Puerto Rico spirals towards bankruptcy amid mass poverty and increasing inequality

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On June 29, Governor Alejandro García Padilla announced that Puerto Rico's $73 billion debt was "not payable." García Padilla said he would call on holders of Puerto Rican bonds to negotiate a debt payment moratorium to extend for several years so that the US commonwealth could build up financial reserves and revive an economy that has been in a decade-long recession.

Puerto Rico owes $73 billion, part of which ($48 billion) is in general obligation bonds. The rest ($25 billon) is owed by public corporations such as the water and sewage system and the island's electrical utility. Its debt-to-gross domestic product ratio is 68 percent.

In the aftermath of the governor's June 29 announcement, shares of Puerto Rican banks plummeted on Wall Street, losing between 9 and 30 percent of their value. The stock of bond insurance companies MBIA and Assured Guarantee also fell sharply. Both of these firms suffered heavy losses in the 2007-2008 collapse of the US housing derivatives market. The two have insured, between them, some $10 billion in Puerto Rican debt.

The bond rating agency Moody's downgraded Puerto Rico's bonds to Caa2, deep in junk bond territory. That was the seventh downgrade in five years.

Oppenheimer Funds, which holds $4.5 billion in Puerto Rican bonds, has declared its intention to fight for full and on-time payment, saying it will "defend the previously agreed-to terms in each and every bond indenture." A spokesman for Oppenheimer said the firm believed the island could repay bondholders while providing essential services to citizens and growing the economy.

Speaking on behalf of the US financial aristocracy, the *Wall Street Journal* in a July 2 editorial called for a "Detroit-like overhaul" of the island's economy, including cuts in welfare programs and the elimination of the minimum wage. Endorsing calls for Congress to pass legislation allowing Puerto Rico to declare bankruptcy (a remedy currently not available), the editorial added that Congress should "require a financial control board that can enforce changes in governance and other reforms that politicians refused to consider."

The Obama administration has made clear there will be no federal bailout of Puerto Rico. Shortly after García Padilla's speech, White House Press Secretary Josh Earnest said: "There's no one in the administration, or in DC that's contemplating a federal bailout of Puerto Rico."

In July 2014, a consortium of hedge funds met with representatives of Milco LP, one of the companies advising the Puerto Rican government, in support of legislation to restructure debt owed by a number of public corporations, including the Puerto Rico Power Authority (PREPA), the Puerto Rico Sales Tax Financing Corporation and the Public Buildings Authority.

The hedge fund group includes Brigade Capital Management LLC, Fir Tree Partners, Monarch Alternative Capital LP, Perry Capital LLC and Aurelius Capital. This last company, together with Elliot Management's NML Fund, aggressively bought Argentine bonds at a discounted price following that country's 2001-2002 financial implosion and debt default, and is aggressively fighting the Argentine government for full repayment in a New York federal court.

As Puerto Rican bonds sink deeper into junk status, risk-wary pension funds and investment funds are selling them off. As a result, the value of existing bonds has fallen to less than 70 percent of face value and their yields (which move in the opposite direction of bond prices) have soared by over 30 percent.

As was the case with the Argentine default, "vulture" hedge funds such as Aurelius are picking up outstanding Puerto Rican bonds at rock-bottom prices, hoping to benefit from a potential settlement with the commonwealth. The hedge funds are also speculating on the future privatization of public agencies such as the electrical and water utilities.

At the base of Puerto Rico's debt pyramid are the assets of the state—including public corporations, pension funds, and current and future tax receipts—which are being diverted from public services, infrastructure, education and social welfare into the coffers of financial predators.

A $1.9 billion payment was made on time on July 1, helping to stabilize bond markets and creating some breathing space. Part of that payment was new debt, as the Puerto Rico Power Authority renegotiated its obligations and borrowed even more cash. PREPA owes $9 billion and has obtained several extensions this year to avoid default.

Following the example set by the "troika" (European Union, International Monetary Fund, European Central Bank) against Greece, Puerto Rico's creditors are taking a hard line. While agreeing to extend a debt payment deadline until September 15, they have warned that the agreement will automatically terminate if no progress is made in restructuring PREPA by September 1.

The restructuring, meant to make PREPA more attractive to potential buyers, involves collaboration with creditors in the day-to-day operation of the company, including the operation of power plants and transmission and distribution of electricity. It also includes the imposition of management efficiencies.

The object, according to PREPA, is to make the public utility more “sustainable, solid and profitable.” In 2014, PREPA already agreed to a bondholder-approved US management team to oversee its operations.

