A LONG HISTORY OF WALL STREET BAILOUTS AND HOW PUERTO RICO WILL NOT BE DIFFERENT

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Abstract: Even though in 2012, publications such as *Morningstar* were advising investors to "Watch Out for Puerto Rico," and pundits were commenting about a very likely default, by 2013 and 2014, Wall Street was frenetically buying up Puerto Rican bonds. Wall Street incurred in a risky behavior that is comparable with what happened during the 1980s Latin America crisis, the 1997 Asian crisis, the 1998 Long-Term Capital Management (LTCM) crisis, and the 2008 mortgage subprime crisis. By giving a brief overview of a series of economic crises around the world caused by speculation and risky lending, this article shows that the case of Puerto Rico, a nonincorporated territory of the United States of America, mirrors the same patterns of financialization of the economy and risky lending. It suggests that Wall Street bought these speculative-level bonds since this type of behavior has always been compensated by a bailout either through the US Treasury or an International Financial Institution (IFI), thus posing a moral hazard problem. The main argument of this article is that Wall Street and other bondholders will try to get their risky loans paid by the Government of Puerto Rico by forcing austerity measures, and when this inevitably fails, they will turn to the Treasury of United States to recover their money. It concludes with the question on how long the Island will have to suffer through the wave of higher taxes and cuts on social services before Washington bails them out.

Key words: Puerto Rico; debt crisis; bailouts; moral hazard; financialization

Introduction

Richard Weinert (1978, 143), an investment banker and Columbia University professor once said that "Indebtedness is a two-sided relationship. It depends not only on a willing borrower but equally on a willing lender." Pundits have always analyzed the causes of debt crisis as an issue of irresponsible demand, blaming those who uncontrollably borrow. However, demand alone does not explain historical debt crises' patterns, without equally including the patterns of irresponsible supply of lending in the analyses. The neoclassical view usually explains variations in terms of lending, primarily as a function of the creditworthiness of the borrower. Weinert argued that in the 1970s, the criteria to categorize a country's creditworthiness responded to the banks' need to lend, and not on the countries' actual borrowing capacities. In spite of numerous contributions and empirical analysis of the risks of financialization of the economy (i.e., Fouskas and Dimoulas 2013), mainstream economists[1] tend to ignore the incentives and perils of capital creation through the process of financial speculation (Krippner 2005).

If a debt crisis is caused by both irresponsible demand and supply of loans, who is to blame for the moral hazard of this behavior? According to mainstream economists, moral hazard is a "situation in which one party gets involved in a risky event, knowing that it is protected against the risk and the other party will incur the cost" (Brott 2017, 20). To show that debtor countries incur in moral hazardous behavior, we have to show that the same countries somehow feel they are protected from risks, thus borrowing over and over, leading to a recurring debt crisis. However, to show that banks and hedge funds incur in a moral hazard behavior, we have to show that they knowingly take unnecessary risks leading to survival-threatening consequences since they know they are protected. In other words, they invest and lend from one crisis to another. The fundamental issue of the moral hazard problem is that individual risk behavior is compensated by shifting the burden of the costs of such behavior to the public. Therefore, this article will show that Wall Street's behavior is characterized by private gains and public pains.

This is the case of Puerto Rico. Yet, whenever the case of Puerto Rico's fiscal crisis is discussed, the analysis automatically lands the following logic: Puerto Ricans spent themselves into a fiscal crisis and now have to pay for what they borrowed; America's taxpayers will not bail Puerto Ricans out. Otherwise, they will never learn. Similarly, to the public discourse about the Greece debt crisis, the sociologist Wolfgang Streeck (2013) argued that pundits framed the analysis as a moral duty to repay the national debt. These statements are problematic for several reasons. First, it assumes that the debt crisis is solely the debtor's responsibility and is only due to the demand for loans. Second, it assumes that the collectivity "Puerto Ricans" were composed of borrowers and spenders, without appropriately referencing to those who were making the decisions and, in many cases, profiting from the crisis. Finally, it assumes that any possible bailout is to help Puerto Ricans instead—which I argue is the case—to help Wall Street[2] investors to recover their excessively risky bets.

In this article, I argue that Wall Street has incurred in a risky behavior in Puerto Rico and that it is comparable to what happened during the 1980s Latin America crisis, the 1994 Mexican crisis, the 1997 Asian crisis, the 1998 Russia crisis, and the 2008 mortgage subprime crisis.[3] By giving a brief overview of a series of economic crises around the world caused by speculation and risky lending, it shows that in the case of Puerto Rico, a nonincorporated territory of the United States mirrors the same patterns of lending practices. Why would Wall Street buy Puerto Rico's junk-grade bonds? This article shows that this risky behavior has been compensated by bailouts through either the US Treasury or any International Financial Institution (IFIs).

Given that these bailouts are the quintessential cause of the moral hazard behavior, I argue that Wall Street took a risky bet lending money to Puerto Rico, regardless of all signs of an immediate default, yet they will still try to get their risky loans paid by the people of Puerto Rico by forcing austerity measures. And when this inevitably fails, they will most probably turn to the Treasury of the United States to recover their money, as they have done in all previous debt crises.

This article is organized into four parts. The first part describes the historical pattern of risky lending and bailouts we have witnessed since the 1970s. The second part describes the events and main actors leading toward Puerto Rico's debt crisis. The third part of this article shows how major banks and hedge funds ganged up into working in three fronts to get their risky bets paid: manipulation of public opinion, lawsuits, and lobbying. Finally, the last part discusses the creation of the Fiscal Control Board and analyzes the possibility of a future bailout.

Private Gains and Public Pain: A Long History of Debt Crises and Bailouts

In 1982, Mexico, a developing country, found itself unable to pay the debt it had accumulated for over a decade. Within a few months, another 27 countries declared insolvency. It was the first time in history that a sovereign nation declared bankruptcy. Many thought (and some still do) that a country could not go bankrupt since it has the ability to print money, but yet, here was the world at the brink of an unprecedented economic crisis.

