

Puerto Rico's Economic Slump Weighs Hard on Consumers

Cost of Living Surges As Inflation Helps Tip Island Into Recession

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SAN JUAN, Puerto Rico -- With her living costs rising, Teresa Cruz has stopped shopping at her favorite stores. Instead of buying clothing at Marshalls, a popular merchant known for selling name-brand clothing at a discount, she now looks for bargains at local thrift shops.

She is also buying less-costly packaged foods instead of fresh fruits and vegetables. "I have to use my money only to pay for necessary [items]," says the 34-year-old telemarketing supervisor, who says it costs \$50 to fill up her Kia Sedona with gasoline, up from \$30 a few months ago.

Left Behind: While inflation in most of the U.S. has remained subdued, prices in Puerto Rico are rising faster, putting pressure on consumers.

Dangerous Mix: Puerto Rico's economy is hobbled by a troubled manufacturing sector, national debt, costly imports because of geography and a heavy reliance on oil.

More Pain Ahead: The government has trimmed costs but also raised taxes, further increasing prices and cutting consumer spending.

The rising cost of food and energy has been a nagging problem for many Americans. Yet even as oil neared \$80 a barrel before its recent slide and the cost of milk has surged to a record \$3.80 a gallon in the past year, overall inflation in most of the U.S. has remained subdued. In June, the consumer-price index was up 2.7% from a year ago.

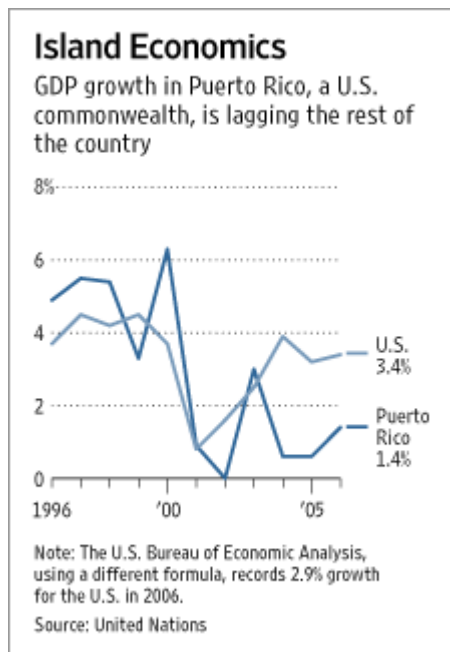
But here in Puerto Rico, the consumer-price index, which includes food and fuel prices, was up 15% in 2006, according to the Puerto Rico Department of Labor and Human Resources. Water and sewer rates have more than doubled over the past two years, and electric bills jumped about 40% last year, according to Standard & Poor's.

Economists and the Puerto Rican government say the Labor Department figures overstate inflation by a large margin (the government says it is in the process of revamping its consumer-price index) but they generally agree prices are rising faster here than in the rest of the U.S.

The increases are more painful to Puerto Rican consumers, whose \$17,000 median household income is less than half that of U.S. residents. Those problems, which come as the island's manufacturing segment is hurting and the government is struggling with deficits, have helped push an already troubled economy into recession.

"You hate to use the term 'the perfect storm,' but whenever you get all these different things coming together at the same time there's no other way to describe it," says Miguel Soto-Class, executive director of the Center for the New Economy, a Puerto Rican think tank.

Puerto Rico's gross national product is forecast for a 1.4% decline in the fiscal year ended in June. The overall U.S. economy grew 2.9% last year, as measured by changes in gross domestic product, and expanded at an annual rate of 3.4% in the second quarter.



Inflation is higher in Puerto Rico partly because of its geography. Located 1,000 miles southeast of Miami in the Caribbean Sea, most of what the island consumes is transported by plane or by boat, adding to the cost. And while Puerto Rico has built natural-gas and coal-fired plants to reduce its dependence on oil, about 67% of its electricity comes from petroleum, compared with 3% for the U.S.

The price run-up comes at the worst possible time. A self-governing commonwealth of the U.S., Puerto Rico's economy is essentially built around two sectors: the government and manufacturing, which combined account for 39% of the territory's jobs and 52% of its GDP. But in recent years, manufacturing has been facing tough competition from international competitors while the government is cutting costs and reducing payrolls as it struggles with debt.

Puerto Rico's manufacturing sector, much of it pharmaceutical makers, was built up with the aid of low taxes and inexpensive labor. But those advantages have recently eroded: Two years ago, the U.S. completed a

decade-long phase-out of a section of the tax code that allowed many U.S. companies to operate in Puerto Rico without paying federal taxes on profits generated there.

Meanwhile, some lower-cost manufacturers have moved to less costly destinations such as South America and Eastern Europe. These and other challenges caused Puerto Rico's manufacturing sector to lose about 8,400 jobs last year, a 7.3% decline, according to Moody's Economy.com. The losses were heavier in lower-skill sectors such as textiles, which saw a 16% contraction; chemical and pharmaceutical manufacturing dipped 7%

Amid these cutbacks, employment has declined and consumer spending has fallen. This has reduced government tax revenue, creating a nasty cycle where the government has trimmed costs but also raised taxes. That has further increased prices, hurting consumers even more. "It was almost a self-inflicted recession," says Horacio Aldrete-Sanchez, director of public-finance ratings for Standard & Poor's Ratings Services, the credit-rating service.

The Commonwealth had a budget deficit of \$605 million for fiscal-year 2007 and is projecting a deficit of \$260 million next year. To address the gap, the government has cut jobs and introduced its first sales tax, at 5.5%. The average electric bill increased to about \$81 last year, from \$58 the year earlier, a 40% increase. The government is also cutting costs, dropping workers and delayed almost \$100 million in payments to contractors and suppliers.

Security guard Luis Rivera says the financial troubles cost him his job. Mr. Rivera says he was one of many employees let go by Island Security, which had a contract with a San Juan hospital. After he left, city police officers temporarily took over security, but were later replaced by another private company. Mr. Rivera has since gotten a job with a new security company. "The economy gets worse everyday because the government fails too much," he says.

High costs are also tough on business owners such as Tony Larrea. The president of fast-food operator South American Restaurants Corp., Mr. Larrea says the water bill at his restaurants increased 70% over the past year and he now pays an average of 18 cents a kilowatt hour for electricity -- about double the rate in the U.S. "We pay more in electricity than we pay in rent," he says.

With less to spend, consumers have drastically cut back on their car purchases. Car dealers in Puerto Rico sold 117,838 cars last year, a 16% decrease from 2005. Sales are down another 17% this year through June. Carlos Lopez-Lay, chief executive of Bella Group, a Honda distributor in San Juan, says one of the hardest things for dealers to accept is that there just aren't as many customers anymore.

"The market has been reduced," he says. Between layoffs and attrition, Mr. Lopez-Lay has reduced his work force by 42 people, or about 8% of his employees, most in administrative and office jobs.