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Policy Brief

2022 – The Opportunity of a Generation for Puerto Rico

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INTRODUCTION

Several trends are currently converging, both worldwide and in Puerto Rico, to create the conditions for a rethinking of the process of economic growth and development. Since the 2008 financial crisis, critics from both the left and the right have questioned the prevailing Washington Consensus, also known as the neoliberal or Thatcher/Reagan model of economic growth, which is based on privatization, low taxes, deregulation, cutting back the social safety net, trade liberalization, strongly pro-market structural reforms, and limited government intervention in the economy. That model has several defects that, over time, have worked to discredit it.

FAILURE OF THE WASHINGTON CONSENSUS

In terms of its internal logic, the Washington Consensus is a tautology, it essentially states that the "way to have an economy like Denmark's is to become Denmark". In other words, it suffers from one of the "most common misconceptions of economic development theories: the misguided notions that economic prosperity can only occur in places with an excellent business environment and that growth is the result of painful and politically difficult reforms."[1] However, the challenge for policy practitioners *is to jumpstart economic growth and development precisely in places where, by definition, the preconditions for success are missing or suboptimal*.

Second, the Washington Consensus approach to economic growth is ahistorical and failed to take into account local conditions. In the words of economist Dani Rodrik, it favored a simplistic "cookbook recipe" approach to economic growth. This limitation was highlighted as early as 2008 in *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, drafted by the Commission on Growth and Development led by Nobel Prize-winning economist, Michael Spence. While the Commission identified some stylized facts associated with sustained and inclusive growth, namely, access to capital in all its forms, openness to the global economy, macroeconomic stability, robust spending in innovation, research, and development, and stable institutions; it also pointed out that:

> We do not know the sufficient conditions for growth. We can characterize the successful economies of the postwar period, but we cannot name with certainty the factors that sealed their success, or the factors they could have succeeded without. It would be preferable if it were otherwise. Nonetheless, the commissioners have a keen sense of the policies that probably matter— the policies that will make a material difference to a country's chances of sustaining high growth, even if they do not provide a rock-solid guarantee. Just as we cannot say this list is sufficient, we cannot say for sure that all the ingredients are necessary…A list of ingredients is not a recipe, and our list does not constitute a growth strategy.[2]

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[1] Justin Yifu Lin and Célestine Monga, *Beating the Odds: Jump-Starting Developing Countries*, (Princeton University Press, Princeton, 2017), p. 6.

[2] Commission on Growth and Development, *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, (World Bank, Washington, DC, 2008), p. 33.

Yet the Washington Consensus was based precisely on this kind of one-size-fits-all formula and on the premise that economic growth is nothing more than the sum of the aggregate effects of a disparate set of structural reforms, which if implemented would somehow generate growth anywhere and everywhere, regardless of local conditions, history, or institutional framework.

It should not be surprising, then, that these policies did not yield the widespread growth its proponents promised. For instance, professor James K. Galbraith describes the European experience with structural reforms in the following terms:

> Europe's economy today makes nonsense of claims that "structural reform" is the key to growth. Structural reform has been tried throughout Europe; it has produced growth nowhere. Granted, the enactments often fall short of the promises; but each shortfall and each failure to show results sparks a call for more reforms—the true mark of fanaticism. The governments that continue to comply do so cynically: in Greece to escape (unsuccessfully, so far) from the bailout; in Italy to strengthen Mr. Renzi's EU negotiating stance. Very few in countries stricken by structural reforms delude themselves into thinking they will work.[3]

Furthermore, both the IMF and the OECD have also concluded that supply-side structural reforms have, at best, a marginal effect on growth, and at worst, no or negative effects on medium to long-term growth rates. [4]

Yet, by deepening existing inequalities and eroding the social safety net, structural reform programs created the conditions for the emergence of *an anti-system politics* that have fueled the political polarization and social unrest we have seen around the globe and which have been articulated in the United States, specifically, first by the Tea Party and the Occupy Wall Street movements, and more recently, by the conservative populism of Donald Trump and by a radically progressive faction within the Democratic Party.

Finally, the global COVID-19 pandemic has triggered a re-evaluation of the role of the state in the economy and called into question the benefits of globalized supply chains and just in time inventory management practices.

