

Economic

Sovereign FC MLT Ratings

Moody's: NR
S&P: NR
Fitch: NR

Nominal GDP (2010)

USD 60.7 bn

Population (2010):

4.0 mn

Total Trade / GDP (2010):

176%

Currency:

US dollar (USD)

Exchange regime:

Dollarized

Merchandise Imports from

Canada (2010):

CAD 0.5 billion

Top exports:

Chemical products
Processed foods
Computers & Electronics

Largest Merchandise Export

Destination (2010):

United States (73%)

Risks to the Outlook



Domestic economic a main driver.



US economic activity stagnates.

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MARKET SPOTLIGHT: Puerto Rico GDP growth is expected to show little improvement over the ST. • The fiscal position and economic instability will continue to be the main economic sore points for the Fortuño administration. • Legislation to bring referendum to fruit will be debated.

Real economy: Real GDP suffered a fourth consecutive year of decline, contracting an estimated 4.2% y/y in 2010. The domestic economy continues to stagnate, unaided by high unemployment (approximately 15% in 2010), and is expected to post little improvement in 2011 and 2012. On the upside, the government announced it will focus on public-private partnerships to expand private investment and further development of the economy. Lending activity was halted following a bail out of the five major banks (financed by US Federal Reserve) in 2008 and 2009. As banks start to recapitalize their books, lending is expected to resume. Due to uncertainty surrounding fiscal and economic instability, the economy is expected to decline 1% y/y in 2011 and demonstrate minimal improvement, growing 0.4% y/y in 2012.

Fiscal Policy: Chronic fiscal deficits have placed the government in a precarious position, hindering program implementation to revive the ailing economy while relying on stimulus moneys from the US and increasing its public debt stock to meet its expenditure obligations. The administration will be shifting much of its efforts from fiscal consolidation measures of drastically cutting expenditure to tax cuts and stimulus spending to boost the ailing economy and enhance re-election prospects running up to the November 2012 elections. In late 2010, tax cuts for individuals and domestic corporations were announced to boost the domestic economy funded by a new 4% tax on transactions between affiliates of foreign companies, primarily in the manufacturing sector (could have an adverse effect by forcing foreign companies to relocate to lower cost locations). Thus far, the tax cuts have had a positive impact on the economy; however, concerns over foreign companies potentially exiting the market will persist. In addition, the underfunded public pension fund will continue to exacerbate liquidity risks as the government scrambles to pay out pension obligations. Liquidity and solvency indicators are increasingly concerning; however, the government demonstrated its commitment to fiscal consolidation, improving the liquidity outlook over the ST. Notwithstanding, the MLT outlook is uncertain.

Fortuño's pro-statehood New Progressive Party has brought to congress legislation proposing a two-step referendum to reassess the political status of Puerto Rico. It is unclear when the referendum will be voted upon but the pro-status quo opposition Popular Democratic Party is expected to put up a fight.

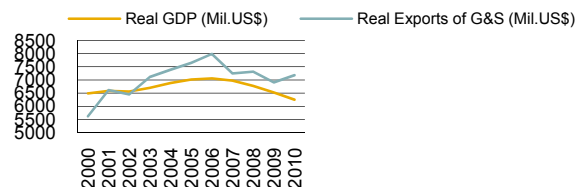
Monetary Policy: Puerto Rico uses the USD as its currency due to the economy's close ties to the US. It maintains a dollarized currency regime, thereby relinquishing its monetary policy. The inflation rate will follow that of the US, and based on Puerto Rico's lacklustre economy, consumer prices are expected to show sluggish growth. Movements in inflation will largely be explained by a low base effect.

External Sector: The current account suffered greatly during the US recession as exports and investment flows declined. Current account earnings will see better conditions in 2012 as US economic activity recovers; however, may experience a cut back of US government transfers given consolidation efforts in the US. Sluggish private consumption, and in turn import demand, will counter balance some of the downward pressures on the current account. High oil prices will have a shrinking affect on the merchandise trade surplus.

Outlook: Although improvements in the past two years have demonstrated positive effects on the fiscal position, structural weaknesses will persist over the forecast horizon. Reviving the muted domestic economy will be the Fortuño administration's main priority, in addition to promoting a 2012 re-election. Should the tax reforms and fiscal consolidation prove to have been successful, it will provide the government with needed wiggle room to implement stimulus programs in hopes of ending the long lasting recession. Needless to say the outlook over the MLT will remain uncertain until the changes and effects are fully felt by the economy.

Economic Indicators

	05-09 avg	2010e	2011f	2012f
Real GDP (%)	-1.1	-4.2	-1.0	0.4
Inflation (CPI, %)	5.0	2.5	3.0	3.5
Budget Balance (% of GDP)	-2.8	-5.7	-4.2	-3.0
Export of goods (%)	1.7	5.0	4.5	5.0
Import of goods (%)	1.1	3.3	4.0	4.5
CA balance (% of GDP)	-6.0	-0.5	-0.5	-0.5
External Debt (% of GDP)	74.3	65.0	53.0	53.0
Debt service ratio, due (%)	8.1	8.6	9.5	10
Exchange rate (LCU/US\$, avg)	1.0	1.0	1.0	1.0



Source: Junta de Planificación de Puerto Rico, EIU and EDC Economics