An analysis of Puerto Rico's debt relief needs to restore debt sustainability

Executive Summary

Puerto Rico's economy has been suffering a recession for more than a decade. The recession has led to a debt and economic crisis. The lack of opportunities has resulted in migration outflows that affect the lives of thousands of families and leave a higher burden on those who stay. Overall, the current macroeconomic dynamics is destabilizing the lives of nearly 3.5 million U.S. citizens in Puerto Rico. Reversing this dynamic requires appropriate macroeconomic and debt policies.

The collapse of economic activity has made the full payment of public debt unfeasible. Our study's main goal is to offer insights for designing a plan of action for resolving Puerto Rico's current debt crisis. The design of a restructuring proposal must note that the relationship between debt restructuring and fiscal policies exhibits bi-directional causality. On one hand, absent macroeconomic policies that expand the aggregate demand, Puerto Rico will not recover; and if the economy does not recover, Puerto Rico will not be able to pay its creditors without imposing severe damages on its nearly 3.5 million residents. On the opposite direction of causality, a larger debt reduction would imply that the territory would have more resources for expansionary macroeconomic policies, making the recovery more feasible and full repayment of the restructured debt more likely.

Our contribution is thus twofold. First, we examine the macroeconomic implications of Puerto Rico's Fiscal Plan that has been approved for fiscal years 2017-18 to 2026-27, as it is a crucial element for a computation of Puerto Rico's debt restructuring needs. Second, we perform a Debt Sustainability Analysis (DSA) that incorporates the expected macroeconomic dynamics implied by the Fiscal Plan in order to compute Puerto Rico's restructuring needs.

Our analysis of the fiscal plan detects two core flaws in its design:

(I) The plan is based on assumptions that are not sensible, thus it fails to appropriately recognize the magnitude of the destabilizing dynamics that it would create. Specifically:

(i) The values of fiscal multipliers used for the GNP projections are unjustifiably optimistic: they assume that the fiscal contractions scheduled in the Fiscal Plan will be associated with output contractions that fall on the lower bound of the range of estimates provided by the empirical literature.

(ii) The GNP projections ignore the feedback effects that the fall in economic activity would have on fiscal revenues, leading to an underestimation of the contractionary impact of the proposed fiscal policies.

(iii) The plan's assumption that structural reforms that affect mostly the formation of aggregate supply will be the driver of economic recovery by as early as 2022 is inconsistent with sound macroeconomic theory, given that Puerto Rico's economy is in a demand-constrained regime, i.e. it is in a situation where there is underutilization of the factors of production of the economy. Any spending-reducing reform will more likely deepen the recession in the short-term.

(iv) The plan is silent about how a deeper depression would likely intensify migratory outflows.

(II) The plan falls short on presenting a debt restructuring and sustainability analysis. Instead, it simply specifies what is the amount that must be repaid to creditors during the next decade, without being explicit about the longer-term obligations that the island will face and their sustainability. This has negative consequences in the short term, because the uncertainty about the island's long-term obligations will reduce the attractiveness of investing in the island in the present, thus harming the recovery prospects.

We also conduct a sensitivity analysis of the expected macroeconomic dynamics implied by Puerto Rico's Fiscal Plan. This allows us to construct more realistic scenarios of Puerto Rico's debt restructuring needs. The GNP projections of the Fiscal Plan lie on the upper-bound of our range of projections. And the entire range of projections predicts that real GNP will be lower by the end of the Fiscal Plan (year 2026) than in 2017. Thus, the implementation of the Fiscal Plan is projected to lead to a lost decade in terms of the evolution of economic activity.

Subsequently, we report the results of a Debt Sustainability Analysis (DSA) that incorporates our sensitivity analysis of the expected macroeconomic dynamics implied by Fiscal Plan. We report three main conclusions of this exercise.

(I) Assuming the fiscal plan will be respected, and absent a debt restructuring that reduces the current public debt stock, the territory would have to *permanently* sustain primary fiscal surpluses between approximately 3.5 and 7.4 percent of GNP, from 2027 onwards. Such a target is economically and politically infeasible. As a result, Puerto Rico's current debt position is unsustainable.

(II.A) When we maintain the assumptions of the Fiscal Plan, we obtain that the necessary reduction of Puerto Rico's debt to restore debt sustainability should include a full cancellation of the interest payments that are scheduled not to be repaid in the Fiscal Plan, plus a face value reduction that should lie roughly between 45 and 65 percent of the current debt stock of $51.9 billions included in the Fiscal Plan.[1]

(II.B) However, the relevant universe of the public sector's debt obligations may go beyond the debts included in the Fiscal Plan, as the sustainability of the public sector's debt may also depend on the sustainability of a large part of debt issued by other public entities that is not included in the Fiscal Plan. When we compute the necessary relief assuming that the relevant stock of debt corresponds to the total debt of the public sector[2], which increases the relevant stock to $72.2 billions, we obtain that the necessary reduction includes full cancellation of unpaid interest plus a face value reduction of between 60 and 73 percent of this alternative relevant stock of public debt.