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[3] James K. Galbraith, *Welcome to the Poisoned Chalice: The Destruction of Greece and the Future of Europe*, (Yale University Press, New Haven, 2016), p. 43.

[4] See, for example, Dereck Anderson, Bergljot Barkbu, Luisine Lusinyan, y Dirk Muir, "Assessing the Gains from Structural Reforms for Jobs and Growth" in *Jobs and Growth: Supporting the European Recovery*, (International Monetary Fund, Washington, DC, 2014); Romain Duval, Davide Furceri, Alexander Hijzen, João Jalles and Sinem Kiliç Celiç, "Time for a Supply-Side Boost? Macroeconomic Effects of Labor and Product Market Reforms in Advanced Economies" in *World Economic Outlook* (International Monetary Fund, Washington DC, April 2016), p. 103; Luiza Antoun de Almeida and Vybhavi Balasundharam, *On the Impact of Structural Reforms on Output and Employment: Evidence from a Cross-country Firm-level Analysis*, IMF Working Paper, WP/18/73, April 2018, p. 13; and Ana Fontura Gouveia, Silvia Santos, and Inês Gonçalves, *The Impact of Structural Reforms on Productivity: The Role of the Distance to the Technological Frontier*, OECD Productivity Working Papers No. 8, May 2017, p. 13.

We must keep in mind that many households (though by no means all) in the highly developed economies have managed to escape the worst economic effects of the pandemic due to the timely implementation of robust fiscal and monetary policy support policies by governments around the world. While on the supply side, many multinational firms are considering simplifying as well as adding a layer of redundancy to their supply chains. These events, in turn, have led many governments to reconsider the role of national industrial policies, not only as part of traditional Great Power geopolitical competition but also as a matter of securing access to both key intermediate inputs and final products in the case of a global emergency.

The Opportunity for Puerto Rico

It is, then, in this global context that Puerto Rico faces the next stage in its economic development. After 15 years of economic stagnation, a fiscal and debt crisis, the bankruptcy of its government, the damage caused by Hurricanes Irma and María in 2017 and a series of earthquakes in 2020, and the pain inflicted by the COVID-19 pandemic, Puerto Rico has a once in a generation opportunity to turn its economy around.

First, the debt restructuring process is over. The certified Plan of Adjustment provides significant debt relief to the island by cutting the Commonwealth's debt by approximately 50%. It is quite difficult, though, to determine today whether this amount of debt relief is sufficient. What is clear is that the medium to long-term viability of the Plan depends on jumpstarting economic growth in Puerto Rico.

Second, the Biden Administration has been willing to disburse the money appropriated by Congress five years ago to finance hurricane reconstruction efforts, which will allow Puerto Rico to significantly upgrade a large part of its physical infrastructure endowment in a relatively short period of time.

Third, there is reason to believe, or at least hope, that the worst of the pandemic may be ending soon. While the risk of the emergence of a new variant is still, and will probably always be, present, it is also true that humankind has made tremendous progress in understanding the clinical evolution of this disease and developed in record time both vaccines and new treatments that reduce the incidence of severe symptoms, hospitalizations, and deaths.

Finally, the intellectual and political turn towards a more activist state affords Puerto Rico the necessary policy space to develop and implement creative solutions to its economic problems. The *zeitgeist* is favorable for the development and implementation of a carefully crafted economic strategy for Puerto Rico. In this sense, it is important to note that while the Pierluisi Administration and the Financial Oversight and Management Board (the "FOMB") have proposed new economic incentives and the implementation of structural reforms, respectively, both efforts fall well short of crafting an economic strategy for Puerto Rico.

These efforts are certainly significant and seek to address important issues, but are inadequate on the whole, because both the government of Puerto Rico and the FOMB are looking at only some pieces of the puzzle, and *no one is looking at the entire puzzle.* Here we would do well to follow the advice of Michael Spence when he said "we shouldn't slip into the mistake of equating something useful, like financial-sector development or anything else, with a sufficient condition for growth."[5]

Similarly, we shouldn't make the mistake of equating a set of quite disparate and perhaps marginally effective structural reforms with an economic strategy. Simply stated, the structural reforms favored by the FOMB and set forth in the Fiscal Plan are second-order issues and will not generate the long-term economic growth Puerto Rico requires, both for increasing the living the standards of its people and to pay off its restructured debt, *unless* they are embedded or framed within a larger economic strategy or vision.