For over a decade, these countries' exports dropped due to the global recession caused by the oil embargo from the Organization of the Petroleum Exporting Countries (OPEC). But most importantly, they found several banks more than willing to lend them money to subsidize their poor economic growth. Ironically enough, these private banks were the recipient of the money from the oil-exporting countries. This merry-go-round of money was known as the Petrodollars recycling. In less than 8 years, the debt accumulated by the least developed countries (LDC) skyrocketed (Federal Deposit Insurance Corporation 1997, 195). For example, in 1970, the total outstanding debt to American banks was only US$29 billion, but at the end of 1978, the debt went up to US$159 billion. In total, as the Federal Deposit Insurance Corporation established in a publication in 1997, the largest portion of Latin America's debt came from US banking institutions.

According to a report from the Federal Deposit Insurance Corporation (1997, 195): "The primary motivation for overseas expansion of US banks during the 1970's was the search for new markets and profit opportunities in response to major structural changes in the domestic market. . . ." Since many commercial banks were getting undermined by the commercial paper market, they were desperate to find a new source of revenue. Overseas investment, though risky, provided a new opportunity to make massive profits. In a clear example of financialization, Wall Street was not aiming to aid production but to find a source of profits in face of stagnation of the underlying economy (Foster 2008). Therefore, these cash-strapped developing countries were the perfect clients.

According to the research done by Robert Devlin (1989), nine of the largest US banks controlled 60% of all international lending. This handful of large banks competed to lend money. Even though the debt crisis was spread among LDC, the borrowing was concentrated within five borrowers taking over 50% of the money lent. Just to put it in perspective, Brazil, Mexico, Chile, Venezuela, and Argentina together owned US$176 billion. Of this money, more than US$37 billion was owed to eight of the largest US banks. These banks were so badly exposed, that some had up to 176% of their capital lent in sovereign bonds from Latin American countries, and nearly 290% of capital to the rest of the LDC debt (Sachs et al. 1988).

Even when it was clear that these countries had weak institutions and alarming structural problems, banks continued to lend to them for more than a decade. These problems were noticed by economists and politicians alike. For example, in 1977, Arthur Burns, chairman of the Federal Reserve, was advising banks to stop lending money to the developing countries, more specifically, to stop concentrating their lending to Brazil, Mexico, Venezuela, and Argentina (Federal Deposit Insurance Corporation 1997, 197). Arthur Burns's premonition became a reality when Mexico declared insolvency. Banks were so exposed and had compromised so much of their capital into lending, that a default by more than two dozen countries would have taken a huge toll on the banking industry, dragging down the US economy.

As a response to the crisis, the Federal Government took four important courses of action. First, it organized a cooperative rescue effort to "encourage" banks to restructure these countries' debt, specifically, to reschedule lending terms and to reform debt services payments. This process of negotiating with each lender resulted too cumbersome and inefficient. The second course of action was through the US Treasury Secretary, James Baker, who initiated what was known as the Baker Plan. The Baker Plan included a series of debt buybacks, debt rollovers, low-interest bonds, and debt swaps (Bertola and Ocampo 2012). Baker was able to get from different banks, more than US$32 billion in new loans for these countries, especially, for Mexico and Brazil. Under the Baker Plan, US banking regulators (Office of the Comptroller of the Currency (OCC)) allowed banks to delay recognizing the full extent of their losses. If the banks recognized their true financial situation, they would have to declare insolvency. The OCC basically gave a tacit approval to violate the law, that such concentration on bad sovereign loans was not "unsafe and unsound," which was a clear violation of the 10% rule (Sachs 1989).

When the Baker Plan did not work, the third course of action was led by Nicholas Brady, Baker's successor. Brady devised a plan to push Wall Street to get a discount on their bonds, in exchange for new bonds called Brady bonds. These bonds were fully collateralized by the US Treasury. More than US$50 billion of debt was converted into Brady bonds. Mexico alone issued US$11.7 billion in Brady bonds.[4] As of December 1999, there were still outstanding around US$130 billion of Brady bonds (Lee and Venezia 2000).

Several points are important to understand regarding the Brady bonds. First, the borrowing country issued Brady bonds only if the lender was willing to exchange a nonperforming debt of the country for a Brady bond. The debtor country bought the Brady bonds from the US Treasury and used them to pay the lender. These bonds had different types of interest, but the principal was collateralized by US Treasury's zero-coupon bonds. This did not mean that the United States guaranteed their payment. Collateralized meant that, at maturity, the bank would get a payment from the US Treasury. Although Brady bonds represented a reduction in the interest rates these banks were charging, the trade-off was avoiding financial collapse since they could remove a nonperforming (defaulted) debt from their books for a performing one. Even in the case of a default from a country who issued a Brady bond, the bank will at least get the principal (face value) of the bond paid. Therefore, Brady bonds were another attempt to use public resources indirectly by bailing out these banks, while simultaneously keeping debtor countries still heavily indebted.

The International Monetary Fund (IMF), the US Treasury, and the World Bank worked together to find a resolution to the Latin American debt crisis. When banks and debtors were unable to reach agreements, the IMF understood that the international system was different to the one in other previous crises. It was a more profoundly capitalized and highly vulnerable system. According to an IMF publication, "Losses—possibly exceeding the value of a bank's capital—to the leading international banks could have generated cascading losses and failures throughout the financial system" (Boughton 2001, 276). It was the origins of the notion of "too-big-to-fail." The IMF's role had to profoundly change from one of a lender of last resort to an active policy maker.

From 1983 to 1985, the IMF's lending was based on the country's quota. For example, within the first weeks of the crisis, Mexico drew the maximum access under the Extended Fund Facility (EFF), which over 3 years totaled SDR 3.6 billion, or the equivalent of 450% of Mexico's Fund quota (Boughton 2001, 290). All these loans were conditioned to substantial fiscal austerity measures or structural reforms. These measures were later known as the Washington Consensus (Williamson 2009). But by 1985, the IMF's credit was on its limits, and the crisis was not subsiding. Fund-supported adjustment programs began to include more structural elements and were now aimed at generating real economic growth. During this period, the Fund got involved in 30 different crises episodes in 20 countries.

Finally, by 1987, it was clear that further coordination between banks and borrowers was impossible to achieve. Due to US pressure, the IMF decided to "bail-out these countries," through a program known as "LDC Debt Relief." The new strategy consisted of these countries using the Fund's resources to finance operations such as "repurchases of their own debt at discounted prices (buybacks) and the establishment of escrow accounts to guarantee future interest payments in exchange for cuts in interest rates" (Boughton 2001, 278). Similarly, to the Brady bonds, banks were allowed to get rid of these nonperforming bonds off their books while countries continued to be indebted.

