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To: Bipartisan Congressional Task Force on Economic Growth in Puerto Rico
United States Congress

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Economic Reform for Puerto Rico

Among the most fundamental of Puerto Rico's many economic problems is that it is "stuck in a monetary union with the United States" (as Desmond Lachman of the American Enterprise Institute has correctly characterized it). In this situation of being forced to use the U.S. dollar, the Puerto Rican economy is simply uncompetitive, but the use of exchange rate policies to improve competitiveness or cushion budget tightening's impact on domestic demand is precluded.

This is the same massive problem that Greece had and still has from being stuck in the monetary union of the euro. With any external currency adjustment forbidden, all the adjustment falls on internal reduction of costs. As Greece demonstrates, this continues to be very difficult and daunting, both economically and politically. This is true even after its creditors have taken huge haircuts. Puerto Rico's creditors will take big haircuts, too, but that won't solve its ongoing lack of competitiveness or the impact of the required budget tightening.

The European Union leadership feared that Greece's exit from the euro might set off the unraveling of their whole common currency project. In contrast, there is not the slightest possibility that whatever happens in Puerto Rico will affect the stability or dominant role of the U.S. dollar. Even in the Greek case, European policy makers did seriously consider a back-up plan for a paper currency to be issued by Greek banks which would certainly have depreciated against the euro.

Dr. Lachman argues that Puerto Rico "needs the boldest of economic programs." My suggestion is that the Task Force should consider "thinking about the unthinkable," and include in its work a study of the "outside the box" possibility of currency reform for Puerto Rico. This would involve creating a new Puerto Rican currency which would be considerably devalued with respect to the U.S. dollar, thus allowing external, not only wrenching internal, adjustment of Puerto Rico's uncompetitive cost structures. There is plenty of precedent for such currency reform, although this case is certainly complicated by the status of Puerto Rico as a territory. Could a U.S. territory have its own currency? Why not?

In such a study, one would have to consider the balance sheets of all the Puerto Rican depositories and how they would be affected in detail by denomination in a new currency, how various contracts would be affected, how exchange between the new currency and other currencies would be introduced, whether a new Puerto Rican central bank would be established, and many other problems of transition and functioning, of course. Existing Puerto Rican government debt in U.S. dollars would not be subject to redenomination, but this debt, a growing amount of it in default, is going to have to be significantly written down in any case.

Does the current monetary union pose deep problems for Puerto Rico? Undoubtedly. Would it make sense to release Puerto Rico from being stuck in a monetary union in which it cannot compete? Possibly. Would this be better than the Greek model of forcing internal cost deflation while providing big external subsidies? Probably. It does seem sensible to take a serious look at the possibility of currency reform.

Thank you for the chance to comment on this critical issue. It would be a pleasure to provide any further information which might be helpful.

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