Last week, García Padilla signed a law allowing public corporations to acquire Tax Revenue Anticipation Notes (TRANs) worth up to $400 million. Using this law, the government is preparing to saddle the workers’ disability insurance fund and the state Auto Accident Insurance Administration with government debt, to be backed by expected revenues from sharply increased sales taxes. The island’s government is also encouraging private debt holders and hedge funds to acquire TRANs.

The law also suspends government payments to a special fund for the redemption of general obligation bonds. Though Puerto Rico’s government house (*la Fortaleza*) issued a statement that “the suspension of these deposits does not imply default with bondholders on the days when payment is due,” the measure is a clear signal to holders of Puerto Rican debt that the government may suspend future payments on its outstanding bonds.

Puerto Rico’s decade-long recession is, in part, a consequence of the end of US tax incentives that had attracted industry, especially pharmaceutical firms. The resulting fall in investments was compounded by the 2008 financial crisis, which shattered any hope of increasing government revenues.

Three successive administrations, headed respectively by Anibal Acevedo Vilá, Luis Fortuño and Alejandro García Padilla, have responded to the crisis with austerity policies. Acevedo Vilá and García Padilla are from the Popular Democratic Party, which defends the island’s current commonwealth status and has ties to the US Democratic Party. Fortuño is from the New Progressive Party, which favors statehood and has ties to the US Republican Party.

In a recent address to the legislature, García Padilla placed the blame for the debt crisis on the Fortuño administration. In fact, throughout these nine years, the policies to deal with the economic crisis have been very similar, aiming to shift the burden onto the working class.

Rising unemployment has resulted in a wave of emigration. Beginning in 2006, some 300,000 Puerto Ricans, unable to find jobs, migrated to the United States despite rising unemployment in the US after 2008.

Since 2014, the government has steeply reduced public pensions and raised the retirement age. It has laid off 70,000 government workers, frozen wages, eliminated holidays and cut the customary Christmas bonus. It has consolidated public agencies, shut down over 100 schools and raised utility rates. In his June 29 speech, García Padilla warned that more “sacrifices” lie ahead.

These cuts notwithstanding, government economists estimate that this year’s budget deficit will be as high as $740 million, half a billion more than previously projected. Rather than reviving the economy, the austerity measures are deepening the recession and compounding the debt crisis.

The recession and debt crisis are the latest consequences of the deindustrialization of Puerto Rico. This process predates the 2006 recession, having begun at the end of the post-World War II boom and developed in parallel with the economic decline in the US.

The establishment of the commonwealth in 1952 opened the way for the rapid industrialization of the island. Historian Raymond Carr describes this policy, known as “Operation Bootstrap”:

“At the height of Operation Bootstrap in the 1950s, one factory was established every day on the island … by 1968, Puerto Rico’s per capita income was the highest in Latin America.” [1]

During these Cold War years, the US used Puerto Rico as an example of the success of capitalism and a model for the rest of Latin America.

Aided by the island’s links to the US market and favorable tax policies, capital-intensive petrochemical, pharmaceutical and electronics industries established themselves in Puerto Rico. At their high point in 1980, these firms employed 180,000 industrial workers. Currently, the industrial work force of Puerto Rico is below 90,000.

The implementation of Great Society programs such as food stamps, Medicare and Head Start, together with increases in Social Security benefits, stabilized living standards through the 1980s. In the 1990s, the attack on social programs in the US and the elimination of tax subsidies for US businesses in Puerto Rico under the Clinton administration accelerated Puerto Rico’s decline.

By 2009, Puerto Rico had the fourth highest level of socioeconomic inequality in Latin America, after Brazil, Nicaragua and Paraguay. Today, about half the population of 3.6 million people lives in poverty. Many people cannot afford basic services such as electricity and running water. In 2012, the bottom 20 percent of the population received 1.7 percent of national income, while the uppermost 5 percent controlled 26 percent.

Those conditions of poverty and inequality have worsened. Puerto Rico is an island with a shrinking population, in which 35 percent of inhabitants receive food stamps and 41 percent are living in poverty, nearly double the rate of the poorest US state, Mississippi.

One hundred and seventeen years after the United States announced its arrival on the world scene as an imperialist power by seizing Puerto Rico from Spain (along with the Philippines and Guam) in the Spanish American War, Wall Street is set to impose a new financial dictatorship on the US territory.

Notes:

[1] Carr, Raymond, *Puerto Rico, a Colonial Experiment*, New York: Vintage Books, 1982), p. 205.