During a whole decade, these countries had to continue imposing austerity measures recommended by the IMF, the US Treasury, and the World Bank to refinance their debt.[5] The recommendations were the bitter pill to "cure" the problems of instability and inflation. However, as Michael Cohen (2013, 930) stated, "these policies were acknowledged in many countries that have not achieved the stated goals as evidenced by worsened poverty, increased inequality, and growing unemployment." These countries had to borrow from the IMF and the US Treasury to pay private banks. Their debt was not pardoned; it was the banks who got bailed out. Most importantly, the greatest cost was suffered by the population of these countries who had to undergo drastic spikes in taxes and cuts on basic services.

Ten years later, it was clear that a new wave of massive movement of Wall Street's capital was going around the world without much fear. This impressive renewal in confidence on the benefits of globalization was underpinned by the end of the Cold War and the triumph of the free market. Lo and behold, this led to a series of back to back crises: The Mexican Tequilazo in 1994, the Asian crisis of 1997, and the Russian crisis and Long-Term Capital Management (LTCM) crisis in 1998.

In 1990, Mexico seemed to be on the road of recovery, it had implemented the Washington Consensus and allowed capital to flow freely into the country. Inflation was reduced substantially, foreign investors were pumping money into the country, and its central bank had accumulated billions of dollars in reserves. Again, the market was overconfident. One telling sign was the current account deficit, which had ballooned from US$6 billion in 1989 to US$15 billion in 1991 and to more than US$20 billion in 1993 (Whitt 1996). When the United States raised its interest rates, it became harder for Mexico to keep its peso pegged; investors started to flee. Mexico was left with US$30 billion-dominated bonds, a failing peso, and its foreign reserves depleted.

Right away, President Bill Clinton committed a US$20 billion package to save Mexico. He was also able to find US$50 billion of internationally financed loans disbursed by the IMF. The crisis exploded in December 1994. Sanger and DePalma (1995) from *The New York Times* were reporting that

> already the cash-starved Mexican Government has used $13 billion of a total $50 billion aid package, including more than $5 billion from the United States Treasury to pay off billions in debts, it ran up in a risky financial strategy that collapsed in December.

According to *The New York Times*, most of those investors were a mix of rich Mexicans, Americans, and other foreigners who ". . . swept up their hefty profits and immediately transferred their money out of the country" (Sanger and DePalma 1995).

Yet, during this same time, Wall Street's banks were pouring capital into Thailand, South Korea, Singapore, Hong Kong (China's SAR), China's mainland, and Taiwan (China). Several Asian countries, including Thailand were undergoing an economic transformation promoted by rapid capitalization of their manufacture industries. Governments promoted borrowing and capital mobilization through the liberalization of their financial markets. Local political pressures to keep a high rate of economic growth pushed companies to seek outside borrowing to invest domestically. Corsetti, Pesenti, and Roubini (1999) stated that one major cause of the crisis was the banks' willingness to lend. Investment and lending in Asia remained very high in spite of problems of low profitability of most projects and companies. Suddenly for Wall Street, developing countries became "Emerging Markets," a clear signal of the optimism on the capacity of these countries to provide a new source of income.

These countries were suffering from several economic problems: the insolvency of major economic conglomerates, low profitability of their businesses, and a financial bubble created by the entrance of "hot money," aspects which characterize the financialization of their economy. In spite of these clear signals, the market was too lucrative to be concerned over the economic fundamentals of these countries. The market was further distorted given the "lax supervision and weak regulation, low capital adequacy ratios . . . non-market criteria of credit allocation" (Corsetti, Pesenti, and Roubini 1999, 307–308). Furthermore, since their currencies were pegged to the US dollar, they faced a trade deficit when the US dollar appreciated.

Similar to the Latin American debt crisis, economists, and academics were advising about the dangers of lending and investing in these countries. By 1995, US Treasury Secretary, Lawrence Summers, was asking investors to pay attention to those Asian countries experiencing current account deficits[6] (Corsetti, Pesenti, and Roubini 1999, 309). Again, the premonition became a reality. In 1997, Thai exports dropped together with its currency. Suddenly, South Korea, Indonesia, Malaysia, and the Philippines were also affected by a massive herding-type withdrawal of Western capital. This contagion effect attacked other currencies and markets around the world. Most banks in the United States and Europe had lent heavily to these countries, especially, to South Korea. The world was once again at the brink of an economic collapse.

In this case, the United States was not as exposed as it was in the 1980s during the Latin American debt crisis, but still, 20% of all US bank lending was invested in these Asian countries. However, more than half of all the lending done by European banks was concentrated in Asia. A default on the debt from these countries meant that the global crisis averted in the 1980s was about to happen finally. Within weeks, the IMF, the World Bank, and the US Government took matters into their hands.[7] Immediately, the United States pledged to contribute to the US$14.5 billion IMF's capital base. The IMF approved billions of dollars in bailout for South Korea and Thailand (Corsetti, Pesenti, and Roubini 1999). By July 1997, Philippines got a US$1.1 billion loan package, and by August 1997, Thailand got a US$3.9 billion credit. These loans continued to increase through the months leading up to December 1997, when South Korea alone got US$57 billion which at the moment is the largest bailout in history. By October 1998, the IMF and other banks had created a US$23 billion multilateral package to help Indonesia. Meanwhile, Thailand received around US$17.2 billion for bilateral and multilateral assistance (International Monetary Fund 2000).

After this major global economic turmoil, it was expected that most banks would have learned their lesson, and a period of prudence and loathing of unnecessary risks would reign. Yet, a new wave of unfathomable optimism only attributable to "Animal Spirits" (Greenspan 2013) took over Wall Street again. The best example of this optimism was when, in 1998, Secretary of the Treasury Robert Rubin was testifying before Congress regarding the Asian crisis. He said that ". . . the contagion risks that threatened in the early stages of the crisis, have so far been largely contained, and economic instability has not spread to other developing countries in other parts of the world."[8] Most neoclassical economists thought these crises were caused by individual characteristics of these countries, such as corruption, inefficiency, low productivity, and not by Wall Street's fundamental characteristic of excessive risk-taking attitudes and a sense of immunity to the costs of such.

