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The Path Forward: Examining Puerto Rico's Economic Trajectory

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After two years of persistent inflation and uncertainty on different fronts, such as progress on debt restructuring, the disbursement of federal reconstruction funding, and the future trajectory of interest rates, some observers argue that Puerto Rico's economy is normalizing and that, even without federal funds, the economy is strong enough to sustain robust growth. However, I am skeptical about this assertion.

The decreasing rate of inflation continued through 2023, with annual headline inflation growth settling at 3.4%, a notable decrease from the 6.1% recorded in 2022. Alongside this trend, the labor market exhibited resilience, seeing a net creation of 26,200 jobs and maintaining the unemployment rate at a historic low of 6.0%. Furthermore, the annual growth in average weekly earnings for all workers (5.8%) surpassed the inflation rate (3.4%) in 2023, marking a reversal from 2022. These positive shifts may positively impact the economy of Puerto Rico in the short term.

While the improved purchasing power and a potential reduction by the Federal Reserve (i.e., Fed) in the Fed fund rate sometime

Graph 1: Average weekly earnings all workers and inflation (%)

Source: Bureau of Labor Statistics

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in the second half of 2024 may support consumer spending and economic growth, a closer look at various factors raises doubts. For instance, inflation in the island, particularly for certain food items and services (e.g., cereal and bakery products, recreation services, and lodging away from home), still substantially exceeds the 1.8% average between 1984 and 2019. In any case, a lower inflation rate should not be confused with lower price levels.

Moreover, the reduction in the Fed fund rate may not necessarily ease local credit conditions, as loan pricing is more likely to be guided by long-term interest rates, which are, in turn, influenced by factors beyond the Fed's control, including inflation expectations, the federal government deficit, and foreign central bank appetite for U.S Treasuries.

Graph 2: 10-year U.S. Treasury (%)

Source: Federal Reserve Economic Data, Federal Reserve Bank of St.

Structural issues such as labor shortages, an aging population, lower productivity, and the transition to net zero greenhouse gas production by 2030 would keep prices and interest rates high. Nobel laureate in economics Michael Spence said in The Next Phase of Our Inflation Journey (2024) that "with structural shifts having diminished the supply side's capacity to respond to demand-side pressures, higher real interest rates will be needed to keep demand – and thus, inflationary forces – in check." This would imply a higher cost of capital which, in our case, will continue constraining private investment. Costly loans, such as residential mortgage loans, will also limit housing affordability in the local market.

Finally, geopolitical risks (i.e., the Israel-Hamas war, Ukraine-Russia war, and the Houthi's attacks on international vessels using the Red Sea route), local upward adjustments in the commercial, industrial, and residential electricity bills, higher highway tolls and increased food prices and volatile gasolines prices could revert the trend towards lower inflation of the last two years.

Thus, arguing that economic conditions are normalizing may be premature. There is room for some optimism, but the outlook for 2024 and 2025 remains highly uncertain, particularly regarding inflation and interest rates, given the complex interplay of structural and global factors. Let's wait and see!

From Globalization to Regionalization?

