Puerto Rico

Puerto Rico faces worse debt crisis than Argentina

The island has not learnt from past international restructurings, says John Dizard

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4 HOURS AGO by: **John Dizard**

Nobody should go hungry in America. Anyone can get the free food that is distributed from US Department of Agriculture surplus stocks, including the notorious orange government cheese, packed with calories, fat, sodium and protein. It is not something most would buy with their own money. The term has become a synecdoche for the low quality of life offered to dependants of the state in the US.

The bankruptcy process (https://www.ft.com/content/3bc1fcc0-0a6b-11e7-ac5a-903b21361b43) that the Commonwealth of Puerto Rico is about to enter under Article III of the federal Promesa law adopted last year threatens an eternity of government cheese for the island's people. After May 1, creditors of the commonwealth, including the holders of its $72bn or so of bonded debt, will be free to take its government to the Federal District Court in San Juan to carve up future cash flows dedicated to servicing their debt.

The Article III process is expected to take 18 months or longer to play out before a plan is approved by the court. The bondholders are now divided by legal fights over where in the "waterfall" of seniority each class of issues should rank. Also, over the past couple of months, they have been surprised to find that Puerto Rico's newly elected governor and the new federal Financial Oversight and Management Board agree on imposing deep haircuts on the bonds' value.

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commonwealth and the oversight board would appear to have drawn a series of wrong lessons from past international sovereign debt restructurings and the history of US municipal debt defaults and workouts. To begin with, the Promesa act incorporates language insisting that Puerto Rico (https://www.ft.com/content/f0dfd14e-0832-11e7-ac5a-903b21361b43)will not receive any credit or credit guarantees from the US government. The idea is that once shriven of the excessive part of its debt burden, Puerto Rico will be able to return to the debt markets to finance the necessary renewal of its infrastructure.

Well, no. Consider what has happened to Detroit since it emerged from bankruptcy in December 2014. It has issued about $860m of bonds, for which it has paid at least a 40 basis point premium over comparably rated issuers. But despite the improvement in Detroit's finances and general management, it could not have raised any money at all with its own B credit rating. It only has market access thanks to the (Republican-governed) state of Michigan's commitment to specific revenue flows to service the debt.

A post-default Puerto Rico will be in the same fix. It will need a creditworthy sponsor to help underwrite the risk. So far, the federal government's position, explicitly reiterated in the Promesa law, is that the commonwealth will get no such support.

Now you might think that a couple of years from now Congress will bow to the reality of Puerto Rico's dependence on the US. Think again. How many senators or House members will want to vote for a bailout that would be sure to be the subject of attack ads during their re-election campaigns?

In some respects Puerto Rico is in worse shape than Argentina (https://www.ft.com/content/8ba6660c-f9e7-11e6-bd4e-68d53499ed71) was after its default in 2001. That came at the end of many years of debt financing and capital inflows, a significant amount of which actually went to build power systems, roads, telecommunications and other real assets. In contrast, Puerto Rico enters insolvency with a creaky, expensive power grid, a water system in need of big improvements, a rundown tourism industry and a declining manufacturing base that had been built to take advantage of now-defunct federal tax breaks.

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Puerto Rico does benefit from its ready access to the US mainland's market, and its citizens have US passports. But that cuts two ways. If young, ambitious and educated Puerto Ricans are dissatisfied with the poor quality of local governance, they can just get on a flight to the mainland and instantly become residents of any state. And they have. There are now more Puerto Ricans on the US mainland than on the island itself. This reduces the pressure for reform on the island.

There is a way for Puerto Rico to be able to stand on its own. The sensible path would be for the commonwealth government and the oversight board to ask the district court to pick one class of senior bonds that could survive the Article III proceeding more or less intact. The choice is between general obligation bonds and the sales-tax based, or "Cofina" issues, both of which are defended by tenacious holders with ferocious lawyers. Most states and municipalities use GO bonds as their most flexible instruments, but so far the Puerto Rico government has chosen to favour the Cofina bonds by keeping up payments while suspending payments on other issues.

If there were a surviving bond issue class, that would give investors in post-Article III Puerto Rico some comfort that they would be paid in the future. Otherwise, the island's future will be that of an underfunded welfare state.

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