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

Press Summary

For almost a decade, Puerto Rico has been in a severe recession that has led the territory into a social, economic, and debt crisis. As a result of the collapse of economic activity, the debt has become a burden that the territory is unable to bear and one that causes even further instability in the island's economic activity. This fact has been recognized by most of the interested parties.

A year ago, a group of internationally recognized experts in the subject of public debt led by Columbia University economist Martin Guzman, working in the context of an agreement with Espacios Abiertos and the Center for a New Economy (CNE) in Puerto Rico, undertook a research project that sought to throw light on the needs faced by Puerto Rico in restructuring its public debt. The results of the study provide valuable information on central elements that must be taken into account in designing a financial plan and debt-restructuring proposal that together lay the foundation for a feasible recovery for Puerto Rico.

The study offers two main contributions. The first is an analysis of the macroeconomic implications of the Financial Plan proposed by the government of Puerto Rico and approved by the Financial Oversight Board for the period from FY 2017-18 through FY 2026-27—a plan now being revised and whose new version is expected to be published on January 24 of this year (2018). The second is an analysis of the sustainability of the territory's public debt. This latter study takes into account the macroeconomic dynamics that are to be expected should the Financial Plan be implemented and it also serves as a basis for calculating the needs faced in Puerto Rico's debt restructuring. With respect to this part of the study, the authors provide figures on the amount of debt release that was necessary before Hurricane Maria for restoring Puerto Rico's ability to meet its commitments without stifling economic and social development.

With regard to the group's analysis of the Financial Plan approved in March of 2017, the conclusion is unequivocal: It is a plan based on unrealistic and inadequate assumptions that lead to an underestimation of the negative consequences its implementation would have had for the Puerto

Rican society. The study provides a detailed analysis of these assumptions and thus can be taken as a guide for the current revision of the fiscal plan. The analysis shows not only that the current revision should incorporate the economic effects of Hurricane Maria, but also that the fundamental assumptions on which the first plan was based should be revised. Just circumscribing the revisions to the new, post-Maria scenario, without modifying the assumptions on which the previous plan was based, will once again result in a flawed analysis of the island's needs with respect to fiscal and debt policies for its recovery.

With regard to the analysis of debt sustainability, the study shows the following:

1) Puerto Rico's public debt is not sustainable, and must be restructured.
2) The necessary debt relief to restore public debt sustainability before Hurricane Maria was substantial. The computation of the necessary debt relief is a function of the assumptions made with respect to the effects of the proposed fiscal policies and structural reforms, as well as of the definition of the stock of relevant public debt. (While the Fiscal Plan includes a stock of $51.9 billion in public debt to be taken into account, the stock of relevant debt may be substantially higher, up to $72.2 billion if the rest of the public debt net of the Children's Trust and HFA debts is included.) The computations of the necessary debt relief are conservative because a number of the over-optimistic assumptions included in the Fiscal Plan were maintained, in order to make the analysis more informative of the restructuring needs in reference to the proposed Fiscal Plan. (It should be noted that the study analyzed the consequences of modifying some of the central assumptions of the Fiscal Plan.) In all the scenarios analyzed, the study found that the necessary debt relief includes a total cancellation of interest and reductions in the face value of at least 45 percent of the relevant stock and up to 80 percent of the relevant stock, such that adding the necessary reductions of face value and interest, the necessary debt relief reaches a fraction of up to 90 percent of the relevant stock.

It should be kept in mind that all these computations were done before Hurricane Maria. The hurricane's impact has consequences for the necessary debt relief—it obviously becomes higher in the aftermath of the storm. A precise computation of the necessary relief under these new circumstances requires accurate information on the costs of the storm and on the aid Puerto Rico will receive from the federal government. Nevertheless, the methodology used in the analysis remains valid, and the study provides direct guidance for the government of Puerto Rico and the Financial Oversight Board for the presentation of a debt-restructuring proposal.

Finally, the study argues that debt restructuring is just one condition, and far from a sufficient one, on which economic recovery will depend. Puerto Rico needs more than simply restoring debt sustainability; it also needs a new strategy for growth, a subject on which the CNE's Growth Commission is working. However, if the debt is not restructured appropriately, no new growth strategy will be feasible.