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Background

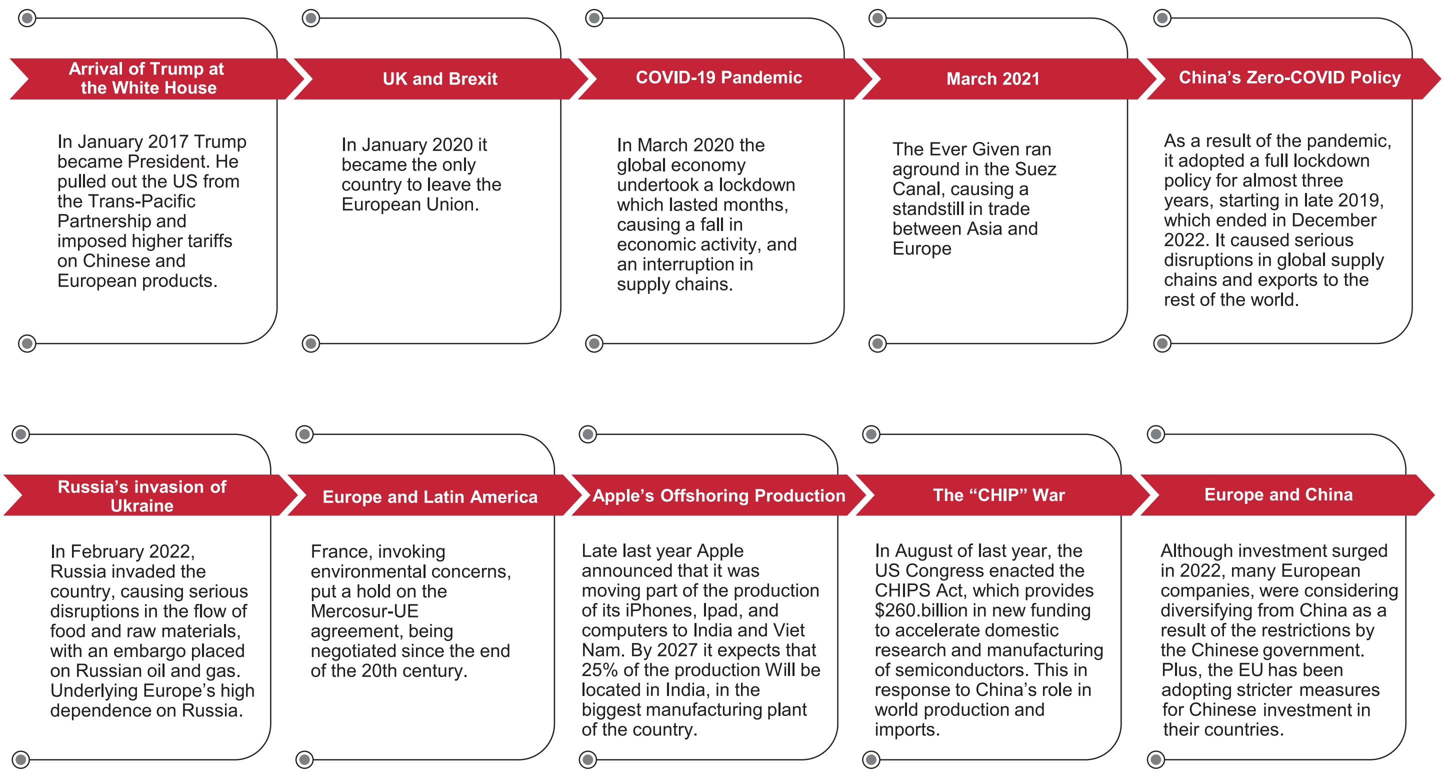
The recent discussions on the dichotomy globalization-regionalization, highlighted by the world pandemic and the US-China trade war, are not new. Already by the end of the last century scholars were examining the interaction of these forces, with some considering them as overlapping one another, that cannot be examined in isolation, and "never harmonious".[1]

One important characteristic of the global economy since the end of the 20th century has been how global and regional economic linkages strengthened significantly, with a more integrated global economy as flows of trade and finance increased considerably, and intra-regional linkages also became stronger.[2] Between 2000 and 2019, total world exports of merchandise increased, from $6.5 trillion to $19.0 trillion, with manufactured products accounting for 67.0% of the total.[3]

The role of certain economies and regions, in particular those of China and of Southeast Asia, as centers for the location of investment and production by foreign companies, was very much highlighted, in which the movement of supply chains from the East to the West became economically and strategically indispensable for the economic well-being of the US and Europe. In 2021, about 40.0% of total containerized trade was on these routes, with Asian container exporters among the top five, accounting for almost half the traffic, and included China, Viet Nam, the Republic of Korea and Japan.[4] By 2019, seven out of the 10 biggest container ports in the world, in terms of freight handled, were in China, a ranking that still holds today.[5] By that year China's share of global throughput (Handled container freight in volume) rose to 30.0%, from 24.3% in 2010.[6] That importance was highlighted during the pandemic, when China's economy, as that of the rest of the world, was in lockdown. The conflict in Ukraine and the related sanctions have affected mostly trade between China and Europe, as China's policy of zero- COVID also had an impact on its trade with the rest of the world.

