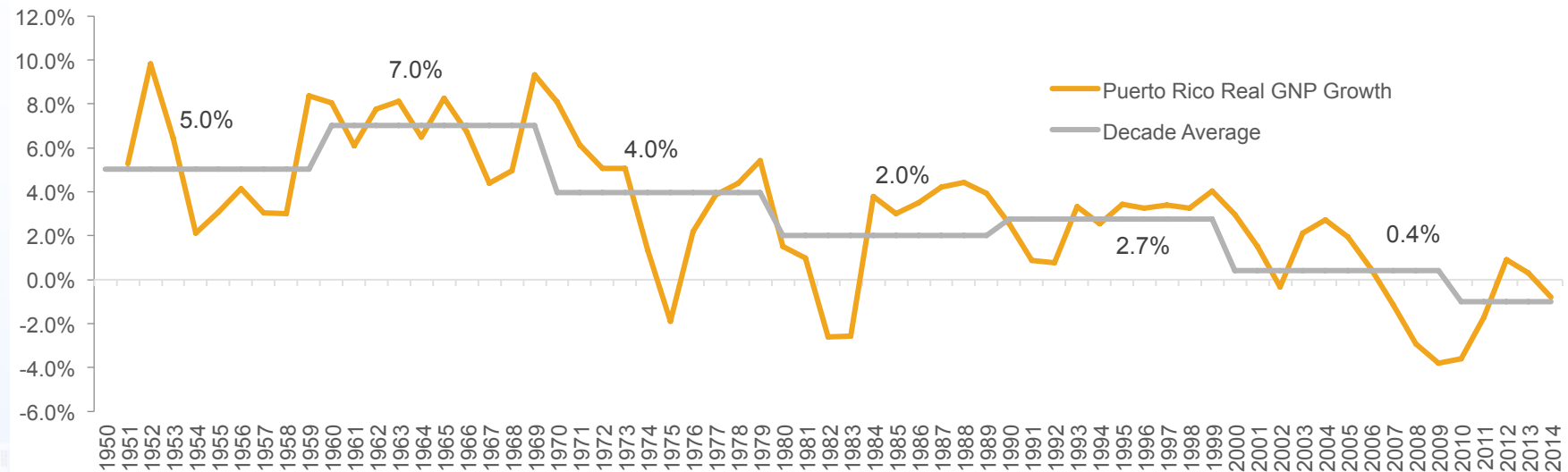
**The Economics of PROMESA**  
**José J. Villamil, Estudios Técnicos, Inc.**



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## Long Term Trends

Over the past five decades: a collapse of the capacity to generate growth. The recent experience is clearly the culmination of a long process of economic decay. The following graph shows a rapidly declining rate of growth over the last six decades.

