Economic Analysis

The Puerto Rican Debt Crisis

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- **Governor of Puerto Rico calls for restructuring and reform on $72 billion debt**
- **Puerto Rico met its debt payments due Wednesday, avoiding default**
- **Population outflow and low business investment suggest dim outlook**

The world has been hyper-focused on the debt crisis in the Mediterranean as of late, but it is important not to forget the potential storm that is brewing closer to home in the Caribbean. Puerto Rico may not be an independent nation like Greece, but the implications for the U.S. could be more significant. On a televised broadcast on Monday, June 29, Puerto Rico's governor Alejandro Garcia Padilla stated that the commonwealth would be unable to pay back its $72 billion debt. To alleviate this debt burden, the governor proposed significant concessions from Puerto Rico's creditors, including repayment extensions and deferrals for up to five years. However, it appears that over $1 billion in scheduled payments due Wednesday had been successfully paid to existing bond holders. This included three key debt payments—$645.2 million in general obligation bonds, $415 million on Puerto Rico's Electric Power Authority (PREPA), as well as the final $265.5 million in payments on a syndicated loan.

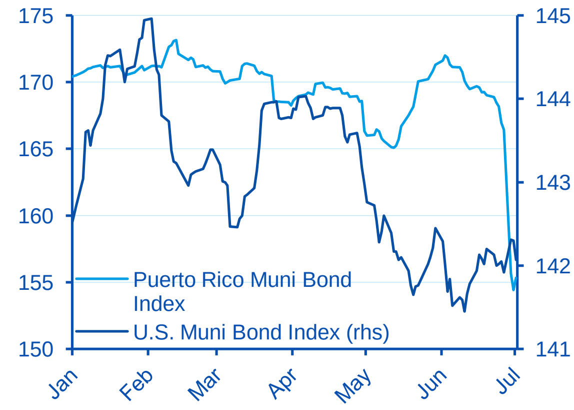
Despite meeting its debt payments in a timely manner, borrowing costs exceed double digits in many cases and dropped below 70 cents on the dollar. Over the last seven days, the S&P Municipal Bond Puerto Rico Index dropped 8% while a national municipal benchmark index remained unchanged, signaling that there is a low risk of contagion. This reflects that the mainland's economic exposure to Puerto Rico is small and that fiscal conditions in most states and municipalities are in significantly better shape.

Show Me the Money

On a measure of debt to personal income, Puerto Rico's debt is far greater than that of any U.S. state. This unprecedented amount of debt accumulated as the commonwealth borrowed increasing amounts to balance its growing budget deficit. The principal holders of its debt are U.S. hedge funds and institutional investors, who were drawn to the generous tax advantages of Puerto Rican municipal bonds. Municipal bonds traditionally offer additional tax exemptions to residents of the state/city issuing the bond. Puerto Rico's bonds offer a triple tax-exempt status (federal, state, and local) regardless of the residence of the investor, further attracting individual mutual fund holders based in the U.S., particularly those living in higher tax states. Strong tax incentives were enough to persuade individual and institutional investors to buy about $35 billion in municipal bonds in 2014, even while rating agencies downgraded their credit rating status to junk.

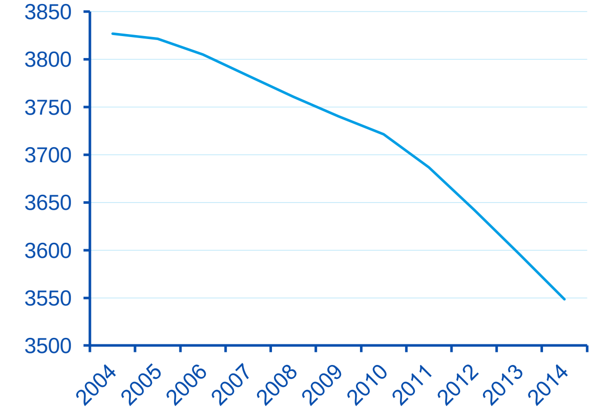
The vicious cycle of increased borrowing to feed a growing deficit complicated recent attempts of the administration to implement measures to raise taxes and cut pensions and public jobs, in order to alleviate reduce the debt burden. Attempts to raise taxes had little effect on the deficit due to the country's low personal income as a result of the migration of Puerto Ricans to the U.S. mainland. In the past ten years, the Puerto Rican population living on the mainland has exceeded that of those actually residing in the commonwealth. Puerto Rico has historically benefitted from a strong manufacturing sector, especially in pharmaceuticals, producing 16 of the top 20 top-selling drugs in the U.S. However, in 1996, Puerto Rico's popular corporate tax exemptions were placed on a 10-year phase-out schedule, which resulted in investment outflows that further lowered the island's competitiveness. Adding to misery, the Great Recession hit Puerto Rico sooner and harder than the mainland, and it has yet to recover given its declining population, low competitiveness and lack of structural reforms.