An added dimension now is the role of Chinese-owned companies in the US, and worldwide, as China's increased preponderance in high-end technologies presents challenges to US technology companies inside and outside the US. Witness the recent debate on the manufacturing of microprocessors, with the US government responding with the enactment of the CHIPS Act last August.[7] It has become the main contention between both

Figure 1: Timeline International Events



Source: Estudios Técnicos, Inc.

countries in the race for future technology.[8] Right now, most of the production of semiconductors is done by a Taiwanese company, TSMC, which controls 90.0% of the physical production of high-end chip, with the back-end stages done in China, Vietnam, and South Korea.

Meaning of globalization and regionalization

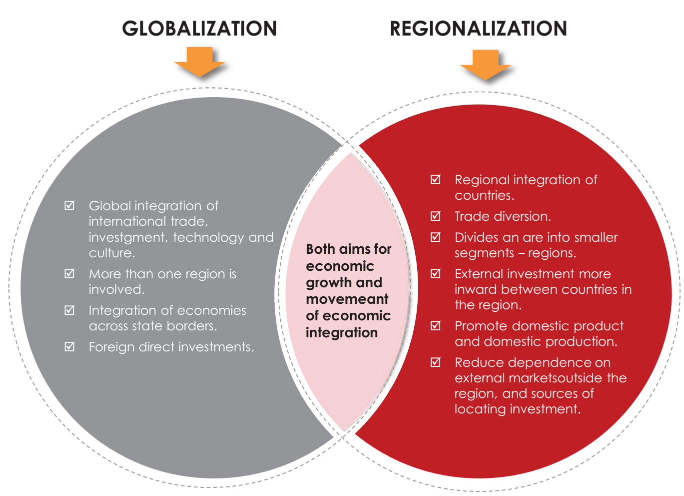
Globalization means the transformation of businesses to employ global supply chains and sell in global markets. The characteristic elements that constitute economic globalization are cross-border flows of goods and services, capital, people, data and ideas.

On the other hand, regionalization can also refer to administrative structures, in which corporations, instead of making all decisions in a global headquarters, devolve power to regional managers who can more swiftly respond to changing local conditions.

In both cases, there is a movement towards economic integration of more than one country. In regionalization, the countries of a region integrate their economies. In globalization, more than one region is involved. Figure 2 illustrates the differences and overlapping between the two.

It should be noted that the approach examined here is in terms of global strategy within the nation-state system, not in the context of developing business/corporate strategy, to which it also applies.

Figure 2: Globalization vs. Regionalization



Source: International Monetary Fund, 2013.

Globalization and international trade - toward regionalization

It is difficult to establish a clear demarcation between the two processes, as pointed out before, but certain differences and issues can be ascertained, that can guide through for implications.

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Table 1: Distribution of US Exports of Goods and Services by Region and Trade Agreements, and Other Key Markets ($mm)

	US Total	USMCA*	European Union	China	ASEAN	Brazil	India	CAFTA-DR	Rest of Countries
2017**	1,762,931	462,324	404,382	138,055	124,483	46,522	35,404	24,295	527,466
2022**	2,230,981	592,075	440,467	146,813	152,048	57,724	54,113	39,486	748,255
Shares:									
2017**		26.2%	22.9%	7.8%	7.1%	2.6%	2.0%	1.4%	29.9%
2022**		26.5%	19.7%	6.6%	6.8%	2.6%	2.4%	1.8%	33.5%

Sources: U.S. Bureau of Economic Analysis, International Data; ASEAN StatsData Portal. * Canada and Mexico ** Up to third quarter.
USMCA = US-Mexico-Canada Free Trade Agreement.

