



COMMONWEALTH OF PUERTO RICO **FISCAL UPDATE**

December 2007

A Midyear Review

At the mid-point of Fiscal 2008, the Commonwealth of Puerto Rico has addressed major issues that it has been facing over the last 18 months.

Action to Reduce the Structural Deficit

Fiscal reform is in full implementation and spending has decreased. The structural deficit has been reduced more than 70%, to a more manageable \$400 million in Fiscal 2008, from as high as \$1.4 billion in Fiscal 2006, with reform legislation requiring structural balance by Fiscal 2010. Tax reform is in place and is substantially on target. Despite the economic slowdown, tax revenue has increased. The Sales Tax is producing almost twice the revenues of the Excise Tax that it replaced. A Government restructuring plan to revitalize economic growth is being implemented, with the emphasis on private sector growth and the knowledge economy.

Action to Improve GDB Liquidity

GDB's liquidity and balance sheet have been strengthened. We reduced our loan portfolio by more than \$3 billion since June 2006. Total assets and total liabilities at June 30, 2007 amounted to \$11.9 billion and \$9.7 billion, respectively, for net assets of \$2.3 billion. The decision to reduce total assets resulted in a lower ratio of liabilities to assets and a proportionately higher ratio of net assets to total assets (19% at June 30, 2007 vs. 16.4% at June 30, 2006). This improvement resulted in a stronger, healthier capital structure, a program that is continuing. Other Commonwealth credits have been strengthened, too. The rate increase beginning in 2005 by the Puerto Rico Aqueduct and Sewer Authority has enabled the Commonwealth to reduce its General Fund subsidy to PRASA by \$400 million. The toll increase by the Puerto Rico Highways and Transportation Authority (PRHTA) boosted its financing capacity.

Action to Reduce Debt Levels

The dedicated portion of the Sales Tax has been used to create a fund that will extinguish \$6.8 billion of "extra-constitutional debt" that built up as a result of the Commonwealth's structural deficits. This fund issued its first \$4.0 billion A+ rated bonds to refinance such debt in July 2007. At the same time, the Commonwealth's General Obligation (GO) debt issuance is declining. New money raised has dropped 35%, to \$325 million for Fiscal 2007, from \$500 million for Fiscal 2006. It is expected to drop another 15%, to \$275 million for Fiscal 2008. As a result, the ratio of GO debt to Gross National Product is falling. To further reduce Commonwealth and public corporation debt, GDB recently held its first Puerto Rico Infrastructure Forum to explore a new financial model that could complement public investment. Representatives from major international infrastructure companies, investment funds and our public corporations discussed ways to develop public-private partnerships (P3s). Our priorities for implementing such programs are focused on PRPA, PRHTA, and PRASA.

Action to Increase Pension Funding

We are implementing a plan to issue \$7 billion in Pension Funding Bonds within the next 12 months. This will reduce the unfunded liability of the Government employee retirement system to less than 30%. By way of comparison, the fund had \$2.2 billion of assets and an unfunded liability of 81%, or \$9.9 billion, as of June 30, 2005. The bonds will be backed by existing statutory employer contributions and thus will not increase debt payments by any employer. To improve the system's current return on investments, we have also developed a new investment policy. As part of this new policy, the system recently selected 18 new investment managers.



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Result: Improved Credit Ratings

As a consequence of all of the above activity over the last 18 months, on May 22, 2007, Standard & Poor's improved the outlook to stable from negative on Commonwealth GO debt, although it downgraded the rating to BBB-. On November 6, 2007, Moody's improved the outlook for the Commonwealth to stable from negative and confirmed our investment grade Baa3 rating. On December 13, 2007, S&P raised its counterparty credit rating on GDB to BBB/A-2 from BBB-/A-3. GDB is the first Commonwealth credit to be upgraded since 2005.

"The upgrade reflects the improved liquidity profile and the refortification of GDB's capital base and balance sheet," according to S&P's news release. "It also reflects improved fiscal management at the Commonwealth level, exemplified by the formalization of structural limitations on the Government's ability to borrow from GDB, and the establishment of a dedicated repayment source for some preexisting GDB loans in the form of sales tax proceeds."

The improvement to a stable outlook by both agencies assures the stability of our current ratings and has benefited other offerings. Early in December, the Puerto Rico Public Buildings Authority successfully issued \$900 million in bonds (approximately \$600 million for refinancing and \$300 million in new money) with a 17-year average life and at an attractive rate. As a percentage of tax revenues, current maximum debt service on outstanding issues remains at the lower end of the historical range for Puerto Rico.

The projected Fiscal 2008 ratio is 8.9%, slightly higher than the preceding year, but significantly below its peak of 12.6% in Fiscal 1984 and well below the 15% Constitutional limit.

Expected Financing Transactions: Short Term

Over the next three months or so, we anticipate approximately \$5 billion in financings: \$150 million for the Tourism Company; \$4 billion in the first of two Pension Funding Bonds; and \$930 million for PRASA's permanent improvement plan.

Economic Factors: Short & Medium Term

Now that Puerto Rico's credit ratings have begun to improve, and structures are in place to continue to enhance that improvement, the focus is on revitalizing the economy. The outlook remains challenging. The recession that began in late 2006 remains, and is being affected by high oil prices and slower growth in the US. Non-performing assets at private banks are on the rise, although Puerto Rico has no subprime real estate issues. On the other hand, tourism has remained vibrant, and continues to grow. Individuals in Fiscal 2008 and Fiscal 2009 will benefit from tax relief as a result of recent legislation.

To help jump start the economy, the Governor called a special session of the Legislature to consider various economic stimulus measures. Thus far, the most important of those approved provides up to \$25,000 in tax credit applicable to the purchase of a new home. The Legislature still has other measures under consideration.

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