Consequently, in 1995, Wall Street was also rushing to lend and invest in Russia. Russia was undergoing a "borrowing spree" with the help of the United States and the IMF. Russia was issuing Government Short-Term Commitments, also known as GKOs.[9] These GKOs were meant to prop up the value of the ruble. Yet, they were risky to the extent that at a point in time, their interest rates rose to 150% (Buchs 1999). As with previous crises, these banks were taking a great risk by ignoring poor Russian growth and low tax collection for the sake of attractive and quick returns on their investments. One of these Wall Street hedge funds betting on Russian debt was Long-Term Capital Management (LTCM), at the time one of the largest hedge funds in Wall Street. LTCM directly controlled over US$100 billion in assets and indirectly controlled over a trillion dollars (Edwards 1999, 198). LTCM's debt to capital ratio was 30 to 1. It was clearly overexposed.

Similar to Latin American and Asian countries during their respective crises, Russia could not keep the ruble up, and its market collapsed. In a period of 4 months, between 1997 and 1998, LTCM lost over US$4.6 billion. Yet again, the Federal Reserve came to the rescue by organizing a financial package under a consortium of private banks. The Federal Reserve itself injected US$3.5 billion into LTCM. Russia also got a loan from the IMF. Despite the IMF's resistance, they agreed due to US Treasury pressure to also deliver an emergency IMF Loan of US$4.8 billion. This allowed to prop up the ruble enough for foreign investors to recover some of their money and leave the country.

Four major debt crises that threatened the international system and US economy should be enough deterrent to fast and risky lending practices. Yet, fast forward another decade to 2008, and again, Wall Street's banks and financial institutions continued to take risks by lending mortgages to subprime borrowers. Given the availability of cheap money and rising housing values, it was very attractive to take risks in lending to those who clearly should not have taken out a mortgage. These subprime mortgages were packaged and resold into the primary, secondary, or tertiary circuit to the quaternary circuit of capital (Albers 2008), others of these mortgages were used for securitizing, and many, such as JPMorgan Chase and John Paulson made hefty profits by betting against the housing market. The 2008 crisis demonstrated the process of financialization, in which banks that were meant to be facilitators in the investment in housing, became a market in their own right.

Even though this risky behavior caused the deepest economic recession in the United States since the Great Depression, the Federal Reserve and the US Congress bailed them out through the Emergency Economic Stabilization Act of 2008 (Shah 2009). Congress approved the modest amount of US$700 billion to avoid the collapse of these banks deemed "too big to fail."[10] As an example, AIG Insurance received US$67 billion, JPMorgan Chase received US$25 billion, Goldman Sachs received US$10 billion, while Morgan Stanley got another US$10 billion. Although only US$350 billion was actually given as bailout to these banks, Congress also approved buying most of these underperforming mortgages from them (US Treasury Department 2008). Similar to Brady bonds, this allowed the banks to remove most of these nonperforming mortgages off their books.

Every single one of these crises had several things in common. All of them had very clear signals of an impeding collapse or default. Although pundits and politicians alike were advising about the dangers of each of these markets, Wall Street was not deterred, until each of them imploded under their own weight of debt and weak economic fundamentals. The other thing these crises had in common was that they were followed by direct bailouts, such as rescue packages or indirect bailouts through financial instruments such as Brady bonds, buybacks, Debt Relief Programs, and so on. Finally, the brunt of these crises was felt by the general population who carried the costs of waves of austerity measures of higher taxes, higher living costs, and lower social investment.

Initiation of Puerto Rico's Debt Crisis

Early in 2007, Puerto Rico was hit by one of its worst economic crises due to a combination of several factors. The first of them was the elimination of the Section 936 of the IRS code in 2006, a Federal Government Incentives Regime which granted American corporations operating on Puerto Rico, a tax exemption from income originating on the Island. The second and less discussed factor was the towering increase of petroleum prices in 2007, leading to a soaring inflation on all consumption products and leaving the people struggling to afford basic items. The consumer prices' spike was especially acute given the fact that most products consumed on the Island, including more than 90% of its food, were imported.[11]

These factors were preluded by the ratifications of dozens of free-trade agreements between the United States and other developing countries. Compared with these other countries, Puerto Rico was more expensive in every possible way for American business operating on the Island. But above all, it became a struggle for the survival of its own residents. With no investment, no exports, and decreasing purchasing power, the conditions for a perfect storm were created, leading to the worst economic and fiscal crisis we have seen.

These severe economic and structural problems were weathered by years of issuing debt to balance the local government's budget.

The first signs of an impending fiscal crisis showed up as early as 2006. The Government created the Puerto Rico Sales Tax Financing Corporation or COFINA.[12] This corporation started to sell what were known as COFINA bonds, although their proper name was "Sales Tax Revenue Bonds." COFINA was created as an independent instrumentality, separate from the Government Development Bank of Puerto Rico which was in charge of issuing general obligation bonds.[13]

The signal of the arrival of an inevitable crisis was clear by then. COFINA was created for the specific purpose of financing the payment, retirement, or defeasance of certain debt obligations of the Commonwealth of Puerto Rico outstanding as of June 30, 2006. COFINA provided a definite and secure repayment mechanism of some US$6.8 billion in debt that previously lacked a source of repayment.[14] What COFINA did was to promise part of the revenue of the previous newly created sales tax of 7% (currently 11.5%) to pay for these bonds, which in turn were meant to pay an outstanding old debt. It created a bond which, by law, had a secured source of payment.[15] It is fundamental to understand that Revenue bonds are not meant to be issued to pay other debt. Generally, Revenue bonds, such as Sales Tax Revenue Bonds from COFINA, are for essential services or infrastructure projects which generate their own revenues and, above all, have a direct impact on economic growth. In spite of these precarious signals, COFINA has borrowed between 2007 and 2011,[16] more than US$15 billion (Government Development Bank of Puerto Rico 2017). This debt was separate from the general obligation debt issued by the central government, and the debt issued by its public corporations.