The first issue would be, Is globalization dead? A question with no clear and definitive answer. There have been rising risks in the globalization process. By 2019, the number of trade disputes between the US and its major trading partners was soaring, and by the end of 2020 the US was involved either as a complainant or a respondent in a total of 280 trade disputes addressed through the WTO.[9]

Table 1 provides a view of the US's main exports markets. The two most important are Canada and Mexico (part of the USMCA agreement), and the European Union, followed by ASEAN countries. On a single-country basis, its main export markets are Canada, Mexico, China, and Japan. It is interesting to see that, while their share in the US total exports of goods and services basically remained stagnant or decreased between 2017 and 2022, that of the rest of countries rose, from 30.0% to 33.5%, reflecting a greater increase in US trade with other countries. They were responsible for 47.2% of the absolute increase in total US exports in the period.

One of the key instrument or examples of globalization is international trade of goods and services. Globalization has been the consequence of the increases in trade and investment flows. And it is in international trade that the shift toward the regionalization model becomes evident.

The flows of trade between emerging and developed economies increased significantly, contributing to the economic integration of the global economy, as flows of direct investment moved from the developed to the emerging economies over time, with Southeast Asia – in particular China – being the favorite destinations for production. It is here that the movement from globalization to regional production is becoming evident. As Galo (2022) points out, "globalization is shifting towards regional production chains in the face of increasing international tensions and logistics barriers", with some regions, like Latin America, being viewed as highly attractive for locating production from China, in what is known as nearshoring or offshoring.[10] The Russian invasion of Ukraine contributed to consolidate that shift from globalization to regionalization, as the US-China trade and technological wars are doing.

These conflicts are having an impact on international trade. Although reflecting lower growth of the global economy, international trade in goods and services is expected to slow this year, in which "the Ukraine conflict and its consequences have replaced the pandemic as the leading drag on growth". [11] According to the World Trade Organization (WTO), since late 2022 global trade of merchandise was slowing, predicting a growth in volume of 1.0% this year, from 3.5% in 2022 due to shocks related to the Ukraine conflict, lower demand in the case of imports, and high energy prices.[12] Moreover, cross-border flows of goods and capital have been levelling-off since 2008.[13]

What to expect?

The Ukraine conflict is not the only development contributing to changes in the patterns in world trade. As mentioned before, the significant reliance of the US and European economies on China and Russia will diminish (though it will take time), and existing trading blocs, such as ASEAN (Association of Southeast Asian Nations), with which the US has strong trade links, will gain ascendance, as companies with investments in China will diversify their investment and risks to their supply chains.[14] Yet, US companies with operations in China appear to be optimistic that the easing of its zero-COVID policy will improve business conditions.[15]

In the case of Russia, that process of disinvestment has been slow. Almost a year after the start of the conflict, according to a research, out of a total of 2,405 subsidiaries owned by 1,404 EU and G-7 companies that were active in Russia at the time of the first military incursion into Ukraine, fewer than 9.0% had divested at least one subsidiary, and in the case of US companies, fewer than 18.0% of US subsidiaries operating in the country were completely divested by the end of 2022.[16] Of the EU and G-7 companies remaining in Russia, the research found that 19.5% were German, 12.4% were US- owned, and 7.0% were Japanese multinationals.

