Puerto Rico's Fiscal Crisis:

Hurricane Maria and Fiscal Repayment Capacity

May 23, 2018

Governor Ricardo Rosselló and the Financial Oversight and Management Board (FOMB) have announced an agreement on a budget for FY 2018/2019. This agreement is crucial to ensuring compliance with the FOMB's Fiscal Plan, which in turn helps determine how much debt service Puerto Rico can afford – it's repayment capacity.

Accurately assessing Puerto Rico's repayment capacity is problematic, however, due to many unique problems. The April 17th EconoSTATS analysis discussed one of these problems, namely that data irregularities reduce the value of real GDP as an effective metric for estimating Puerto Rico's repayment capacity. Specifically, there are material anomalies associated with Puerto Rico's inflation-adjusted GDP measures that may significantly under-estimate the size of Puerto Rico's economy. Since these anomalies do not impact Puerto Rico's nominal GDP measures, nominal GDP, not real GDP, is a better measure for estimating Puerto Rico's repayment capacity.

There are, however, other important problems that must be addressed as well. Paramount among these, Puerto Rican leadership is asserting that the devastation and economic costs wrought by Hurricane Maria have lowered the Commonwealth's fiscal repayment capacity.

Essentially, the leadership is arguing that Puerto Rico's economy will be permanently smaller because of the hurricane and that it will not return to its previous economic trend. While there are still many problems that must be addressed, there are positive indications that this is not the case.

First, significant federal disaster relief funds are being made available to Puerto Rico. The recently passed disaster relief bill allocates over $11 billion in federal disaster grants for Puerto Rico and the Virgin Islands, including $2 billion that will be dedicated toward Puerto Rico's troubled power system. The federal disaster relief program also allocates an additional $4.8 billion in revenues to help fund Puerto Rico's large Medicaid expenditures – in fact, with the increase the federal government will be paying 100 percent of Puerto Rico's Medicaid expenditures through September 30, 2019.

The macroeconomic data since Hurricane Maria hit further supports the hypothesis that Puerto Rico's economy is returning to its previous trend, see Figure 1. Figure 1 presents the Economic Activity Index (EAI) between January 2004 (just as Puerto Rico's decade-and a-half of economic decline was beginning) and the most recent data (February 2018).

Figure 1
Economic Activity Index
January 2004 - February 2018
Projected Through December 2020

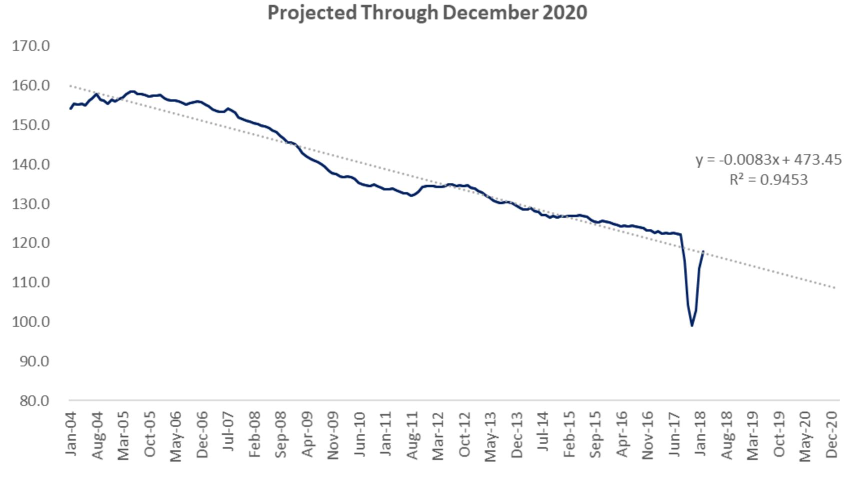


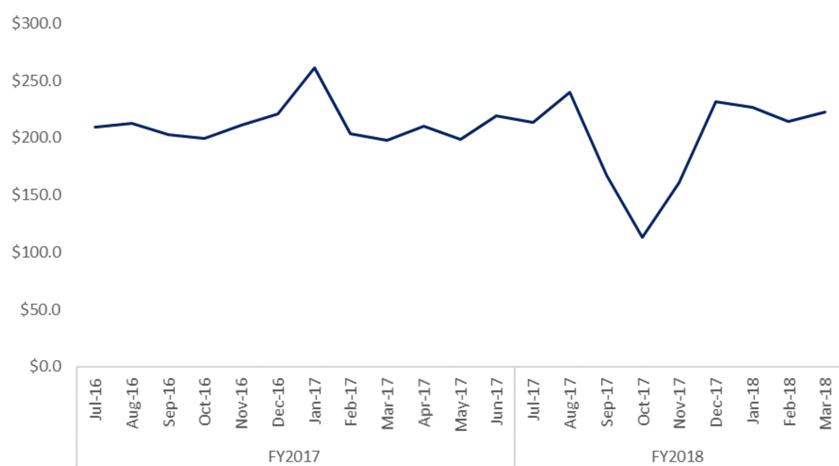
Figure 1 also projects the EAI through December 2020 based on the consistent monthly decline that was evident between January 2004 and August 2017 – the average decline (trend) in economic activity in Puerto Rico prior to the costly hurricane season. Beginning in December 2017, and continuing through February 2018, the EAI has been returning to this previous trend. Thus, despite the negative, but factually correct, news coverage that reported the EAI was down 4.2 percent year-over-year, the full story is that economic activity in Puerto Rico is returning to its previous trend.

Therefore, the steep decline in economic activity in October and November caused by Hurricane Maria appears to be transitory.

This “return to trend” story is also evident in the sales and use tax (SUT) data, see Figure 2. Figure 2 presents the monthly SUT collections between July 2016 and March 2018. Figure 2 illustrates that sales and use tax collections were stagnant, around $214 million per month, prior to Hurricane Maria.

The widescale damage of the hurricane clearly impacted sales tax collections, which fell a devastating 32 percent in October 2017. Had this new level of tax revenues persisted, then Puerto Rico’s fiscal repayment capacity would have been permanently impaired. However, this is not what happened. By December 2017, monthly tax collections have returned to their previous trend and were slightly above $220 million per month.

Figure 2
Sales and Use Tax Collections
July 2016 - March 2018



The economic activity metrics and sales tax collections do not indicate that Puerto Rico’s economy is strong, and significant economic reforms are necessary to revitalize Puerto Rico. However, the latest economic data do not support the position that Puerto Rico’s repayment capacity has been lessened due to Hurricane Maria.