Chart 1
S&P Municipal Bond Indices YTD



Source: S&P Dow Jones

Chart 2
Resident Population of Puerto Rico, K



Source: U.S. Census Bureau/ Haver Analytics

Finding a Solution

Unlike U.S. municipalities such as Detroit, under current law, Puerto Rico is unable to access chapter 9 bankruptcy protections. Puerto Rico also lacks access to development tools such as IMF funding because it is not an independent nation. Up to this point, the White House has made it clear that it has no intention of a bailout, but will encourage Congress to explore possibilities that would give Puerto Rico the option to enter into bankruptcy. Puerto Rico's sole non-voting Congressional delegate has presented a bill that would grant the commonwealth's municipalities the ability to use chapter 9 protections. If Puerto Rico was to become a state, its municipalities would be able to declare bankruptcy; however, this option is divisive in Congress and on the island. In a 2012 referendum, 54% of Puerto Ricans voted for a change, and of that number, 61% desired full statehood, 33% chose status as a sovereign free associated state, and 6% called for independence.

With regards to the bond market, the creditors who refuse to renegotiate their debt payments have the option of filing lawsuits forcing payment from Puerto Rico. In terms of incentives, it is in the best interest of creditors to protect their existing investments, while for Puerto Rico it is imperative to retain access to credit markets given the ongoing need for borrowing. Therefore, rather than filing a lawsuit or writing off the debt, creditors might be willing to invest in a conduit borrower that offers additional legal provisions to protect investors. Puerto Rico established COFINA, a sales tax bond authority, to give the commonwealth the flexibility to meet its financing needs by offering bondholders primacy on sales tax revenue, greater market access and lower borrowing costs.

Sovereignty issues, the growing focus on Hispanics and the large concentrations of Puerto Ricans in swing states suggest that Puerto Rico could become a topic in the 2016 election. Some of the 2016 presidential candidates have already declared their position on Puerto Rico, hoping to sway the 4.9 million Puerto Ricans that reside stateside, particularly in Florida. In 2008, Obama won Florida by less than 1%, with an impressive 86% of the Puerto Rican vote. Puerto Ricans on the island can vote in the primary elections and contribute to campaigns. Jeb Bush visited Puerto Rico in April, prior to the announcement of his candidacy, and has repeatedly affirmed his support for Puerto Rican statehood and recently stated that the commonwealth should be able to seek bankruptcy under chapter 9. Hillary Clinton has reportedly planned a future campaign stop to the island. Although in vague terms, Clinton is the latest candidate to weigh in on the commonwealth's crisis, announcing that she favors offering tools and support for Puerto Rico.

Bottom Line

What lies ahead for Puerto Rico is highly uncertain. Double-digit bond yields and lower confidence from financial market participants will lead to greater volatility and pressure on domestic businesses. Lack of business investment, outflowing population and weak economic growth will make it increasingly difficult for Puerto Rico to meet current obligations. This crisis has been decades in the making and was the result of a shift in global dynamics and geopolitics, as well as policymakers' failure to implement the necessary reforms that would boost productivity, employment and the island's attractiveness for investment. There is still opportunity for policymakers to regain this loss in competitiveness and to achieve higher economic growth. However, it will require an unprecedented commitment to lowering labor costs, encouraging job creation, reducing utility and transportation costs and enhancing the ease of doing business. Achieving this will require major fiscal reforms and greater institutional credibility. In the end, the crisis in Puerto Rico is unlikely to have a major impact on the U.S. outside of the 2016 presidential campaign.