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The Political Economy of Sovereign Risk

Remarks by

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Thank you. It is my pleasure to be here today at this Global Treasury Summit. Being in this historic and beautiful location is particularly nice, but frankly, being anywhere but Washington D.C. is a real pleasure. Still, even 800 miles away, the specter of Washington hangs over me. As you may know, Chairman Greenspan is scheduled to give his Humphrey-Hawkins testimony before Congress this week. That testimony requires that we adhere to a blackout period in the week leading up to the testimony. So, I will have to avoid discussing the current state of the economy or monetary policy in today's presentation and during the questions and answers that follow.

Instead, the focus of my talk, The Political Economy of Sovereign Risk, will be on the changed nature of risk in lending to sovereign governments. The market perception of sovereign risk -- the possibility of either total or partial default on government debt -- has changed dramatically in recent years as has the market's means of pricing such risk. The result has been a change in the incentives faced by politicians. Fundamentally, I think that we are coming to realize that default risk is not simply a measure of political instability. Even well established governments carry some potential risk. The development of public choice theory suggests some courses of action which, while seemingly irrational in the short run, result from the long term incentives faced by political or economic decision making institutions. To illustrate this point, and how it applies to decisions we face today, bear with me as I engage in some historic and futuristic speculation.

Let's start with some speculation about a famous historical default -- the Russian Revolution. It has been in the news recently since the first underwriting of Russian

government bonds in 80 years was announced just last week. If one really had a firm conviction in the validity of public choice theory, it would be easy to conclude that revolutionary ideology might be just a convenient rationalization for inevitable but inconvenient political decisions. It is not at all surprising given the ideology involved that Lenin chose not to honor the Czar's bonds. The price of that decision was that Russia was unable to borrow in world capital markets for eighty years. But, it is certainly not impossible that someone as calculating as Lenin probably knew the consequences but made a rational calculation of the costs and benefits. On the one hand, being freed of the previous government's international debt service burdens allowed a much greater degree of fiscal freedom at a time when the cost of procuring resources for the government was extraordinarily high. In plain English, given the choices of continuing the Revolution, feeding the population, and paying off foreign bond holders, Lenin placed his priorities in exactly that order.

But if even Lenin made a rational calculation about default, and the same analogy could be applied to a whole variety of coups d'etat and revolutions, can we conclude that sovereign risk is really just a rational calculation made by any political process? Recall that Alexander Hamilton's decision for the new federal government to assume, rather than repudiate, the debts that the states had run up during the revolutionary war was considered very controversial at the time. If war is just diplomacy by other means as Clausewitz argued, is default on the nation's debt just a part of a continuum of options for public finance? If the answer is yes, then we Americans as well as residents of other prosperous democracies are probably in a lot more trouble than we now think.

Democracies place an unfortunate bias toward short term rewards. For the self-interested career politician the pay back period on a public policy decision extends only until the next election. We must hope that there is some institutional structure or wisdom embodied in the electorate which supersedes the short term incentives which periodic elections place on our decision makers. It does not take much to slide from the modern politician's motto of "Not during my term" to Louis XV's more memorable "Après moi le déluge".

Fortunately, the opening of nations to the world economy and the consequent development of international financial markets have helped impose a discipline which even the most shortsighted politician cannot ignore. Nations which are actively engaged in world trade have every incentive not to default on their obligations to foreigners. The resulting cutoff of access to international credit and its consequences for the capacity to trade are severe. Even when the political economy of default seemed attractive in Latin America during the 1970s and 1980s, for example, some kind of "work out" of the foreign debt represented a preferable option.

The capacity to partially default by inflation on the real burden of domestic debt, that is debt denominated in a country's own currency, has also become a less attractive option since the 1970s. The lesson of that decade is that those nations, including the United States, which chose to inflate paid a price in terms of higher real interest rates on their obligations. Today bond and currency markets are very quick to react to even the slightest hint of inflationary policies.

As a result of the prevailing bias against inflationary pressures, we have even

witnessed a shift in the focus of the market's policing of policies from the monetary sphere to the fiscal sphere. Today, the domestic debt of many nations is widely held internationally. Thus, domestic fiscal policy developments can put pressure in foreign currency and bond markets. In the past two years Canada, Sweden, and Italy have each been forced by international market pressures to begin a drastic restructuring of their fiscal policies in order to preserve long run credibility. All three nations had reached long run fiscal positions that the markets judged as unsustainable.