The report by Gilbert et.al. (2023), from the Boston Consulting Group, provides an insight as to the implications of the current changing dynamics to global trade through 2031:[17]

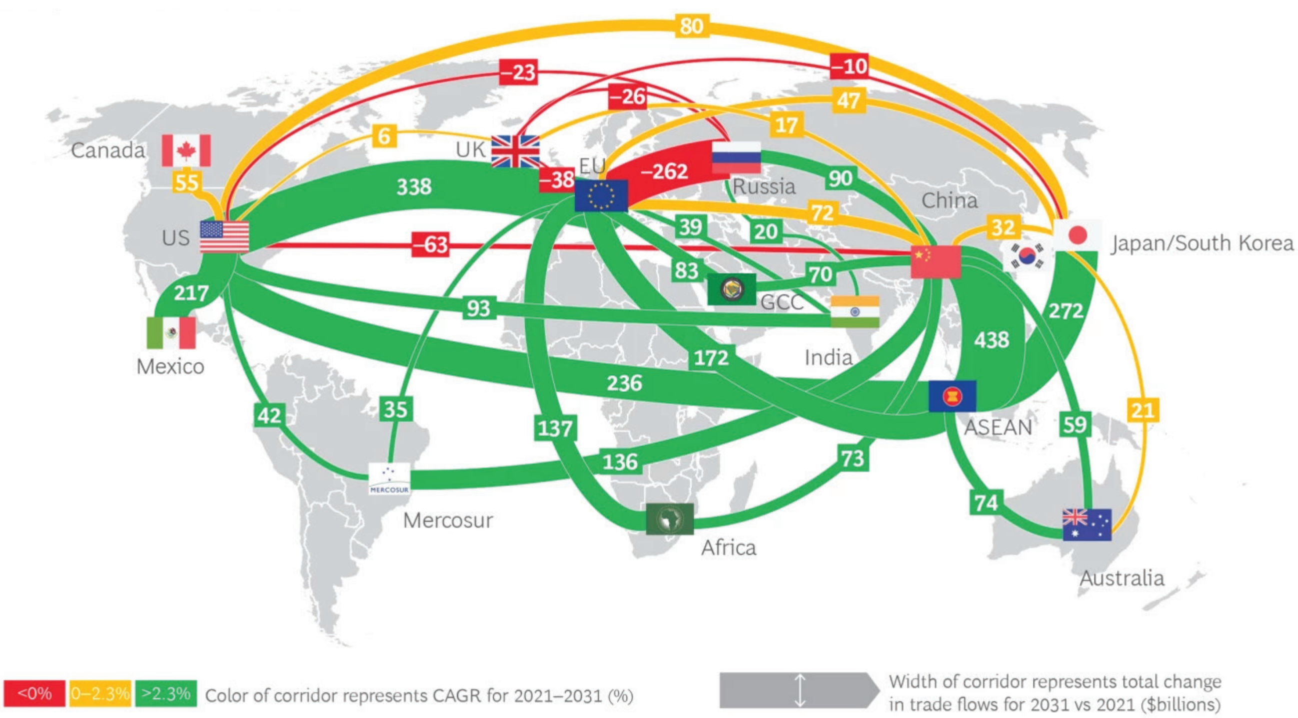
1. Global trade will continue to expand but at a slower pace of 2.3% through 2031. For 2023 the WTO forecasts a 1.0% growth in merchandise trade.[18]
2. A sharp decrease in trade between Russia and the US by $262.0 billion during the period 2023-2031.
3. Trade between the US and China will decrease by $63.0 billion through 2031.
4. The region that will benefit the most from this overhaul will be ASEAN, in which China is the biggest player. The region will see much greater trade with China, the US and Japan, and the EU, driven by the reshoring and offshoring of companies diversifying their supply chains, given global tensions and China's rising manufacturing costs. ASEAN trade with China will increase by $438.0 billion, the largest increase among the regions.
5. The above changes will continue to weaken globalization and trade opening.

Will globalization be reversed?

One characteristic of the global trade environment is the existence of regional trade agreements (RTA), of which the ASEAN, the European Union, and the USMCA (US-Mexico-Canada) are examples. Almost all countries, including the United States, are part of at least one.[19] They cover more than half of international trade, operating alongside multilateral agreements, and have proliferated since the mid-90's.[20] Today, the United States is signatory to 20 RTA's, bilateral, and multilateral free trade agreements, most of them with countries in this hemisphere.[21] It also has negotiated bilateral agreements with all ASEAN members, except Laos and Myanmar.