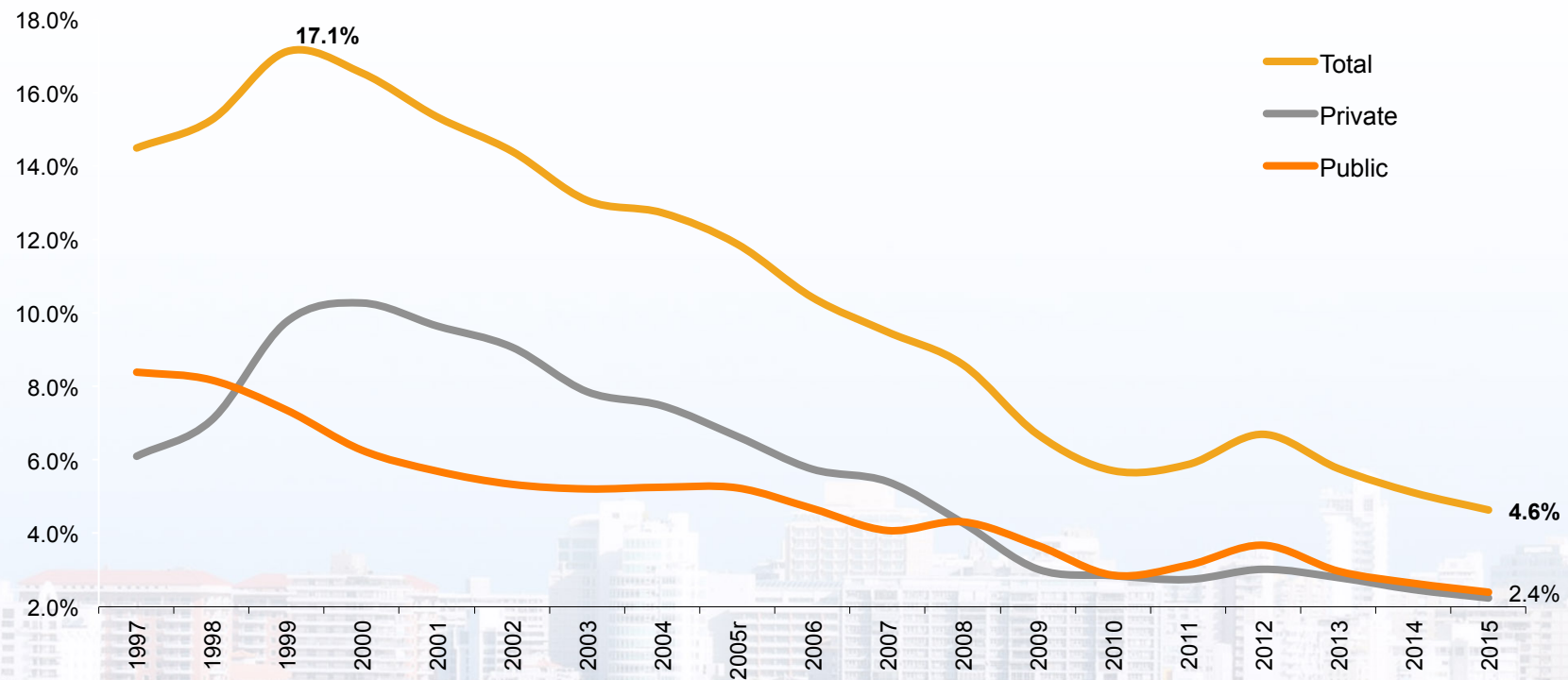


Major structural transformations have resulted making useless the traditional economic tool kit for dealing with recessions.



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## Investment in Construction (I/GNP)



- Investment in construction fell from nearly \$7.0 billion to around \$3.4 billion.

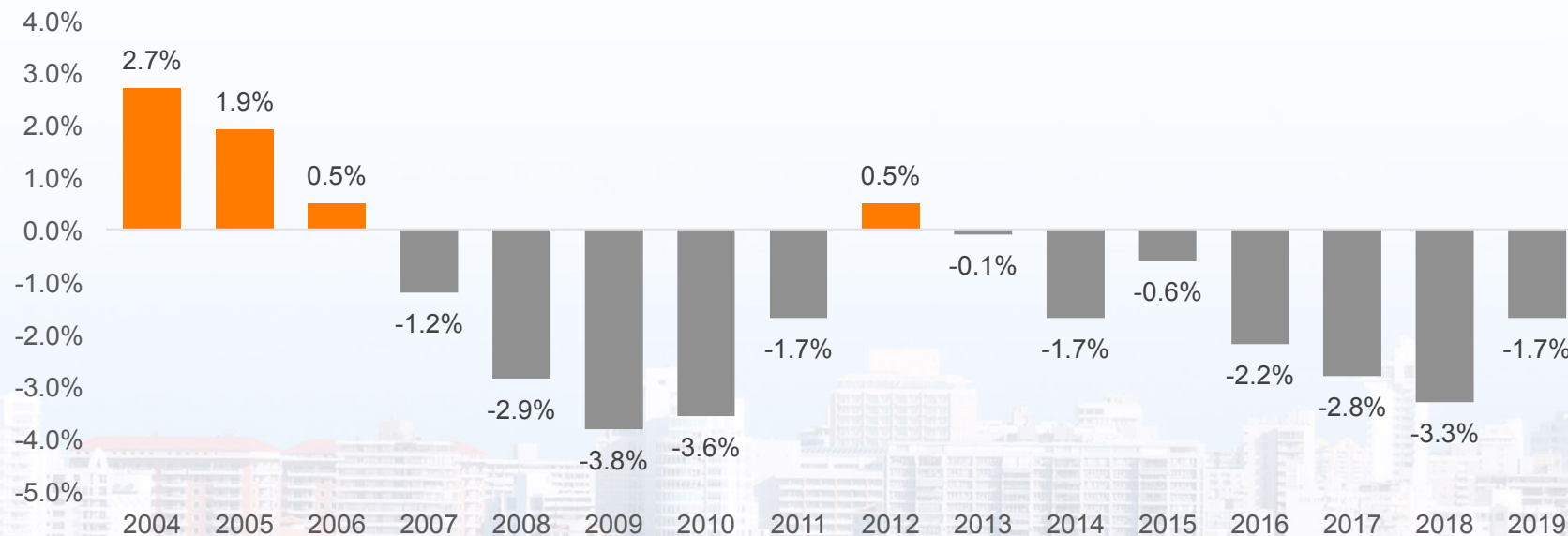




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## Annual Real GNP Growth for PR and its Forecast (2004-2019)

- The Government's role is no longer that of stimulating the economy. Its recent actions lead the economy in the opposite direction. The International Monetary Fund (IMF) projects contractions in the economy until 2021.