COFINA's bonds are not like any other bonds.[17] Some of these bonds are known as capital appreciation bonds or CABs, a financial instrument created by Goldman Sachs. What makes CABs so perilous are two special features. First, these bonds do not require payments until their maturity; Bondholders receive a single payment that includes the principal amount plus the cumulative investment returns, which means it pays interests on accumulated interests. Second, for accounting purposes, CABs are considered as compounded interests, so they are not counted as new debt, which allows municipalities to overcome laws on debt limits, in the case of Puerto Rico, the Constitution. According to Robert K. Rasmussen (2016, 234), professor of bankruptcy law, "the entire reason behind the creation of the COFINA bonds was precisely to evade the demands of the [Puerto Rican] Constitution."

These CABs are precisely the type of predatory lending which exacerbated the crisis. According to Bhatti and Sloan (2016) from the Roosevelt Institute, "$33.5 billion of the so-called Island's debt is actually interest on CABs—the municipal version of a payday loan." The structure of this financial instrument allows Wall Street to amass massive returns. To put this in perspective, Hedge Clippers reported that they have found in one of the government documents "$2.3 billion in principal was borrowed with $10.2 billion in interest at maturity: a principal to interest ratio of 433%" (Hedge Clippers 2016). However, Bhatti and Sloan (2016) found that another emission of debt led to the borrowing of US$4.3 billion in principal, and Puerto Rico has to pay it back with 785% interest. Moreover, because of the way these deals are structured, most of the US$33.5 billion is of interest which has not even accrued. It is pure investor profit (Bhatti and Sloan 2016). Singlehandedly, CABs are the culprit of COFINA's woes. Over 63% of Puerto Rico's total CABs debt belongs to COFINA.

By 2012, it was clear that Puerto Rico's debt was unsustainable. Credit Houses' ratings had degraded Puerto Rico's bonds to almost junk status (which eventually was achieved in 2014). At that moment, the Island was suffering 6 years of economic depression, low tax collection, and the continuation of massive emissions of debt. Yet, hedge funds and investors continued to pour in buying up the Island's bonds. Why would they not? It offered one of the highest yields in the market, and most importantly, these municipal bonds were triple tax exempt. Thanks to the 1917 Jones Act, the Island has a hybrid domestic foreign treatment by the United States for taxation purposes essentially. These bonds were exempt of federal taxes, state residency taxes, and Puerto Rico's taxes. They were so attractive that by 2012, the Franklin Double Tax-Free Income Funds had over 69.8% of its assets in Puerto Rico's municipal bonds.

Even though in 2012, publications like *Morningstar* were advising investors to "Watch Out for Puerto Rico" (*Morningstar* 2012), by 2013 and 2014, Wall Street was buying up these bonds like "cheap TVs on a Black Friday," in other words, with apparently no regards to quality, and in a complete herding behavior. It was clear that Puerto Rico was in a severe fiscal crisis and heading to a very likely default. The signals were so loud and clear that in 2013, I was giving a speech about Puerto Rico at a university in New York, and at the end of the speech, the conversation turned to the Island's economic crisis. I ended up advising my audience to check into their retirement investments for funds having Puerto Rico's bonds and to ask their financial advisors to get rid of them.

Nonetheless, by March 2014 when the Island's bonds were already classified as junk, Matt Wirz (2014) from *The Wall Street Journal* revealed that several large hedge funds "doubled down on Puerto Rico's bonds sale." In the same article, he reported that, in that month alone, more than US$3 billion worth of Puerto Rico's debt was bought by hedge funds, such as Brigade Capital Management, Paulson and Company, Och-Ziff Capital, among others. As Cintrón-Arbasetti (2016) revealed, more than 275 investment firms offered to buy the Island's bonds. These companies ordered more than US$16 billion from the US$3.5 billion that was actually being offered. These bond offerings were the largest sale of junk-rated municipal debt in US history. Eventually, these bonds were sold at 93 cents a dollar, with the interest rate of 8.73%—not too shabby for junk bonds.

A month or two later, the government approved a series of desperate laws and executive orders that proved what everybody, "except" Wall Street, already knew—the Government of Puerto Rico was not able to pay. The first of these laws was the approval of a law known as the "Creole Bankruptcy Law" or in Spanish "Ley de Quiebra Criolla." This law sought to enable some Commonwealth Public Corporations in financial distress to restructure their debt obligations. The second move was to transfer available money the government had in its central bank (Government Development Bank) to private banks; as a way to impede the possibility of bondholders seeking to confiscate the little money available. The government was indeed bankrupt.

Wall Street Fights to Get Their Risky Bets Paid

Similar to other processes of financialization in which state suffers from a diminishing role in front of transnational financial actors (Strange 1996), these institutions sought to displace and discredit the legitimacy of the Commonwealth's government actions. As soon the government clearly signaled its impending default on payments, various Wall Street players started to take matters into their own hands. They ganged up to work on three fronts: manipulation of public opinion, lawsuits, and lobbying.

On the first front, these Wall Street players tried to manipulate public opinion. Since mid-2014, several special interest groups launched an impressive media campaign against the Government of Puerto Rico. A series of media ads appeared in newspapers and magazines such as *Politico* and *The Wall Street Journal*. With a gigantic photo of Governor Alejandro Garcia Padilla, the Republican-based group, American Future Fund (AFF), accused the Puerto Rican government of having "a culture of corruption that resembles the dishonest governments of Argentina's Cristina Kirchner, and Venezuela's Nicolás Maduro."[18] The AFF, the Koch-funded organization, had ties to the then political party of opposition, now in the government, the New Progressive Party. The Hispanic Leadership Fund, which has also received Koch funding through one of their intermediary organizations, joined the fray, comparing Garcia Padilla with Cuba's Castro (Novak 2014).

In 2016, a local media campaign running on radio and TV showed a group of elderly Puerto Ricans asking the Government of Puerto Rico to fulfill its responsibility because "all" their retirement money was tied to these bonds. Local citizens were persuaded by this campaign. But what this campaign failed to mention, of course, is that many of these banks and hedge funds who were managing their retirement money had incurred in unethical behavior which put at high risks the monies from these retirees. For example, UBS, Merrill Lynch, Santander Securities, Morgan Stanley, Oriental Financial Services, and Popular Securities all faced Financial Industry Regulatory Authority (FINRA)[19] arbitration cases for dishonest advisory practices which included overconcentration of Puerto Rican bonds. Most notorious was UBS, which served as an adviser to the Commonwealth's Employees' Retirement System, led the underwriting of a US$2.9 billion bond issue for the pension agency in 2008, and then stuffed half of those bonds into a family of closed-end mutual funds it sold exclusively to customers on the Island (Evans 2015).