But the biggest free trade agreement region in the world is the Regional Comprehensive Economic Partnership (RCEP), signed in 2020, in which China is an important member. It includes the ASEAN countries, plus China, Japan, South Korea, Australia, Viet Nam, and New Zealand. India is not a member. One interesting benefit is that it links complementary supply chains. For instance, one member country can import raw material from China and use them to make finished goods that can be exported to China and elsewhere.

Figure 3: Change in Trade of Goods Flows Between Major Regions, 2031



Sources: UN Comtrade; Oxford Economics; IHS; WTO; BCG Global Trade Model 2022; BCG analysis.

Note: Estimated inflation-adjusted trade growth within the EU by 2031 will total $1.5 trillion at a CAGR of 1.8%.

[1]The corridors shown in the map represent ~46% of global trade.

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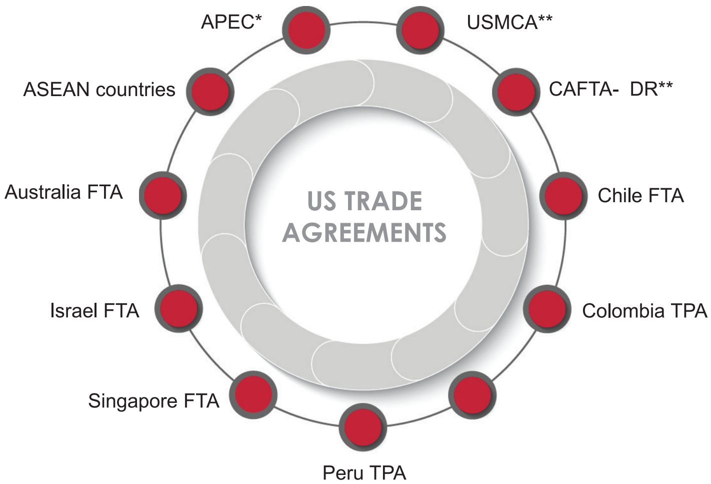
Figure 4: US RTA's, Multilateral and Bilateral Trade Agreements



* Includes Canada,China, Mexico and Russia. Nine of the top markets for the US were APEC members, accounting for 60.0% of US exports of merchandise.
** Multilateral. TPA = Trade Promotion Agreement (Bilateral).

Source: Office of the United States Trade Representatives.

One outcome of RTA's is that they can serve as a basis for deeper multilateral integration, covering investment, movement of capital and persons, services, e-commerce, and intellectual property rights, for example.[22] Thus, it could be that what we are seeing is "the transformation of the current global trade model towards a regional trade model", concentration of trade among proximate countries.[23] That does not mean that there will be no exchange of goods and services between RTA's. For instance, it is unreasonable to expect that in the case of the US and the European Union. But it implies a lesser exchange, with more trade concentrated within member countries, and less trade with China, which in 2022 accounted for 16.5% of US imports, from a share of 22.0% in 2017, with a similar trend in the case of exports.[24]

Further deterioration in US trade with China can be expected, even when in 2022 total trade in goods with that country rose to a record high, totaling $690.6 billion.[25] The Biden Administration announced that it is preparing new rules to restrict US dollars from flowing to China, a measure that, if adopted, will have serious repercussions in trade and investment with China.[26]

There is, indeed, a change in the current paradigm of global trade, but one must be cautious when drawing definite conclusions about the "end" of globalization. The study by Fajgelbaum et.al. (2021) on the global responses to the US-China trade war suggest that it created new trade opportunities in aggregate, and that "globalization, as measured through export growth has not come to a halt."[27]

But, it is true, nearshoring and offshoring are already having an impact on global trade and investment flows, and are becoming very popular in countries like Mexico, with its proximity to the US market and low labor costs, and to take advantage of the trade deal with the United States (USMCA).[28]

