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Debt Alone Won't Crush Puerto Rico. Depopulation Is the Curse.

Erasing the island's bond obligations would not be sufficient, if migration continues.

The trend lines in Puerto Rico are going only one way. Photographer: Xavier Garcia/Bloomberg
"They owe a lot of money to your friends on Wall Street," Donald Trump told Geraldo Rivera. "We're going to have to wipe that out. That's going to have to be — you know, you can say goodbye to that. I don't know if it's Goldman Sachs but whoever it is, you can wave goodbye to that."

Bond markets didn't appreciate the verbal wave. The territory's bonds, already weak from the pounding of Hurricane Maria, fell another 31 percent. White House budget director Mick Mulvaney hastened to say the president didn't mean what he said. "I wouldn't take it word for word with that," he said demurely. Nor should you; as debt expert Cate Long told CNN Money, "Trump does not have the ability to wave a magic wand and wipe out the debt."

Yet the fact remains that Puerto Rico is not going to be able to pay all of its debts. Prior to the hurricane, the territory had $73 billion in outstanding debt, and a population of 3.4 million people. That's approximately $21,500 for every man, woman and child on the island – just about enough to buy each of them a brand new Mini Cooper, provided that they don't insist on the sport package or the heated seats.

Puerto Rico couldn't afford to buy 3.4 million Mini Coopers before; they certainly can't now that Maria has washed out so many roads. Even before the hurricane, Puerto Rico's GDP was around $100 billion, meaning that repaying its debt would consume nearly nine months of everything the island earned. And while there will probably be a brief bump in economic activity as disaster relief funds pour in and the destruction is cleared away, over the long term the hurricane represents a huge setback: businesses destroyed, people killed or injured, funds that could be generating economic growth instead diverted to simply replacing what has been lost.

So whatever President Trump does, or does not do, investors in Puerto Rican bonds are going to have to take a substantial haircut. The problem is, we're not going to wipe out the debt entirely. And even if we could, it wouldn't be enough to get Puerto Rico back to economic or fiscal health.

"If it's that bad," you may be thinking, "surely we ought to simply wipe out the debt holders? After all, they're investment professionals. They can afford to take the loss; ordinary Puerto Ricans can't." The problem is that most of the folks holding Puerto Rico's debt aren't vulture hedge funds sitting on wads of ill-gotten gains; the overwhelming majority of the debt is held by ordinary folks who buy bonds or bond funds. Like, say, your parents. Or maybe you. And also, a lot of Puerto Ricans, who would be hit very hard if the value of their investments were wiped out.

That's because Puerto Rican debt was doubly attractive to the prospective investor. It offered relatively high yields at time when interest rates were rock-bottom, and it was "triple exempt": you didn't have to pay federal, state or local taxes on the interest income. This allowed Puerto Rico to wildly overborrow its actual fiscal capacity to repay the debt.

And why was the government borrowing so much? For one thing, because the government doesn't work very well. The operations of the Puerto Rico Electric Power Authority, for example, defy belief: It essentially gave unlimited free power to municipalities and government-owned entities, which used it to do things like operate skating rinks in the tropics. Everywhere you look, you see signs of a government struggling to perform basic tasks: collect taxes, maintain the infrastructure, improve the health system. In the jargon of development economists, the island lacks "state capacity": It is simply unable to exert the amount of power over its operations that we on the mainland mostly take for granted.

But you can't entirely blame the Puerto Rican government for the state of the underlying economy, which is what had plunged the island into a bankruptcy crisis even before the hurricane. For that you have to look to the federal government, which eliminated a tax break that had given companies incentives to locate in Puerto Rico, and then oversaw a financial crisis that sent them into an even deeper spiral. We also made sure that a relatively poor island was forced to adopt the federal minimum wage, which was too high for the local labor market. That has contributed to the 11.5 percent unemployment rate. And Puerto Rico uses the U.S. dollar, leaving it unable to adjust monetary policy to overcome economic stagnation.

None of those things will change just because we wipe out the bondholders. And the bondholders are not Puerto Rico's only creditors; it has an unfunded pension liability of roughly $50 billion. Covering the current liability will consume more 20 percent of the budget.

That figure will only grow, because the biggest problem of all is Puerto Rico's rapid demographic decline. There has long been a steady migration from Puerto Rico to the mainland. By 2008, there were more Puerto Ricans in the rest of the U.S. than there were in Puerto Rico. But the economic crisis has accelerated that flow to staggering levels. Worse still, the flow is selective: young families, professionals and skilled workers migrate in search of better opportunity, while the old and the dependent stay home. In just one year, 2014, almost 3.5 percent of the young adult population migrated.

Undoubtedly, the hurricane will make this worse. Some businesses will never reopen, and workers will start looking across the water. Some people will decide it's easier to move elsewhere and start over than to rebuild their destroyed home. A look at the experience of New Orleans after Katrina is instructive: Between the 2000 and 2010 censuses, the city lost 30 percent of its population.

As people move, the effect won't only be economic. The debt burden will stay the same size, but it will be spread over fewer and fewer people. The same will happen to all the other fixed expenses of the government — things that also cannot be easily ordered away by a president, or a court: the pension bill, the roads, the hospitals and airports. Whatever happens with Puerto Rico's debt, the Wall Street bankers will probably be fine. But unless we find a way to help the territory reverse these catastrophic trends, Puerto Rico will not.

Bloomberg View

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