The second front was through the courts. In fact, 27% of COFINA's debt was in the hands of Oppenheimer and Franklin Mutual Funds. They held together US$4.1 billion of the US$15 billion total debt issued by COFINA, according to Wirz and Kuriloff's (2015) analysis of the data provided by the *Morningstar*. In 2015, they were the first to gang up suing Puerto Rico. At least four hedge fund and mutual fund companies' clans were formed to sue the Government. Furthermore, Franklin Mutual Funds, Marathon Asset, Blue Mountain, Angelo Gordon, Knighthead, and D. E. Shaw were among those hedge funds opposing any type of debt restructuring (Arbasetti and Minet 2015).

The third front was through lobbying directly to Congress. Between 2015 and 2016, several efforts were made in Washington to deal with the debt crisis. One of them was the Bill HR-870, petitioned by Resident Commissioner Pedro Pierluisi, known as Puerto Rico Chapter 9 Uniformity Act of 2015. The Project sought to give Puerto Rico the same rights every other "state" has; the ability, if it so chooses, to enact a law that authorizes a "municipality" to seek relief under Chapter 9 of the Bankruptcy Code. Wall Street hired well-known lobbying firms, for example, Angelo Gordon & Company, Blue Mountain Capital, D. E. Shaw Galvanic Portfolios, Knighthead Capital, Marathon Asset Management, and Franklin Mutual Funds hired the Venable Law Firm. While Blue Mountain also recruited the Gibson Dunn Law Firm, both law firms successfully lobbied against Project HR-870 (Arbasetti and Minet 2015).

The efforts to stop any legislation which would grant some type of restructuring power to Puerto Rico failed in December 2015. Foreseeing a possible default in May 2016, the Republican Speaker, Paul Ryan, requested the House to craft a responsible solution to the impending fiscal problems of Puerto Rico no later than March 2016. This announcement was met with optimism and fear by different players. It was time to start lobbying again. According to the Federal Electoral Commission's documents, the 14 Republican senators who made up the majority of the members of the Senate Finance Committee, and 10 of the 12 Democrats members of this committee received donations from many of the companies with Puerto Rico's bonds (Cintrón-Arbasetti 2015).

The politician who benefitted the most from donations made by investment firms was Charles Schumer, New York senator and member of the Finance and Judiciary Committees. Among Schumer's donors who hold Puerto Rican bonds are York Capital, Fore Research & Management, Appaloosa Management, Fir Tree Capital, Davidson Kempner, Redwood Capital, Centerbridge Capital, Avenue Capital, Blue Mountain, Apollo Management, and D. E. Shaw. Besides donating to Schumer, MassMutual and The Oppenheimer Funds made donations to Charles Grassley, who led the Judiciary Committee (Cintrón-Arbasetti 2015). These two Committees oversaw all the legislation regarding the possibility of a bailout or restructure mechanisms.

Eventually, Congress passed the Bill HR 5278 named as the Puerto Rico Oversight, Management, and Economic Stability Act or PROMESA. The Bill passed the House by 297 against 127. Republicans almost split in half in this vote, with 41% of the Republicans voting against it, yet a whopping 84% of Democrats voted in favor. The Freedom Caucus is notably one of the groups who voted against PROMESA and who vehemently opposed the 2008 Wall Street Bailout.[20] In fact, during the deliberation of PROMESA's bill, there was the question of whether this was a bailout or not. Paul Ryan, Speaker of the House, was assuring his fellow conservative congressmen that "This bill prevents a bailout; that's the entire point" (DeBonis 2016). However, conservative groups were calling PROMESA precisely a bailout. Freedom Fighters, a conservative foundation, sent a letter to Congress saying that

> On behalf of Frontiers of Freedom, we write today to express opposition to the "Puerto Rico Oversight, Management and Stability Act" (PROMESA). Upon taking office, Conservatives in Congress made a promise to their constituents and the American people to end Washington cronyism by standing for the rule of law and the interests of the American taxpayer. A vote for the PROMESA does exactly the opposite. (Landrith and Wallop 2016)

Will Wall Street Get a Bailout from Puerto Rico?

Puerto Rico's debt crisis is very similar to other crises reviewed in this work. Each of these crises had several things in common. First, all of them suffered from weak economic fundamentals and structural problems that were not resolved by high levels of public investment or spending. Their fiscal problem was also exacerbated by having an inefficient structure for tax collection. Second, all of them were able to continue borrowing money, even in spite of the fact as discussed earlier, their economies were slowing down or were already in recession. Third, all of them had very high interest rates compared with the United States. These countries not only had high interest rates but also had free capital flow. In the case of Puerto Rico, it has no capital controls, therefore is even more open than most Asian countries, Mexico, and Russia. Puerto Rico's ease of investment, triple tax exception, and high interest rates made taking risks very profitable.

Sure enough, the differences between these cases are ample, but for each one of them, hedge funds and other financial institutions were in fact "bailed out." These bailouts added another incentive to lend to Puerto Rico without regard to its economy problem of suffering, or the fact that their bonds were at a speculative level. The question remains, will vulture funds and other hedge funds also get a bailout in Puerto Rico?

As of 2017, for Puerto Rico to pay its debt, it must close its fiscal deficit which was US$7 billion, including debt service and spending. This gap can be divided between approximately US$3 billion in fiscal deficit and the other US$4 billion in debt service. Even if Puerto Rico is to stop spending altogether, it will still fall short in fulfilling its annual debt service obligation. It is almost impossible to devise a solution in which all lenders will get paid. Whether PROMESA itself is a bailout or not will ultimately depend on two things: the results of the negotiations to restructure the debt between the Fiscal Control Board created by the PROMESA law and the bondholders, and the capacity of the Island's economy to bounce back during this process.