Chinese manufacturing companies are investing in an accelerating trend in the country, mainly in the border states, following companies from South Korea and Japan. For instance, in 2021, in the case of the border state of Nuevo León, Chinese companies accounted for 30.0% of the direct investment, in new industrial parks being developed by private Mexican developers and property owners.[29] Since the end of 2021 it is reported that the state has received about $7.0 billion in foreign investment.[30] An increasing number of these companies are sourcing their components and parts from local suppliers, instead of importing them from China, which adds to the multiplier impact of their operation in the country. Mind, you, this production is destined to the US market. So, whatever limitations are imposed on China, production in Mexico offset it, assuring continuing operation to the company.

Interestingly, China's share in Mexico's imports of goods has increased, from 15.3% at the end of the decade, to 19.7% in 2022, and it is its second source of imports of goods after the US.[31] Plus, proposals such as that in the US Senate recently introduced (The Americas Act), to encourage companies to nearshore supply chains from China to the Western Hemisphere through tax incentives and trade preferences could indeed contribute to further regionalization of trade.[32] Although a discussion draft at this time, it demonstrates the amount of consideration being given in the US Congress to nearshoring and shifting supply chains away from China.

Notes:

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offshoring. The first is the transfer of a business process in manufacturing or services, to a country near its main market. The second is when a company moves its manufacturing production to a nearby country, to take advantage of lower labor costs. For an idea of the impact of nearshoring in Latin America and the Caribbean see Impacto del "Nearshoring" en Puerto Rico. ETI Trends, No. 15 (Enero 2023). En: https://estudiostecnicos.com/Eti-trends/

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17. Marc Gilbert, et.al. (2023), pp. 2-3.

18. World Trade Organization (2022).

19. An RTA is a treaty that is signed by two or more countries, to encourage the free movement of goods and services across the borders of its members. It has its own set of rules and preferences for its members, and limitations or exclusions, in some cases, to outside countries. They vary depending on the arrangement among the member countries. There are different types: Preferential Trade Areas, in which member countries do not eliminate the barriers among themselves; Free Trade Areas, in which all trade barriers among the members are eliminated; Customs Union, with all barriers among members eliminated but adopt common external trade barriers, and: Common Market, where the internal barriers to trade are eliminated, common policies are adopted when dealing with non-member countries, and the free movement of resources among themselves.

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Irlanda y Puerto Rico, de un pájaro...

por José J. Villamil.

Esta es la época del año cuando los medios típicamente hacen recuentos del año por concluir y le piden a economistas y empresarios que den sus opiniones sobre las perspectivas para el próximo año. Esto siempre me recuerda un dicho entre economistas: "Los que viven de la bola de cristal tienen que aprender a comer vidrio molido". Se refiere esto a que en un entorno con algún nivel de incertidumbre las proyecciones económicas tienen una alta probabilidad de errar.

Hace cuatro años, en octubre de 2019, escribí un artículo con el título "Aprendiendo de Irlanda" que resumía las medidas de política económica que dicho país adoptó. Se consideraba su experiencia como "el milagro irlandés". Hoy tenemos que aprender de Irlanda, no para hacernos eco de su éxito, sino para darnos cuenta de que economías tan abiertas como la de Irlanda y la de Puerto Rico, pueden sufrir descalabros súbitos en sus economías. En el caso de Irlanda, se espera una contracción en su producto bruto interno para este año 2023, la primera desde el 2012, con expectativas de crecimiento lentos en el 2024 y 2025. Según el diario español, *El Economista*, la Comisión Europea proyectó a

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principios de año un crecimiento para Irlanda del 5.5% pero su más reciente estimado es una contracción de 0.9%.

