Will Puerto Rico Default?

Moody’s recently reported that markets are treating Puerto Rico as having a more than 15 percent chance of defaulting on their financial obligations in the next five years. With only enough assets to cover 8 percent of its public pension liabilities, this US Commonwealth finds itself in a bind. In January, *Forefront* talked with Jean Burson, a Cleveland Fed policy advisor and expert on public pensions to learn more about the financial troubles in Puerto Rico, and what they could mean for the US financial system.

Forefront: First things first: What is going on with Puerto Rico’s finances?

Burson: Puerto Rico is a very important player in the municipal bond market, and investors have begun to question whether the Commonwealth will be able to honor its nearly $55 billion in outstanding net tax-supported debt. It has the highest level of per capita debt outstanding when compared with the 50 states, and most of that debt is not insured. In addition, it has been in recession for seven years, has experienced significant population loss, and has $37 billion in unfunded public pension liabilities, which results in a situation where the funds have only enough assets to cover about 8 percent of their liabilities.

Forefront: Who owns this debt?

Burson: Puerto Rico’s debt is widely held, since it pays a significant premium over other investment-grade debt and it’s exempt from federal, state, and local taxes. In fact, some investors are only now becoming aware that they are holding Puerto Rico’s debt. For example, an Ohio investor seeking exemption from federal and state taxes might choose to invest in a single state (Ohio) fund. But that single state fund might also include Puerto Rico’s bonds, since they are also exempt from federal and state taxes, and the investor might not be aware that these bonds have been included.
Forefront: Do Puerto Rico’s debt troubles pose a risk to the US or world economy?

Burson: The municipal bond market is very resilient due in part to its diversity, and most of the recent headlines — including the announcement of Detroit’s bankruptcy — have been met with measured market reaction. Puerto Rico’s fiscal challenges are well known to investors, but renewed attention in the context of significant market outflows that began over the summer has driven yields on the Commonwealth’s general obligation debt to a spread of nearly 700 basis points over US Treasuries. This reaction is rooted in concerns about a possible downgrade to below investment grade or even a default. In fact, of all of the states and sovereigns rated by Moody’s, only Argentina is seen as more likely to default.

The bottom line, though, is that the municipal bond market is very diverse. While a default by Puerto Rico could certainly impact some financial institutions, we don’t believe it presents a significant risk to the financial system as a whole. Our concerns are further lessened by the fact that most municipal debt is held by high-net-worth households and mutual bond funds, which are not highly leveraged and act as a buffer.

Forefront: It sounds as if the risks to the financial system are somewhat managed, but what about the risks to Puerto Rico?

Burson: Puerto Rico is struggling to emerge from recession. A downgrade would put additional financial strain on the Commonwealth, as it could lead to a requirement to post as much as $1 billion in collateral on financing transactions already in place. Negative headlines are prompting banks to become increasingly cautious in providing short-term liquidity, which makes the situation increasingly precarious.

One of the things that makes the Puerto Rico issue so noteworthy is that the federal bankruptcy code treats the Commonwealth as a state, and so it cannot file for protection under Chapter 9 bankruptcy. As a result, the Commonwealth has no mechanism to restructure its debts or modify its contracts.

Forefront: Is there hope for improving Puerto Rico’s situation?

Burson: The news coming out of Puerto Rico is not all bad. The newly elected governor raised the income tax, implemented new taxes, and enacted comprehensive public pension reforms that are projected to contain costs over time. Unless the debt is downgraded, which could lead to a requirement to post collateral on existing financial arrangements, liquidity does not appear to be a concern for the remainder of 2014. And while debt levels relative to the size of Puerto Rico’s economy are certainly higher than in any of the 50 states, they are actually quite modest when compared with some other countries.

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Forefront: Where does the Federal Reserve fit in to situations such as these?

Burson: The Fed’s efforts to promote economic growth and maintain price stability provide the necessary environment for Puerto Rico to emerge from recession and transition to a more stable fiscal path. Meanwhile, the Federal Reserve Bank of Cleveland has a dedicated team in place to monitor any potential threats coming from state and local government finance, including public pensions and the municipal bond market. We continue to follow developments in Puerto Rico and troubled municipalities carefully and share our insights with our colleagues at the Board of Governors of the Federal Reserve System and others in the System.

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