Puerto Rico Needs a Better Debt Deal.

Rosy assumptions about what the island can afford to pay bondholders threaten to doom its future.

History is littered with examples of ill-designed debt restructuring exercises that soon unraveled at great economic and human cost. Judging by the recently announced debt restructuring arrangement for Puerto Rico's sales tax-backed bonds (COFINA), the island's economy risks joining those ranks.

The COFINA restructuring doesn't go nearly far enough. It saddles Puerto Rico with escalating debt payments for the next 20 years, even though the economy has been in a decade-long slump. It also sets a dangerous precedent. If Puerto Rico's government and the oversight board created by Congress agree to similar terms with creditors who hold General Obligation bonds, it will be just a question of time before the commonwealth is forced to default yet again or curtail public pension payments upon which more than 325,000 workers depend.

By far the most important condition for a successful debt restructuring is a realistic assessment of the economy's growth potential and its capacity to repay its debtors. Overly optimistic assessments of those prospects are a sure recipe for failure. They set up the economy for another debt restructuring and, as the economy labors under the weight of a debt overhang, they undermine investor confidence.

Anyone doubting the adverse consequences of such unrealistic assessments of an economy's ability to pay might want to look at Greece's recent sorry experience.

The Greek economy has paid dearly for the failure of the International Monetary Fund in 2010 to recognize that Greece had a solvency problem rather than a liquidity problem, and that its economy was likely to contract sharply by attempting draconian budget belt-tightening within a Euro straitjacket. The net result of such wishful thinking: After almost a decade since the first restructuring, the Greek economy is still deeply depressed and in need of further debt restructuring.

The Puerto Rican government and its oversight board similarly appear to be unrealistically optimistic about the island's economic growth prospects and thus its ability to pay. The proposed COFINA debt restructuring arrangement, which covers around $17 billion, or one-third of the island's bonded debt, initially reduces Puerto Rico's debt service payments. However, those payments eventually double and then remain at a high level due to the inclusion of an insidious "capital appreciation bond," which rapidly increases in value while the other bonds are being paid off.

Although an influx of federal disaster relief and Medicaid funding is temporarily boosting Puerto Rico's economy, it would be irresponsible to expect these benefits to last and support a rising debt service burden. Indeed, federal budget transfers are due to fall off a cliff in five years. Moreover, the island's economic growth will be impeded by poor demographics, as the economically active population likely will continue to move to the mainland in search of better opportunity.

Prior to Hurricane Maria, Puerto Rico's economy was in a 10-year secular decline that saw it contract by more than 10 percent. Absent the reinstitution of generous investment incentives from Congress or the introduction of a federally funded earned income tax credit, it would seem irresponsible to premise a debt restructuring program on the idea that the Puerto Rican economy is somehow going to boom just as federal grants are scheduled to dry up.

As we have previously written, structural reforms that improve the efficiency of doing business in Puerto Rico are important and would help boost economic growth. However, they cannot reasonably be expected to offset the loss of federal funds, the contractionary effects of fiscal consolidation and ongoing outmigration.

The implications of the proposed COFINA deal for restructuring the remainder of the island's debt obligations are also a concern. The old COFINA bonds were a fast path to deep insolvency, with debt service rising from $0.7 billion to $1.8 billion over the next 25 years. The new bonds offer some relief, with debt service starting at $0.45 billion and reaching $1 billion. The restructured bonds also offer the junior COFINA bonds enhanced security in exchange for the fall in debt service, and the new bonds will be harder to restructure in the future. And by the end of the 2020s, the proposed payments on the COFINA bonds alone would push Puerto Rico's debt burden — assessed using the standard municipal bond metric of debt service against the entity's own revenues — over that of an average U.S. state.

With Puerto Rico's limited ability to repay, generosity to one set of bondholders necessarily reduces what the commonwealth can reasonably offer to other bondholders and claimants. The sustainability of Puerto Rico's debt restructuring needs to be assessed comprehensively, not by looking narrowly at each piece of the bigger puzzle.

It is hardly in Puerto Rico's interest to have a failed debt restructuring agreement that will hobble the island's economic growth prospects, even as it struggles to restore basic living conditions following the devastation of hurricanes Maria and Irma and the loss of thousands of American lives.

From the outset, the oversight board has said that it would seek a "once and done" restructuring of Puerto Rico's debt. One can only hope that it has not now switched to an "over and out" strategy, whereby overly generous consensual agreements are reached with the island's creditors before the board's current term expires in August 2019.

Instead of taking refuge behind unrealistically optimistic assumptions, the board and Puerto Rico's government need finally to take the difficult decisions needed to reset the island's debt at sustainable levels for the long term.

Bloomberg Opinion

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October 8, 2018

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