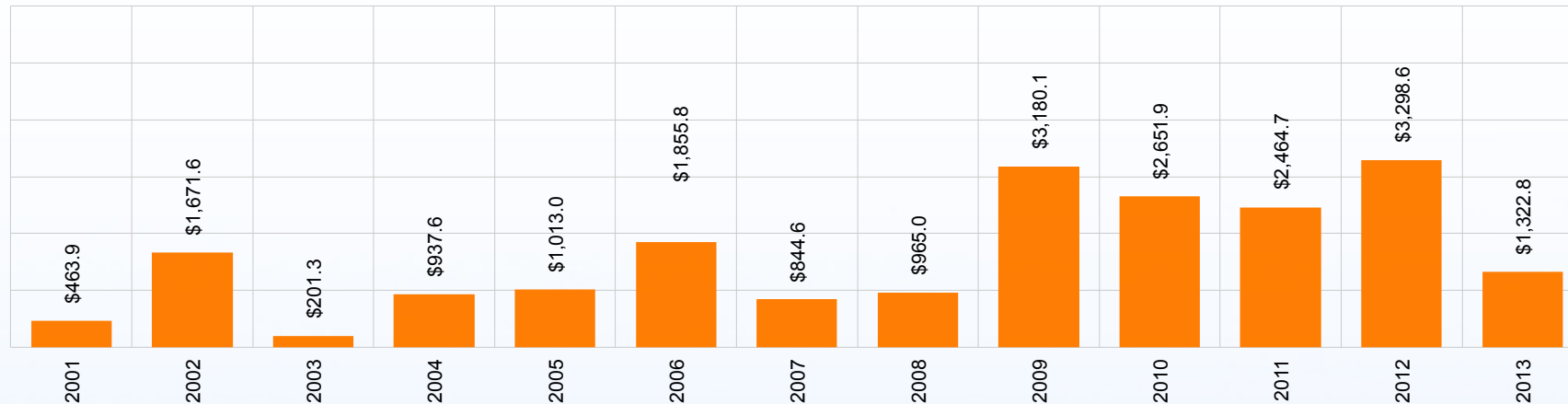


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## Fiscal Deficits

Fiscal Years -- 2001 to 2013

(millions of \$)



Sources: Office of Management and Budget (2015). Budget Petition (various years). Office of Management and Budget (2015). Approved Budget Fiscal 2015. The fiscal 2015 statistic corresponds to the estimated cash flow deficit upon the fiscal year's closing (May 20, 2015).

From 2001 to 2013, accumulated Budget deficits exceeded \$20 billion, during this same period \$42 billion in debt was issued, half of which went to cover budget deficits.



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## 2014 Financial Statements

Released in July, 2016

As of June 30<sup>th</sup> 2014, The Central Government had assets of \$15.9 billion and liabilities of \$65.6 billion, negative net worth of \$49.6 billion, \$2.7 billion higher than the previous year.

A substantial share of the deficit is due to unpaid pension payments by the Government that, in turn, explains why the long term actuarial deficit of the pension system stands at \$35 billion.

The true Budget deficit for **2014** was **\$2.7 billion**, while in 2013 the true Budget shortfall was \$5.1 billion.

Public corporations had a positive net worth of \$6.0 billion, \$3.0 billion below 2013 net worth, and had losses of \$3.5 billion in 2014. Of these the GDB had a loss of \$2.7 billion.

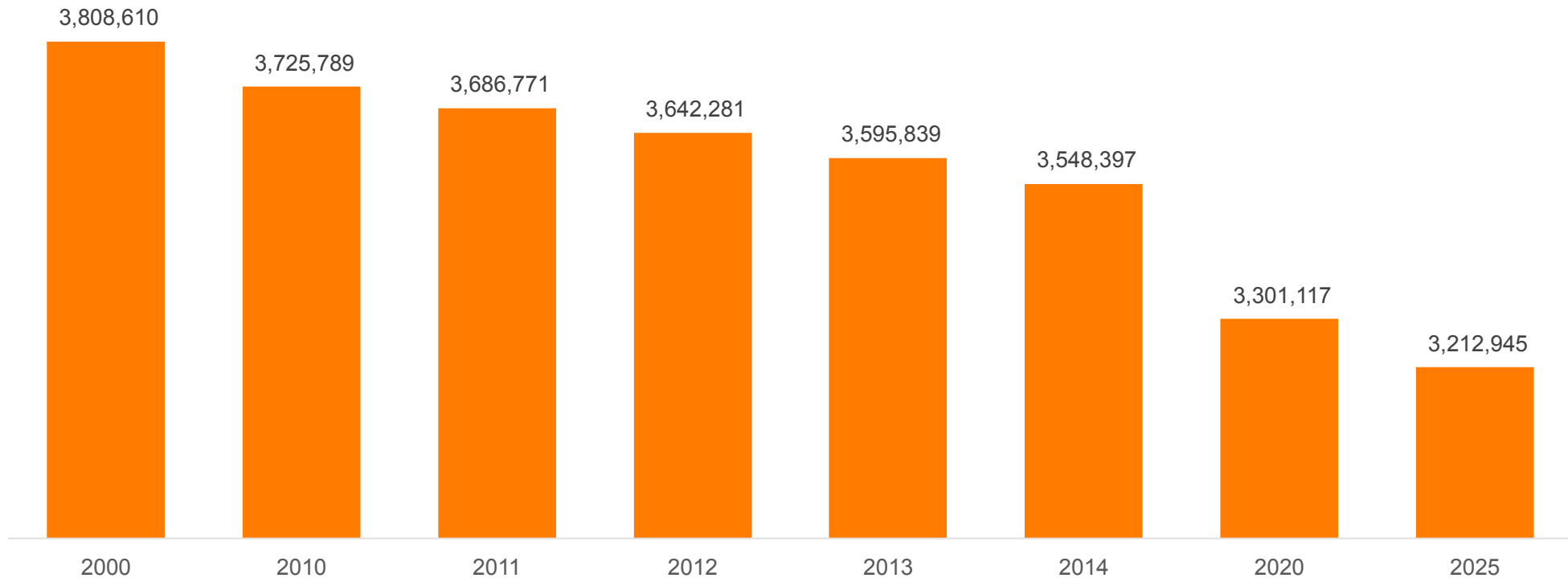
The extremely difficult fiscal situation suggests that returning to balanced budgets without significant cuts in expenditures will be almost impossible.