In each case the existing debt of the country either equalled or exceeded its GDP. In addition, each had long term social commitments in terms of unfunded health and retirement benefits which amounted to two or more times GDP in present value terms. Markets judged that the prospective tax burdens necessary to sustain the resulting debt service were so great that the possibility existed that the country might find some form of default a potentially attractive alternative. Drastic spending reductions were undertaken in order to preserve credibility. In Canada, for example, the Liberal Government cut spending by 3.6 percent of GDP over three years. In Sweden, the Social Democratic government has scheduled cuts of some seven percent of GDP over three years. The good news in both cases is that the rational calculations of the political decisionmakers were in favor of reform and painful cutbacks rather than in favor of default.

In this country we have also had a recent unfortunate flirtation with the notion of default. Interestingly, the bond markets rallied during the period in which the talk of default was most virulent. I think that bad as an interruption in the debt payments on United States obligations might be, the markets do realize the difference between the fundamental and

immediate severity of the problems of Canada and Sweden, and our problems in the United States. Still, one cannot and should not be sanguine for such developments in the budget process cannot be considered healthy for our political economy. These developments have reinforced the notion that default actually is just a part of the continuum of public finance options.

Risks of Postponing Entitlement Reform

But my concern about recent developments in our budget process do not stop there. More alarming to me is the apparent inability of the process to achieve much needed reform of our entitlement programs. It suggests the possibility that our political process is more short sighted than is optimal from the point of view of sound public finance. The fact that our problems are not at crisis levels gives us the luxury of being able to make changes in a non-draconian fashion. However, postponement of needed reforms merely increases the magnitude of changes that will ultimately have to be made and the disruptions that they will cause. I fully appreciate the political difficulties involved. I have learned in 15 years of working on and off in Washington that the laws of politics regularly supersede the laws of economics. But in the end, the problems with entitlement spending come down to the more fundamental laws of arithmetic.

For the sake of illustration, take as a baseline for considering the magnitude of our entitlement problems President Clinton's Fiscal 1997 budget proposal. That proposal produces a balanced budget in FY2002 using CBO budget scoring, the bipartisan sine quo non of the budget negotiations. It also contains \$183 billion of cuts in Medicare and Medicaid over seven years. Nonetheless, the cost of those programs will rise from \$271

billion in the current fiscal year to \$417 billion in 2002. That is an increase from about one fifth of non-interest federal spending to about a quarter of such spending. In order to make room for this increased spending, all other spending, including Social Security falls to its smallest share of GDP since the Korean War.

Yet, impressive though these cuts may seem, the laws of arithmetic show that they simply will not be enough to be sustainable over the long term. Medicare and Medicaid spending are scheduled to rise at an annual rate of just under 7.5 percent per year. Over the same period, the President's Budget has nominal GDP rising at just 5.1 percent per year. As a result, Medicare and Medicaid spending will rise from 3.6 percent of GDP in 1996 to 4.2 percent in 2002. Let's assume that whatever is necessary is done after 2002 to keep these two programs growing at the same 7.5 percent rate. By 2026, when this year's 30 year bonds come due, Medicare and Medicaid will be 7.1 percent of GDP. By 2074, which roughly represents the life expectancy of the children born this year, the same inexorable rise in Medicare and Medicaid will push these programs to over 20 percent of GDP. Left unchecked the laws of mathematics produce the physically impossible result of these programs exceeding 100 percent of GDP in the year 2146. The inexorable laws of arithmetic require that NO program can exceed the growth rate of GDP indefinitely. In this regard I should note that even the Republican proposals for Medicare and Medicaid will eventually run up against this mathematical day of reckoning, although their more drastic cuts postpone it somewhat.