At the moment of this writing, Puerto Rico's central government has gone through two rounds of voluntary debt restructuring negotiations. The first round of debt negotiations started in mid-2015, as soon it was clear, the first default on the payment will happen. These negotiations continued until the approval of the PROMESA law. However, under PROMESA, the negotiations were supervised by the members of the Fiscal Control Board and had set May 1, 2017 as the deadline to reach an agreement with bondholders for a restructuring deal.

The negotiations have been unfruitful for several reasons. The first of them lies on the complicated structure of the debt. As Robert Rasmussen (2016, 233) points out, there are "17 different flavors of Puerto Rican debt." Some of the debt are general obligation bonds, other are sales-tax bonds or COFINA bonds, while a big part of the debt comes from each of the public corporations, most notoriously, the Puerto Rico Electric Power Authority (PREPA). PREPA itself had an outstanding debt of approximately US$9 billion as of 2016. Furthermore, each town and city also has been able to issue debt, and finally, this debt negotiation should include pensioners. Taken together, including unfunded pension liabilities which are at US$44 billion, Puerto Rico's debt reaches US$117 billion (Gillette and Skeel 2016). This means that the debt has been issued by different identities and thus, has different payments sources. But this gets further complicated, as it is also held by different types of creditors, such as mutual funds, bond insurers, hedge funds, and individual retail bondholders (Skuria and Gillers 2017). The biggest amount of the debt is held by individual investors who lack the capacity to protect their own interests and to find a negotiation mechanism that binds them all together.

Another hurdle to the debt restructuring negotiation is the conflict among creditors regarding which of them should have priority. Until the creation of COFINA, general obligation bonds had priority on a constitutional basis. The Constitution of Puerto Rico specifically establishes that in case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt, and amortization thereof shall first be paid. However, COFINA law establishes its payment will come directly from sales taxes. Any attempt of the government to take sales-tax income to obey its constitutional duty and to first pay the general obligation bonds will violate the COFINA law. Debt negotiation has found it hard to compromise on which of these two types of bonds should receive the greatest discount in the debt restructuring process.

Finally, a major impediment to the debt restructuring negotiation is the presence of speculative hedge funds, who bought these bonds for a fraction of their costs and are seeking full payment. For example, those who bought the general obligation junk bonds in the 2014 sale are Aurelius Investments, Lex Claims, Jacana Holdings, Monarch Alternative, and Fundamental Credit Opportunities. From these, Aurelius Investments has gained international notoriety, which together with Elliott Management and Bracebridge Capital, had a 15-year long lawsuit against Argentina. It was until 2016 that the Argentinian Government of President Macri decided to settle their claims. These three companies earned the name "vulture funds" for their tactic of buying junk bonds at a deeply discounted price, and then employing all the legal sophistication they could afford to get as much money as they could. In the case of Argentina, while most creditors got 30 cents a dollar in 2001, these companies were able to get 70 cents a dollar in 2016 (Joffe 2016). Aurelius walked away with US$759 million from the US$299 million of Argentinian bonds it had originally purchased (Merie 2016).

The Fiscal Board invoked Title III of the PROMESA law, after voluntary and good faith restructuring negotiations failed, precisely due to the problems mentioned above. According to some reports, as of May 2017, the Government offered to pay 50 cents on the dollar to holders of general obligation and sales-tax bonds, but they refused the offer (*Associated Press* 2017). The Title III grants Puerto Rico a legal resource similar to Chapter 11 and Chapter 9 of the US Bankruptcy Code. Specifically, it is an "across the board" in-court restructuring process. Here, the court appoints a judge who will have the power to "force bondholders to take a haircut, even if they do not consent to the agreement" (Dayen 2017). How much of a cut these bondholders and pensioners will get, will depend again on the Fiscal Control Board Members and the Judge presiding over the case. According to the PROMESA law, only the Fiscal Control Board can introduce or change the fiscal plans, including more austerity measures to pay bondholders and also to negotiate the debt restructuring.

The second aspect to answer whether Puerto Rico's bondholders will get a bailout will depend on the Island's capacity to bounce back from recession to growth. Without economic growth, any projection on the government's ability to collect taxes to pay its debt is moot. The most recent Fiscal Plan approved by the Control Board puts Puerto Rico's economy to finally reach growth by 2022. More importantly, the projection puts the economy in 2026 below its current level, even without adjusting to inflation. That means the Island is condemned to be in recession for another decade, totaling 20 years of misery. However, these projections are still too optimistic. The current Fiscal Plan does not accurately take into account the impact of the austerity measures, including the increasing migration of a working age population, increasing living costs, and the impact of a public employee furlough program on a population that has negative savings rates.

Conclusion

Although the debt crises reviewed here had different causes and actors, what they all have in common is that risky behavior by financial institutions always paid off. Some will say that countries got bailed out, Mexico got bailed out, and South Korea got bailed out, and so on. But a closer look reveals something else, giving an emergency loan to South Korea or Mexico was not to save the country but ultimately to save the banks who lend them the money.

These bailouts created a serious vicious cycle. As Jeffrey Sachs (1989, 28) stated,

> By using foreign policy pressure and official funds to help keep the commercial-bank debt afloat, the creditor community is sending a signal to the banks: Don't worry about the creditworthiness of your borrowers, since the taxpayers will come to your aid in the end.[21]

Almost 30 years later, Sachs's argument is still relevant. Every single of the crises reviewed here were not just caused by the debtor countries' desire to spend money, but by the very profitable willingness of Wall Street to lend.

In sum, Wall Street and other bondholders are trying to get their risky loans paid by the Government of Puerto Rico. They had manipulated the public opinion, used the courts and even lobbied for enforcing severe austerity measures, and most importantly have argued that the debt should be serviced before any other type of public spending. The Fiscal Board has, as discussed previously, started an overwhelming series of cuts on all essential services, including healthcare, hospitals, closing schools, reducing salaries and benefits for public employees, and even slashing the State University's budget to half. This recipe is indeed the same as what the IMF, the US Treasury, and the World Bank imposed on every single crisis reviewed in this article. The problem of these policies is that this type of austerity measures, without any form of economic stimulus, is doomed to fail (Balmaceda 2017). After 40 years, even the IMF has accepted that these austerity measures only end up damaging the economy (Ostry, Lougani, and Furceri 2016). Therefore, any projections of tax revenues using today's baseline will inevitably be unmet. If this is the case, it will be even harder to pay off the debt and meet the public employees' retirement obligations.