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## Population



Source: U.S. Census Bureau. Puerto Rico Planning Board for projections.

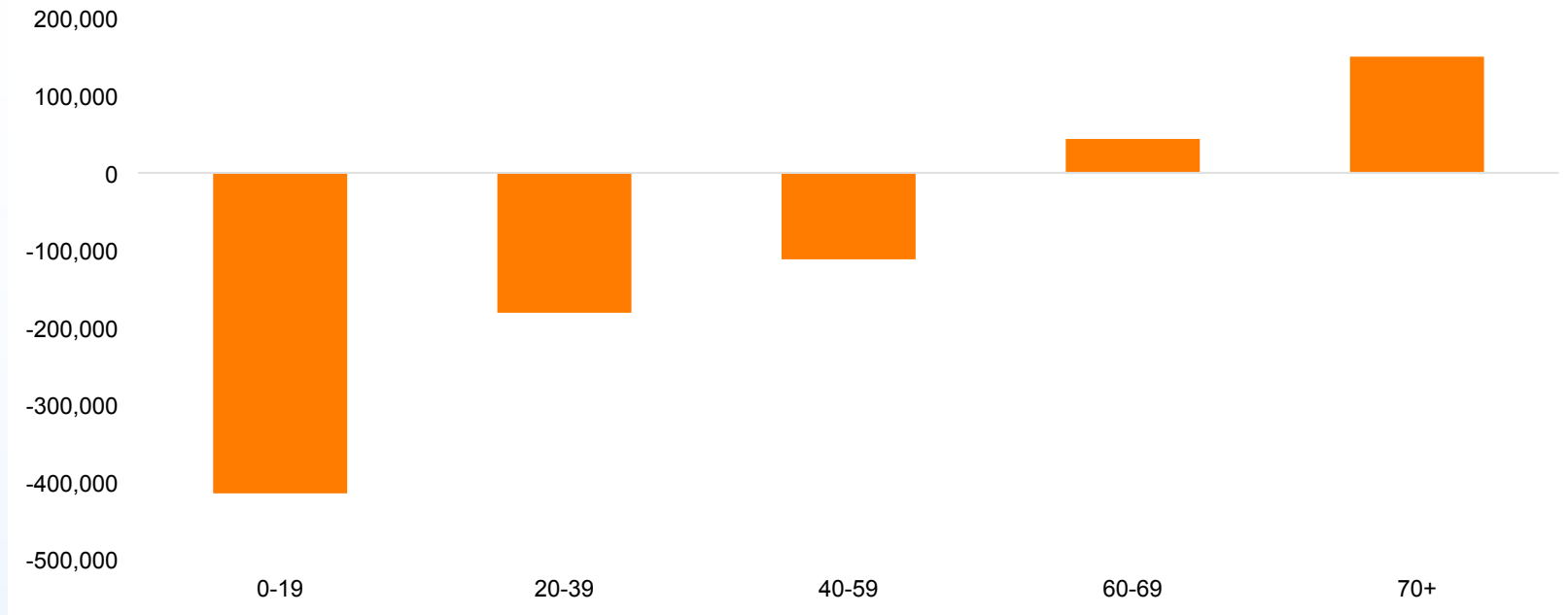
- According to the 2016 Community Survey, every municipality lost population with the exception of Gurabo (3.7%) and Toa Alta (0.1%).



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## Population

Change in population by cohort 2010-2025



Source: U.S. Census Bureau.