Of course, it may seem excessively harsh to expect today's politicians to worry about the mathematical impossibilities of 2145 or even the economic limits of the second quarter of

the next century. Surely there must be some political standard between "Not in my term" and the inevitable deluge sometime in the next century. The problem with that reasoning is that our nation's demographics are the most favorable they will ever be for entitlement reform in the next few years. The people turning 65 during the next decade were born during the baby-bust years of the Great Depression. There were actually 11 percent fewer people born during the last 5 years of the 1930s as during the last 5 years of the 1920s. So, the pressures on entitlements will be less in the next few years than they were in the recent past. On the other hand, those pressures are going to resume early in the next century. There were nearly twice as many people born during the late 1950s as during the late 1930s. The leading edge of the baby boom is only 15 years from retirement.

During this relatively favorable period of the aging of Depression babies, the number of people aged 65 and over will only grow by 0.7 percent per year during the next 10 years. It would seem to be a time to begin to sharply shrink the growth rate in this entitlement. But, a 7.5 percent growth in these programs still allows per capita spending (using the over-65 population as the base) to grow at 6.7 percent per year during this period even with the cuts in the Administration budget. If one takes the Administration's proposal which projects inflation at 2.8 percent over this period and assumes that medical costs will continue their 25 year trend of growing at 2.4 percent more than inflation, there is still an ample 1.4 percent annual increase in real per capita expenditures in the Administration budget.

But, between 2005 and 2015 the population over 65 will rise 2.2 percent per year. That rate of population growth will increase to 3 percent per year between 2015 and 2025. Maintaining a 7.5 percent rate of growth in Medicare and Medicaid spending is one thing

during the next decade, but that rate can only be maintained with actual program cuts when the eligible population increases four times as fast. The 1.4 percent growth in real per capita benefits of the next decade falls to a flat level of benefits between 2005 and 2015 and a level of real benefit decline in the following decade.

Recall that the context of today's speech is the long run viability of fiscal policy in the context of a country's political and economic structure. Let us engage in a little futuristic political economy. Let us consider how our political process will be likely to react to a given set of fiscal pressures in 2026, when today's 30 year bonds come due. Let us assume that we are able to get to a balanced budget by 2002 as both the President and the Congress propose. Let us also assume that we will be able to hold the rate of health care program increases to that contained in the President's budget.

Nonetheless, the share of GDP devoted to Medicare and Medicaid will rise from today's 3.6 percent to 7.1 percent in 2026. Transferring resources from the rest of the budget will be nearly impossible as non-entitlement spending will have been drastically reduced in order to achieve budget balance by 2002. For example, even the complete elimination of our national defenses -- taking defense spending to zero -- will be insufficient to cover the rise in these two health care programs share of GNP between 2002 and 2026.

The tax option is also unattractive. To continue to finance the Medicare portion using the payroll tax, we would have to see an 97 percent increase in the payroll tax rate from today's 2.9 percent to 5.7 percent. Medicaid is financed out of general tax revenues. Today it consumes the equivalent of one sixth of personal income tax receipts. That fraction would have to rise to a third of all income tax receipts, which could be achieved by adding a 15

percent income tax surcharge on top of today's tax schedule.

If you think that this will make taxpayers unhappy, consider the beneficiaries. They will have just been through a decade of declines in their real per capita level of benefits. Seven million more beneficiaries will be arriving in the next 5 years and further declines in real benefits will be necessary just to hold program growth to 7.5 percent. Furthermore, these beneficiaries will comprise 24 percent of eligible voters up from 17 percent today.

We should also consider what will be happening to the retirement component of our entitlement system. The Social Security Actuaries say that the retirement portion of the entitlement system will be nearly broke having gone through not only all of its income but a surplus equal to three years of reserves in just 15 years. The annual retirement deficit will be nearing 1.5 percent of GDP. This will also have to be financed either by some combination of benefit cuts and tax increases amounting to 30 percent of payroll contributions, adding a further four percentage points to the worker's tax rate. The combined effect of these tax increases will mean that median income workers will face federal marginal tax rates of 39 percent while middle income taxpayers, including most two-earner families, will face 54 percent tax rates. One can easily have serious questions about whether this is either politically or economically sustainable.

Thus, even if we balance the budget by 2002, the first two decades of the 21st century will witness significant deterioration in our fiscal situation unless we also get control of our entitlement system. Failure to do so will mean that sometime in the first quarter of the 21st century the United States may well find itself in the same type of fiscal dilemma which recently confronted Italy, Canada, and Sweden. What choices will that Congress make?