Will these private financial institutions eventually get a bailout? It is very probable the debt structuring process can last years, while severe austerity measures are being implemented and the economy inevitably worsens. It is likely that the bailout could come in different forms, from direct cash, as in the subprime crisis, or indirect cash for the Government of Puerto Rico through budget support and social programs cash transfers, or it could be through indirect financial instruments, similar to the Brady bonds. Regardless of the methods, there is a well-known saying that "If you owe the bank \$100, that's your problem. But if you owe the bank \$100 million, that's the bank's problem." It would not be long when Wall Street will try to push for some type of bailout. The question is how long the Island will have to suffer through the wave of higher taxes and cuts on social services before Washington bails them out?

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Notes

1. For example, Milton Friedman (1953) saw speculation as necessary for stabilization since currency prices are set on economic fundamentals.
2. By Wall Street, this article refers to financial institutions originally from the United States, but it can also include other international or foreign financial institutions. These institutions can be banks, but it usually refers to nonbanking institutions such as hedge funds, mutual funds, venture investors, and so on.

3. I do not discuss the Euro crisis or the Greek debt crisis since Wall Street banks were not the main lenders here. However, the events leading up to the crisis, the patterns of behavior and eventually the austerity measures imposed by the "troika" are similar to those of Puerto Rico.
4. These bonds would be collateralized by US government securities purchased with funds made available to Mexico by the International Monetary Fund (IMF) and the World Bank. About US$20 billion of Mexico's US$84 billion debt was rescheduled under the first option and US$22.5 billion under the second option. There was only US$1.6 billion of new loans under the third option.
5. This term was coined by John Williamson, Senior Fellow, Peterson Institute for International Economics. The consensus ". . . refer[s] to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989" (Williamson 2009).
6. Current account deficits occur when the value of imports (good, services, and investment) is greater than the value of exports. This can be caused if the currency is overvalued, there is a decrease on exports, or an increase in the borrowing of money. In the case of Thailand, its baht was pegged with the US dollar, which had appreciated right before the crisis started.
7. The Federal Reserve played an active role in informing and supporting the United States and global policy responses. Behind the scenes, the Federal Reserve provided timely analysis of the underlying adjustment challenges and closely monitored the risks the crisis posed to US banks, and the condition and funding profiles of Asian bank offices in the United States, coordinating policy with other bank supervisors in the United States and internationally. The Federal Reserve also acted as an agent for the US Treasury, including by helping arrange a bridge loan for Thailand in the early stages of the crisis. The Federal Reserve played a catalytic role in an official sector effort to encourage banks to act in their collective self-interest in helping South Korea avoid a disorderly default. For more information, see: http://www.federalreservehistory.org/Events/DetailView/51. Accessed January 22, 2018.
8. "The Crash" Frontline. Air date, June 29, 1999. Accessed June 18, 2017. https://www.pbs.org/wgbh/pages/frontline/shows/crash/.
9. Gosudarstvennoye Kratkosrochnoye Obyazatyelstvo (Government Short-Term Commitments).
10. The implications of the 2008 crisis were felt worldwide. For example, in the United Kingdom, the government also had to bail out its biggest banks, although the total amount of the bailout is substantially lower than in the United States, it still represented a record high. The UK government approved £123.93 billion in the form of loans and share purchases, and another £332.40 billion relating to guarantees and other contingent liabilities.
11. Due to the Jones Act, also known as The Merchant Marine Act of 1920, Puerto Rico, Hawaii, Alaska, and other insular American territories do not have the option of using cheaper foreign vessels to transport goods between American ports. American freight companies are one of the most expensive in the world, a price that is added to the price of goods imported to the Island.
12. COFINA stands for "Corporación del Fondo de Interés Apremiante."
13. Generally speaking, municipal bonds fall into two categories. General obligation bonds are backed by a state full faith and credit. Their payment comes from a general fund recipient of state taxes, while Revenue bonds are supported by specific income or sales taxes, or project-related revenues. We can also think of general obligation bonds as unsecured bonds backed only by the general creditworthiness of the country, while Revenue bonds can be thought of as secured bonds since the government has pledged specific property to ensure its payment.
14. For more information regarding COFINA, its legal basis, and the debt it issued, go to http://www.gdb-pur.com/investors_resources/cofina.html. Accessed July 25, 2017.
15. The payment is payable solely from and secured by a security interest in a portion of the sales tax imposed by the Commonwealth.

16. According to Bhatti and Sloan (2016) from the Roosevelt Institute Think Tank, the data obtained from the government does not reflect the same data at bond level. They argue that the official data from the Government of Puerto Rico, establishes 15.2 billion dollars of COFINA debt, but using Bloomberg bond-level data, it actually reflects 36.9 billion in COFINA bonds.
17. COFINA has issued current interest bonds, capital appreciation bonds, and a convertible capital appreciation bond.
18. These ads can be found around many media outlets. For example, this in the news media NotiCel: http://www.noticel.com/uploads/gallery/documents/f096382c2361050c1ed439852b36e3b3.pdf. Accessed March 20, 2017.
19. The Financial Industry Regulatory Authority (FINRA) is a private corporation which acts as a self-regulatory organization. For more information regarding FINRA, see https://www.finra.org/about. Accessed July 20, 2017.
20. See Puerto Rico Oversight, Management, and Economic Stability Act of 2016. H.R.5278. Voting Record of 114th Congress (2015–2016). Accessed on February 2, 2018 from https://www.congress.gov/bill/114th-congress/house-bill/5278/actions.
21. He actually stated, that creditor taxpayers were picking up the bill for the commercial banks in various ways: (1) through official lending by the IMF and the World Bank, much of which is effectively recycled into commercial bank interest payments (note that the US$75 billion General Capital Increase of the World Bank is an explicit taxpayer contribution to this process); (2) through the Paris Club mechanism, whereby official creditors capitalize interest as well as principal in their rescheduling, in contrast to the banks, which never reschedule interest; (3) through explicit debt forgiveness, as suggested at the Toronto summit: it is important and interesting that the creditor governments apparently did not even suggest that the commercial bank creditors should share prorata in the reduction of the debt; and (4) through direct new lending by the export-credit agencies and other governmental agencies of the creditor governments.

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