¿Por qué este cambio tan drástico en pocos meses? Tanto la Comisión Europea como el Fondo Monetario Internacional se lo atribuyen a factores externos como, por ejemplo, la fragmentación en las cadenas de abasto, la repatriación a Estados Unidos de empresas de dicho país, el aumento en el costo de insumos y otros factores. Lo que es interesante es que se destaca el impacto de empresas multinacionales que responden a la demanda externa, mientras parece ser, según *El Economista*, citando un informe de la Comisión Europea, que la demanda interna ha sido un elemento estabilizador.

Mirando el futuro de la economía de Puerto Rico, es necesario entender los fundamentos de su condición actual y que subyacen sus perspectivas más allá del corto plazo. Al igual que Irlanda, Puerto Rico es una economía muy abierta, y su modelo económico muy similar al de Irlanda en aspectos como la dependencia en la inversión del exterior. Por supuesto, hay diferencias entre ambos países, fundamentalmente nuestra dependencia en los fondos federales que representaron, por ejemplo, el 39.8% del presupuesto consolidado en el fiscal 2023, comparado con el 20.3% en el fiscal 2000, y el 36.0% del ingreso personal (la mayor parte consiste de ingresos por concepto de Seguro Social y Medicare) en el fiscal 2022. No obstante, las similitudes son tantas que opacan las diferencias.

Proyectar la economía en el 2024 puede ser un ejercicio en futilidad en un entorno tan complejo y volátil, si no se tiene un conocimiento preciso del contexto externo y de cómo este nos puede impactar. Hacer precisiones de si la economía crecerá a un determinado por ciento se complica ante un escenario de incertidumbre y volatilidad.

Algunos de los factores mencionados en relación a Irlanda nos impactarán en menor grado, pero hay otros que impactarán directamente a nuestra economía. El mejor ejemplo es lo que ocurra con la inflación en Estados Unidos y la respuesta de la Reserva Federal. Al momento de redactarse esta nota, la inflación general en Estados Unidos se ha reducido, y hay indicios de que la Reserva Federal no aumentará su tasa de interés. Lo que se espera para la economía norteamericana es lo que llaman en inglés un “soft landing”.

Esto, por supuesto, puede cambiar. Hay otros factores, como los que conllevaría un cambio en la Administración federal en el 2024 para la política social y económica del gobierno, aunque sus efectos se sentirían comenzando en el 2025. El precio del petróleo refleja una alta volatilidad, los precios de la carga marítima igual. Ambos nos impactan y pueden cambiar súbitamente. A nivel de la economía global, las expectativas para el 2024, según proyecciones recientes de la Organización para la Cooperación y Desarrollo Económico (OECD), son de un crecimiento económico menor para el 2024, de 2.7%, respecto al aumento estimado para el 2023 de 2.9%, y mucho menor que el crecimiento de 3.3% en el 2022.

Para Puerto Rico, hay unas expectativas económicas para el corto plazo todavía favorables cara al 2024. Por ejemplo, el empleo asalariado privado continúa aumentando, pero sus aumentos intermensuales se han ralentizado, la inflación general se ha moderado bastante, de 6.0% en el período enero-octubre 2022, a 3.8% en igual período de este año, y podría disminuir a 2.0%/2.5% en el 2024, y el desempleo permanece bajo, promediando 5.9% a noviembre 2023, comparado con una tasa de 7.9% en el 2021. Estos aspectos coyunturales, sin embargo, no deben distraer de las consideraciones macroeconómicas y estructurales para el largo plazo: qué hay que entender para apoyar un crecimiento económico sostenible.

Dar opiniones sobre el crecimiento económico, sin incorporar los supuestos sobre el contexto externo y sus implicaciones, no es muy útil. Esos supuestos deben ser explícitos. Por otro lado, además de entender por qué una economía puede cambiar de rumbo súbitamente, la experiencia de Irlanda también nos enseña que fortalecer la economía interna es clave para un desarrollo sostenido y para proveer estabilidad ante eventos esperados y aquellos que caen en la clasificación de “Black Swan Events”, inesperados y considerados como muy poco probables como, por ejemplo, el COVID.