(III.A) Under a more comprehensive range of assumptions for fiscal multipliers that includes both the assumption of the Fiscal Plan and other more realistic scenarios, and dismissing the unjustifiably optimistic positive assumed effects of the structural reforms on GNP growth for the period 2017-2026, we conclude that if the fiscal plan is implemented, the territory would need full cancellation of interest payments not included in the Fiscal Plan plus a face value reduction that lies between roughly 50 and 80 percent to restore debt sustainability – and again, the necessary reduction is larger if we take $72.2 billions instead of the just $51.9 billions included in the Fiscal Plan as the relevant universe of debt obligations.

(III.B) These computations remain conservative, as we are not addressing how migration flows will be affected by the deeper depression that the fiscal plan is projected to generate, and we are also

[1] In a letter sent by one of the authors of this report, Martin Guzman, to the Executive Director of the Financial Oversight and Management Board for Puerto Rico, Ms. Natalia Jaresko, the figures on the necessary debt reduction were adding the face value reduction and interest cancellation. This report separates the necessary face value reduction from interest cancellation.

[2] Net of Children's Trust's and HFA's debts, the reason for excluding the debts of those two entities being that their payment is not the responsibility of residents of Puerto Rico.

maintaining the Fiscal Plan's assumption that the territory will achieve a steady state annual nominal GNP growth rate of 2.6 percent without implementing any expansionary aggregate demand policies. Thus, the computation of a necessary debt reduction that includes full interest cancellation plus 50 to 80 percent of face value reduction must be considered as a *lower-bound*, i.e. as the *most conservative* estimate of the territory's relief needs.

Finally, we note that these computations were performed before Hurricane Maria. The devastating effects of the hurricane have significant effects on the necessary debt relief for restoring sustainability. We still do not have precise estimates of the economic costs imposed by Maria, but we expect to update our computations when more precise information on those costs becomes available.

Conclusions and Further Considerations

The future macroeconomic dynamics of the Puerto Rican economy will hinge upon the fiscal and debt restructuring plan that is adopted. We claim that the fiscal plan does not promote the economic recovery of Puerto Rico nor the sustainability of its debt position. Instead, the fiscal plan will almost certainly lead to an additional decade of depressed economic activity and will worsen the island's debt sustainability, perpetuating a crisis that all parties would like to end.

Restoring debt sustainability requires substantial debt reduction. A voluntary process of restructuring would be very unlikely to deliver the amount of relief that Puerto Rico needs. Recent experiences of public debt restructurings demonstrate that voluntary negotiations often lead to delays, insufficient relief for the country, and unequitable treatment for certain classes of creditors. The predictions from economic theory are aligned with this historical evidence. Thus, we contend that the government made a sensible move when it filed for bankruptcy under Title III of PROMESA on May 3, 2017. Otherwise, Puerto Rico would have been exposed to massive litigation that would have undermined the restructuring efforts and the road to economic recovery.

The restructuring proposal must take into account that decisions will be made under uncertainty. There are different layers of uncertainty, both in terms of the parameters that are used for the computations and in terms of the exogenous shocks to which Puerto Rico will be exposed over the coming decades. To deal with the underlying uncertainty, the restructuring process could be improved by the inclusion of GNP linked bonds that align debt payments with Puerto Rico's capacity to pay. By definition, these bonds improve the sustainability of the restructured debt, and they align the incentives of the debtor and the creditors such that the creditors would also benefit from a stronger recovery.

Our analysis does not study how the debt write-off will be distributed among bondholders but simply provides a perspective on the aggregate relief needs. The seniority structure will imply that not all bondholders will get the same discount, but the distribution of creditor losses will be determined by legal considerations that go beyond the objective of this study. What this study offers is a computation of the aggregate relief needs to restore the sustainability of Puerto Rico's public debt.

Finally, we claim that the debt restructuring will not be a *sufficient* but just a *necessary* condition for economic recovery. Puerto Rico needs more than just the restoration of debt sustainability: it needs a new economic growth strategy that replaces the old one that has clearly failed. However, if debt is not appropriately restructured, no new growth strategy will be feasible. The CNE Growth Commission is doing complementary work to this study that devises a new growth strategy for Puerto Rico.