It is expected that the total population in **2025** will be 3.2 million

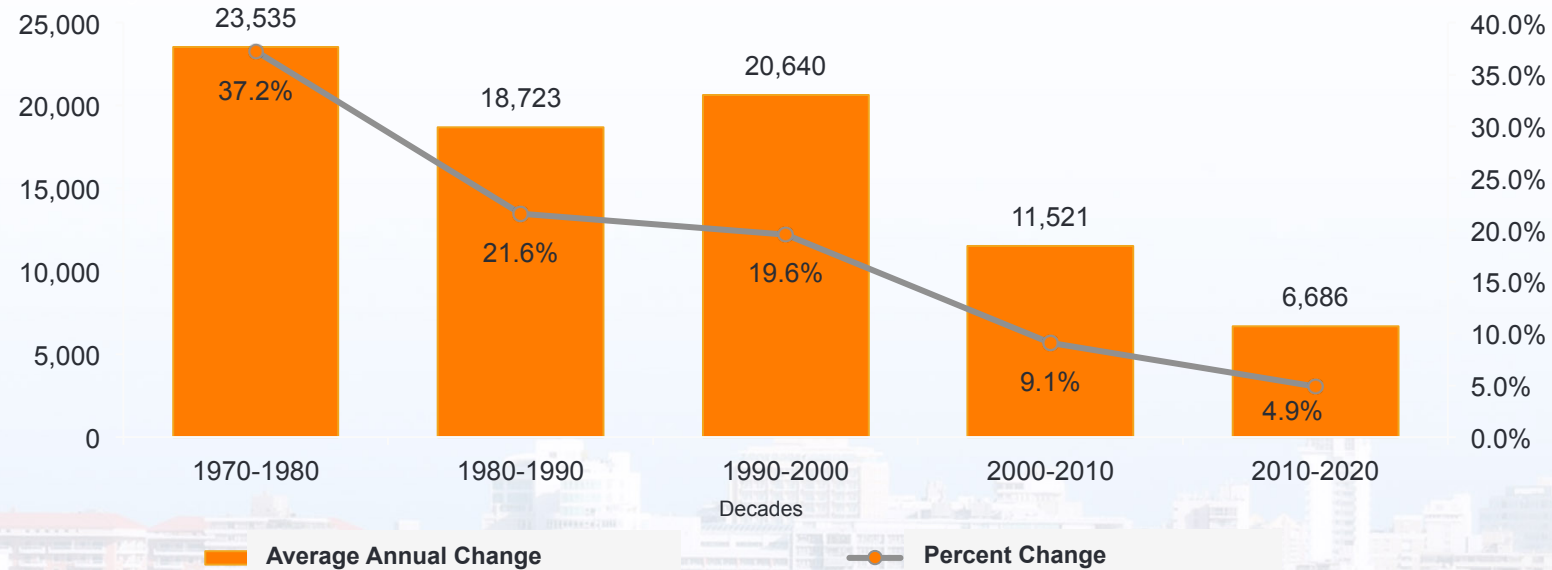




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## Population and Households

Annual Household Formation 1970-2010  
Historical

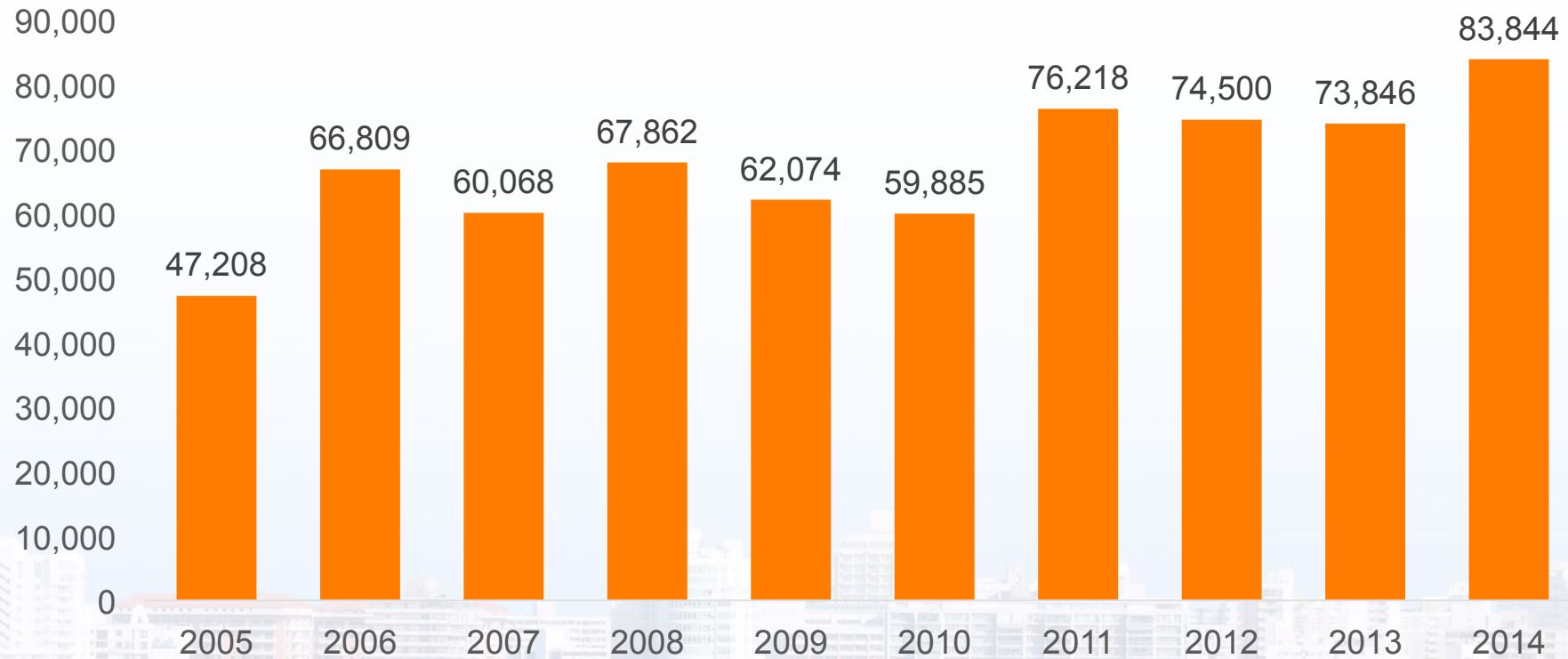


Sources: US Census Bureau 1970 - 2010. Estudios Técnicos, Inc. estimates for 2010-2020.



