THE HILL

Puerto Rico needs a financial control board

By Arturo C. Porzecanski, October 24, 2014

A renewed slide in investor confidence, on the heels of worsening economic and budgetary trends in Puerto Rico, raises the specter that in the absence of enlightened political leadership in San Juan, the U.S. Congress may soon have to establish a federal oversight board to manage the Commonwealth's grave fiscal situation.

In the past six weeks, Puerto Rico's junk-rated bonds have slumped while investment-grade municipals have rallied. The S&P Municipal Bond Puerto Rico Index dropped 3¼ percent between September 9 and October 21, while returns on the S&P National Index were up 1.1 percent. Earlier this month, trading in credit-default swaps suggested that Puerto Rico was viewed as the world's most likely government to default within one year. Given the recent collapse in world oil prices, now it is Venezuela that has bondholders feeling most jittery, with the island's debt priced as the next most risky.

Investors have become pessimistic even though the Commonwealth has recently managed to borrow $900 million from a group of banks led by J.P. Morgan, Morgan Stanley and Bank of America. The reasons are that the island's government was actually hoping to raise $1.2 billion, the loan was for a mere nine months, and it was granted at a punishing interest rate of 7¾ percent. In years past, the Commonwealth had always been able to obtain short-term credit for its seasonal needs at rates below two percent, and highly rated municipal borrowers currently pay less than 0.25 percent for similar funding. According to Bloomberg News, the hedge funds which bought Puerto Rico's last bond issue in March – it was priced to yield an eye-popping 8¾ percent – have been losing confidence as of late and have pared back their holdings.

The market action suggests that sophisticated investors are beginning to realize that Puerto Rico's economic and fiscal situation is unlikely to turn around anytime soon. The economy has been shriveling up for eight years, such that a measure of the island's monthly GDP as of August was off by one-fifth from August 2006 – and down all the way to a level not seen since 1994. The first data points for September are the unemployment rate, which rose to 14.1 percent from 13.1 percent in July, and auto sales, which were down a whopping 17 percent for the third quarter versus the prior year. The underlying reason is a steady exodus of population and jobs: total employment in 2014 through September stood 21½ percent below the 2006 average. The exodus has led to an erosion of the tax base and to political pressure to salvage government jobs and help vulnerable populations.

Indeed, the fundamentals of Puerto Rico resemble those of New York City in the mid-1970s and of other municipalities on which a Financial Control Board has been imposed. NYC lost a chunk of its middle class and 16 percent of its jobs between 1969 and 1977. It was also saddled with too much debt – Puerto Rico's tax-supported debt amounts to nearly $12,000 per inhabitant, twelve times the median of state debt per capita in the continental United States – and NYC's access to financing came to an end when the leading banks resisted underwriting any more bonds.

Behind every fiscal crisis there is a shortfall of political skill and forceful leadership, and Governor Alejandro García Padilla is looking increasingly inept. His plan to balance the budget by tinkering with revenue measures and curbing employee compensation, while avoiding layoffs and the restructuring with intent to privatize inefficient state-owned companies, is insufficiently aggressive. Three months into the new fiscal year, the plan is already falling short. On the funding side, meantime, the strategy is to pledge ever-greater portions of earmarked taxes to back new indebtedness, despite undermining the obligations that are not similarly supported.And then there is García Padilla's economic team, recently reshuffled but not improved. Treasury Secretary Melba Acosta has displayed poor judgment, most notoriously by disavowing a tax refund that was to be paid to Doral Financial, one of the island's largest lenders. Recently, the matter went to court and the ruling was in favor of Doral. Acosta's reaction? "We have no budgetary allocation to pay for that gift."

Governor García Padilla has since nominated her to become head of the Government Development Bank. Her successor at the Treasury's helm is Juan Zaragoza, who has been serving as a top, paid advisor to Ms. Acosta. Apparently, he has remained all along the managing partner of a prominent accounting firm that has represented many clients in tax matters. Now he must defend himself against a formal complaint filed by opposition senators, who accuse him of having failed to avoid conflicts of interest.

Given the current morass, it is hard to recall the happy decades during which Puerto Rico was the belle of the municipal bond market. As a territory, it was able to run deficits and fund them by selling almost as many bonds as New York and California did – because its debt pays tax-exempt interest in all 50 states, a favorable trait that was used and abused. The time is rapidly approaching when the U.S. Congress may well have to take matters in its own hands and, empowered by Clause 2 of the Constitution, establish a financial control board to take the unpopular austerity and reform measures that circumstances warrant.

Porzecanski is the director of the International Economic Relations Program at American University's School of International Service.

http://thehill.com/blogs/congress-blog/economy-budget/221593-puerto-rico-needs-a-financial-control-board