There is a High Level of Uncertainty and Many Risks but They are Manageable

While the trends mentioned above are generally positive, the current economic environment is also characterized by significant uncertainty and downside risks.

First, inflation is currently at levels not seen since the late 1970s and early 1980s. Price increases are driven, in part, by strong consumer demand in the post-pandemic period; supply-chain disruptions; logistical bottlenecks; China's zero-COVID policy which has shut down significant manufacturing capacity in that country; and commodity shortages and higher oil and gas prices due to the invasion of Ukraine by Russia.

The "good news" here is that demand should start to weaken as households spend any excess disposable income they have available from the COVID-19 related government programs and the supply side logjams should resolve to the extent that demand decreases and firms review their inventory and supply-chain operations. The war in Ukraine, though, remains a wild card as there appears to be no clear off-ramp for the parties to negotiate a settlement at this time.

Second, there is a significant risk of a recession within the next 18 months. While there is not much that monetary policy can do with respect to commodity prices or supply chain disruptions, the Federal Reserve really has no other option but to tighten monetary policy because the current rate of price inflation is politically untenable. As interest rates increase, we would expect demand for credit to decrease as car loans, mortgages, and carrying credit card balances all become more expensive. In addition, some new investments in machinery, equipment, and construction may become financially unviable when taking into account the higher cost of capital.

The Puerto Rican economy will certainly be negatively affected by higher interest rates. However, the negative impact of tightening monetary policy could be partially offset by the ramping up of federal spending for reconstruction projects in Puerto Rico. To be clear, we are not saying that Puerto Rico's economy will emerge unscathed if there is a recession in the U.S. or world economy in the coming 18 months. Nor are we saying that federal reconstruction spending will completely offset the effects of a

[5] *Commission on Growth and Development*, p. 33.

broad economic slowdown or that such spending is a sustainable long-term economic growth strategy. Our point is that to the extent federal reconstruction spending is executed in a timely fashion and in accordance with Congressional mandates that require providing a preferential option to local contractors in such spending, then Puerto Rico would have a cushion to partially offset any economic contraction in the short-term.

Finally, there are risks endogenous to the Puerto Rican economy, mostly on the fiscal side. Among those risks, we find a potential shortfall in federal Medicaid funding for Puerto Rico; the end of the federal policy allowing U.S. manufacturing companies in Puerto Rico to take a credit at the federal level for excise taxes paid pursuant to Act 154; and the slow roll-out of reconstruction funds. To the extent any of those risks materialize, then the island's fiscal situation could be destabilized.

Conclusion

In sum, our net assessment of the current situation is that, notwithstanding the existence of certain substantial risks, current conditions are auspicious for undertaking a broad-based economic development effort in Puerto Rico. Several positive trends are clearly converging in 2022 to create the opportunity of a generation for Puerto Rico to turn around its economy and start a process that would generate long-term economic growth and development.

However, that will happen only if we design an economic strategy that allows Puerto Rico to take advantage of this opportunity. Economic growth will not happen on its own. We need to take concrete, affirmative actions to make the most of the current situation.

To that end, CNE will be convening a broad group of stakeholders from academia, government, the private sector, and NGOs over the next few weeks to jumpstart a process that, hopefully, will generate the long-term economic growth and development we so desperately need. Stay tuned.

Puerto Rico's Think Tank

The Center for a New Economy (CNE) is Puerto Rico's first and foremost policy think tank, an independent, nonpartisan group that advocates for the development of a new economy for Puerto Rico. For more than 20 years, CNE has championed the cause of a more productive and stable Puerto Rico through its offices in San Juan, Puerto Rico, Washington, D.C., and Madrid, Spain. We seek to inform current policy debates and find solutions to today's most pressing and complex economic development problems by rigorously analyzing hard data and producing robust empirical research. CNE is organized as a 501(c)(3) nonprofit that does not solicit or accept government funding. It relies solely on funding by individuals, private institutions, and philanthropic organizations.