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## Annual Out-migration





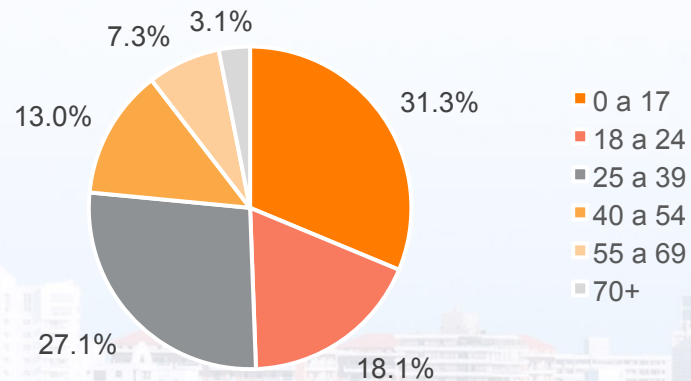
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## Migration is more prevalent among younger populations

### Migrant Profile

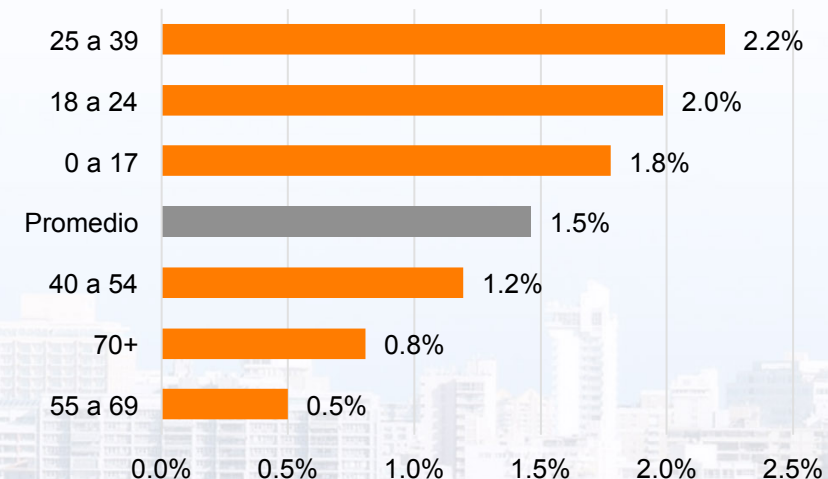
- Out of all immigrants, 49% are less than 24 years old.
- The probability of a young person migrating is twice that of someone 40 to 54 years old.

Net Migration  
By Age Group



Source: Perfil del Migrante 2013, Puerto Rico Statistics Institute.

Probability by Age Group







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## PROMESA

- The Fiscal Control Board has one primary objective and that is to assure payment of the Government's bonds. This means almost certainly a severe austerity program that will push back Puerto Rico's economic recovery and could stimulate further out-migration by impacting social programs.
- The debt restructuring process is so cumbersome and requires that so many conditions be met, that it is unlikely that it will occur within the time framework outlined in the Bill.
- Title III, Section 314 includes the conditions necessary for an adjustment of government debt. It makes clear that the Plan of Adjustment must be "in the best interest of the creditors...". Only the Board is authorized to put together a Plan of Adjustment, and submit the Plan to the Federal District Court.
- On the positive side PROMESA could place Puerto Rico on the route for achieving fiscal sanity.



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## Components

### The Financial Oversight and Management Board

- Composed of seven persons of which six are to be appointed by the President from lists submitted by the Speaker of the House and President of the Senate and Minority leaders of both Chambers. One is to be independently selected by the President.
- There are some restrictions related to qualifications and experience as well as for at least one of the members, a requirement that he be an Island resident.
- The Board members do not receive an honorarium and will be part time.

### Congressional Task Force on Economic Growth in Puerto Rico

- It will have eight members, four from each party. The Task Force has already been completed.
- The objective of the task Force is to look into impediments to Puerto Rico's growth from federal laws and regulations.
- An item that will almost certainly be included in its agenda is the treatment of Puerto Rico in the federal health programs.

### Executive Director

- The Executive Director will be the key person since he or she will be full time and will be responsible for selecting his staff.
- Unofficially, it is generally agreed that Treasury will have an input into the selection of the Executive Director.

### Strategic Projects Coordinator

- PROMESA incorporates a clause that calls for the selection of critical projects that will be given preferential treatment in the permitting process.
- The Governor is to appoint an individual as Revitalization Coordinator to manage the process of selecting and implementing projects.



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## The Five year Fiscal Plan

This document is to be prepared by the Government of Puerto Rico by **December 31st, 2016**.

The Fiscal Plan will be updated **annually**.



It will be the **benchmark** against which the government's fiscal programs and budgets will be **evaluated**.

The Government will provide the Board with **quarterly reports** on income and expenditures and the Board will have the **authority to impose changes** should performance not be in line with the Fiscal Plan.





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## The Restructuring Process Some Numbers



No one expects housing to reach the same level of sales that it enjoyed in 2006, **13,000** new units. Likely levels will be nearer the 2014 level of some 2,200 units for the foreseeable future.



Much of the construction industry, for example, is not only **smaller**, but has disappeared completely. Reviving the industry will require major structural measures not marginal ones.



The banking sector now has roughly **40% fewer** assets than in its peak year of 2005, although it is now profitable.



**250,000** jobs **lost** since 2005 and major shifts in the labor market have taken place.



A major impact of a **shrinking population** and economy is on physical infrastructure planning, with excess capacity developing in some of the major infrastructures, PREPA, for example, but also the Department of Education.



