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Why Didn't Investors Demand Higher Yields for Buying Puerto Rican Government Bonds?

For years, Puerto Rico's economic and fiscal picture was deteriorating. Between 2005 and 2013, real GDP declined by 15 percent, while between 2000 and 2015 Puerto Rico's government liabilities to GDP grew from 70 percent to 109 percent. Nevertheless, investors continued to purchase millions of dollars of Puerto Rico's bonds with only a modest risk premium. In a paper to be presented at the 2018 Municipal Finance Conference, *"What Went Wrong? The Puerto Rican Debt Crisis and the 'Treasury Put,'"* three economists from the University of Illinois at Chicago ask why investors were so willing to continue to lend to Puerto Rico.

Their answer: investors assumed the federal government would ultimately bail out Puerto Rico.

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"The expectation of a federal bailout was perfectly reasonable given past behavior by the federal government, especially the prior bailout of New York," authors Robert Chirinko, Ryan Chiu, and Shaina Henderson say. However, when the government refused to bail out the city of Detroit in 2013, investors realized their assumptions about a federal bailout for Puerto Rico were wrong. This provided a natural experiment to measure the value of what they call the "Treasury Put." Per the authors, the Treasury Put is an "implicit guarantee by the federal government to provide support in the event of financial distress by the issuer of Puerto Rican bonds as perceived by investors." The authors say their work challenges the view of some analysts, including the Government Accountability Office, that the Puerto Rico debt crisis was the result of inadequate disclosure by Puerto Rico of its financial condition. The authors begin by comparing the yields on privately insured and uninsured Puerto Rican general obligation bonds issued on the same days between the years 2000 and 2013, relative to the yields on Aaa, Baa, and junk-rated corporate bonds. Using that data, they estimate the risk premium that investors demand for buying uninsured Puerto Rican debt, and find it to be "exceptionally low," given Puerto Rico's fundamentals. This, they say, "was eminently reasonably given the expectation of financial support from the U.S. Treasury."

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