A strong case can be made in both political and economic terms that entitlement reform should not be postponed until we find ourselves in crisis. First, the demographics suggest that the political process is likely to become even more polarized over these entitlement issues as time passes. I have already noted that the price of maintaining increases in real per capita health care entitlement spending for persons over 65 today means that real benefits will have to decrease for those who are now under age 50. Thus, postponing a decision will mean having to make choices in a fiscal environment of diminishing opportunities. Also, the number of voters aged 65 and over will rise by some 16 million during the 2020s while the number of voters under age 65 will actually decline slightly. The chances that the political process will "freeze" rather than face offending either beneficiaries or taxpayers is therefore likely to be higher than it is today.

Making decisions today which cause gradual adjustments in the prospective growth of benefits also allows potentially affected individuals time to plan and to adjust. In 2026 more than half of the people who are now in their early 50s will still be alive and in their early 80s. According to the Census Bureau, a startling 21 percent of people who are aged 60 to 65 today will be 90-somethings that same year. These individuals are presumably the most politically sensitive to prospective cuts in benefits. Yet, the choice they face is between gradual adjustment beginning today or the chance of a wrenching adjustment under crisis conditions when they are much older and less able to adjust than they are today.

Underlying all of these political choices is one of intergenerational equity. Former CEA Chairman Michael Boskin has estimated that the average retiree in 1980 received a net wealth transfer from the Social Security system of \$63,000. By contrast, a worker retiring in

2025 will suffer a net wealth loss of \$48,000. That is solely from the pension side of our entitlement process. Delaying adjustments in the health care entitlement programs to more realistic and sustainable rates of growth simply means that this vast intergenerational transfer becomes even larger. The embittering effect this has on our political process is already palpable and is likely to get worse over time. A poll conducted in 1994 showed that more young people believed that UFOs existed than believed that Social Security would be there for their retirement. Such disillusionment and cynicism about the commitment of our political process is not helpful and undermines political support for other government commitments -- including to bond holders.

If there is one mitigating factor in this long run fiscal mess, it is that the prospective retirement and health care liabilities of the United States are less unsound than those of other major nations. For example, if we focus on just the retirement portion of our entitlements, we have an unfunded pension liability in our Social Security system equal to 43 percent of GDP in present value terms. According to the OECD, the Germans have an unfunded liability present value equal to 160 percent of GDP, the Japanese have unfunded liabilities equal to twice their GDP in present value terms. In Canada, unfunded liabilities are 2.5 times GDP.

Furthermore, in spite of our problems in the U.S., we have at least designed the system so that future generations are not going to be getting an unsustainably good deal. But, at least in the retirement area, they are instead going to see some of their contributions pay off a fraction of the accumulated obligations of the system. According to the OECD, prospective contributions to our retirement system exceed incremental future claims in the

U.S. by about half of GDP. In Germany, by contrast, future contributions just about equal, in present value terms, incremental future benefits. There is no excess of future contributions over future incremental pension rights to cover the completely unfunded accrued rights earned by workers to date. Even worse, in Japan future contributions will not even cover still to be earned pension rights, let alone already accrued pension rights -- with a shortfall of 56 percent of GDP of future rights over future payments.

From the perspective of world wide political economy, and the stability of the world's fiscal systems, this is a very serious problem. In the United States, we have legislated a cut off so that the younger generation is not going to get a windfall out of social security, but are going to have to be net contributors. In spite of this wealth transfer from the young to the old, we still have a system that is \$2.5 trillion short. But, Germany has yet to get this message out to its young workers and the Japanese are still promising windfall benefits to the young. Unless voters in these countries are radically different than they are in America, the political problems Germany and Japan will have in reining in these costs will make ours seem relatively mild .

In spite of these concerns, I have confidence in our system's ability to handle such problems. There abides in the electorate a common sense and willingness to confront long term problems. Still, it is important to recognize that most public finance decisions are ultimately made by some process of weighing the costs and benefits in political terms. Whatever our concerns about the unthinkability of default are today, that decision will not be made by today's decision makers, but by those who confront the constraints of a political economy 30 years hence. The best that we can do to pass along our wisdom is to provide

them with as benign a decision making environment as possible. Neglecting to make the tough decisions today in the hopes that our successors will do the right thing in an even tougher fiscal environment is imprudent, to say the least.