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## Impacts and consequences of a smaller and destructured economy

- Economists typically think of recessions as cyclical shifts that can be mitigated with the typical tool kit associated with monetary and fiscal actions.
- In 2010, for example, the Government's Economic Advisory Council indicated that our contraction would be a "U" shaped recession. It has turned out to be an "L" shaped situation, where the bottom once reached will remain there for a long period.
- The prolonged and deep contraction has created serious structural ruptures in various sectors such as construction and banking that will take time to mend. Even the economic geography of the Island has been affected.
- Puerto Rico's labor market has been impacted and there has been significant losses of highly trained professionals in medicine, engineering and other areas. Skilled workers have left the Island and recovery in some sectors will require drawing them back. Likewise various jurisdictions in the mainland have been recruiting bilingual teachers in Puerto Rico.
- **Recovery will take a very long time even if the fiscal situation is resolved.**



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## Impacts and Likely Consequences of PROMESA

The Oversight or Control Board will remain in place for at least **four years** and possibly for much longer. Before it is disbanded two conditions must be met:

- The government must have had balanced budgets for four years
- Puerto Rico has regained Access to financial markets.

It will inevitably put in place **austerity programs** that will reduce government expenditures and this will impact aggregate economic performance in the next three to four years.

One possible consequence is that PROMESA will **stimulate** further **out-migration**, particularly should the Governor put in place measures to lower the minimum wage.

One potentially very positive impact of PROMESA is that it could **generate confidence** in the government, badly damaged by its recent performance, including frequent changes in the rules of the game and corruption. This could prove to be important in stimulating investment.



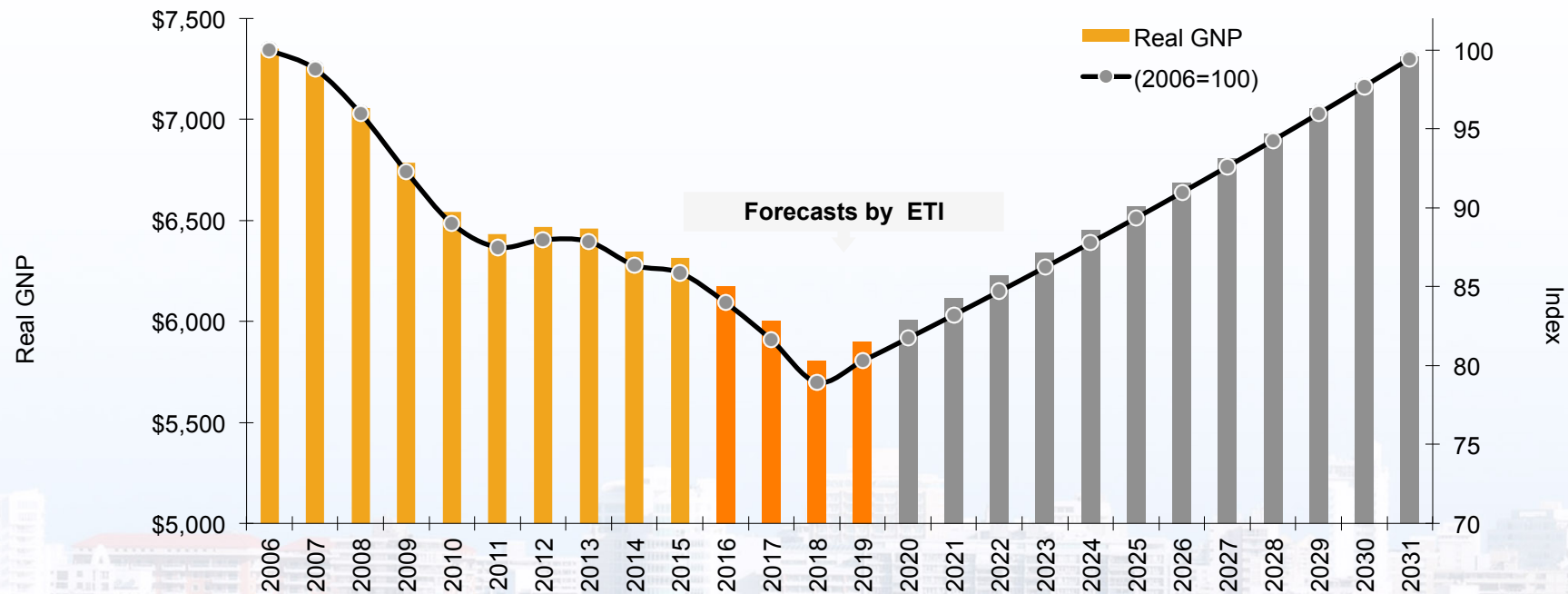


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## Returning to Pre-contraction 2006

How long will it take the Economy to reach the real GNP level of 2006

(Assuming an average annual growth rate of 1.8% from 2020 to 2031)



Sources: P.R. Planning Board (2016); Estudios Técnicos, Inc.

Reversing major structural changes of the past decade will be very difficult and take many years.



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## Long term prospects

- Obviously, moving the economy back to a path of high growth rates will not be easy given the erosion of human, economic, financial and social capital and the need to reconstitute an institutional framework that is not functional with present and prospective economic and social needs.
- Economic culture has become a defensive culture related to the fact that the economy has become a market share economy.
- In the public sphere, the political system has become what Acemoglu and Robinson (*Why Nations Fail*) call an “extractive” political system, one in which maintaining itself in power takes precedence over resolving society’s problems. Further the political system has become an economic sector and the political class an economic class.
- Turning around the cultural context reflected in the above, particularly with respect to the political system, will take time and leadership, most likely from Civil Society.
- An open economy that has shrunk and in which its institutional framework has been severely weakened faces greater risks from external shocks. This requires that risk management assume a central role in economic policymaking.



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## Long term prospects (cont.)

- There is a need to focus on those structures that can be transformed in a relatively short period and that can be instrumental in breaking the negative spiral that has characterized the economy.
- Puerto Rico's approach to development policies has been characterized for decades by a short term operational bias. Given the risk environment for the Island, the absence of resources and the structural deficiencies that have resulted from the prolonged and deep economic contraction, the change to a strategy and risk based decision-making approach is essential in order to minimize the Island's risk profile and advance medium and long term economic perspectives.







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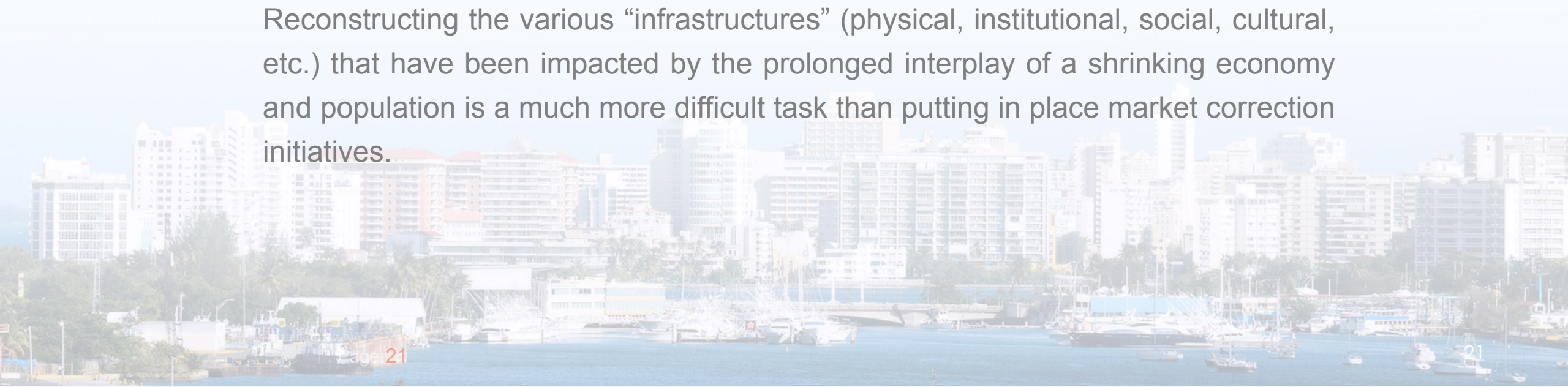
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## Long term prospects (cont.)

Major structural ruptures have resulted in the Island's demographics (including size, age composition and geographic distribution), its economic structure, labor markets, government and even the spatial distribution of economic activities.

Even culture, understood as the set of norms that regulates everyday life, including economic aspects, will have been impacted.

Reconstructing the various “infrastructures” (physical, institutional, social, cultural, etc.) that have been impacted by the prolonged interplay of a shrinking economy and population is a much more difficult task than putting in place market correction initiatives.





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## What can we expect?

### In the United States:

- The U. S. Economy will grow but at a slower rate in the next two years.
- It is reasonable to assume that austerity will prevail over stimulus and that certain programs will be eliminated or downsized.
- The Global economy will reflect mixed performance with the advanced economies growing at modest rates in the next two years and the BRICS slowing down. Latin America's growth will almost certainly continue but at much slower rates. Brazil, the largest regional economy is in a deep recession and faces increased turmoil.
- Overall, oil prices will remain at historically low levels for this and the following year, but a modest increase is to be expected.
- China's economic presence will partially substitute that of the U.S. in the Middle East, Africa and Latin America, although its recent difficulties will impact Chinese expansion abroad.
- The practice of U.S. firms finding better tax environments will continue, but legal efforts to stop the "inversion" process will almost certainly be adopted. The CFC's are threatened by proposed changes to the U.S. tax code.
- The risk of an increase in the Fed's interest rate had been reduced by recent performance of the labor market and Brexit, although the possibility has been mentioned often.



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## What can we expect?

### In Puerto Rico:

- Continued fiscal difficulties will characterize Puerto Rico and a *de Facto* moratorium will most likely be in place well into 2017..
- A prolonged period of litigation is foreseen, with one case already in Federal court questioning the legality of the “clawback”. The GDB has still to present a truly new negotiating position, preferring the “superbond” offer with minor recent modifications.
- PDP candidate for Governor, David Bernier, presented a proposal for a five year moratorium on principal payments, guaranteeing the payment of interest. The rationale for the measure is that it would permit a sufficient timeframe for negotiating a permanent agreement on the public debt.
- With respect to the tax system, a suspension of the VAT has been legislated, as well as freezing the B2B tax on services at 4.0%.
- High energy costs will remain for the foreseeable future, even with low petroleum prices, and will increase as a result of debt negotiations and expected petroleum price increases.
- The 2016 elections will take precedence in defining policy initiatives.





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## Badly needed in Puerto Rico: evidence based decision- making

“... the problem with any ideology is that it gives the answer before you look at the evidence. So you have to mold the evidence to get the answer that you've already decided you've got to have. It doesn't work that way”.

Bill Clinton





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# Thank you!



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