Sovereign Debt and the Myth of the Golden Age[1]

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Distinguished Guests; Ladies and Gentlemen:

It is a great honor and privilege to have been asked to address you today on the occasion of the 74th anniversary of the Central Bank of Sri Lanka.

I wish, ladies and gentlemen, to devote my remarks this afternoon to a single subject — sin.

But sin of a rather special kind — intergenerational sin. That is, the wrongs that one generation of human beings can inflict on its posterity.

Intergenerational sin comes in several varieties. The one that preoccupies the public discourse at the moment is the crime of environmental degradation. An incumbent generation, by its deliberate policies and actions, can so despoil a territory as to cause lasting — the scientific community now warns *ever*lasting — injury to the inhabitants who will follow them. This has been happening in our lifetime on a planetary scale.

What makes intergenerational sin so invidious is that its victims — future generations — are utterly powerless to stop it. Indeed, they cannot even protest their injuries for the very good reason that their voices are not yet in existence. And, when those people do come into their inheritance of the planet, they will be unable to punish or scold the perpetrators of an intergenerational sin; the malefactors will by then have gone the way of all flesh. The victims of intergenerational sins are therefore wholly dependent

[1] Remarks delivered in Colombo, Sri Lanka, on the occasion of the 74th anniversary of the establishment of the Central Bank of Sri Lanka

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upon our, the incumbent generation's, willingness to resist the temptation to smooth our own passage in life at their expense.

There is nothing novel in this observation.

In 1789, Thomas Jefferson, then American ambassador to France, wrote this sentence in a letter to his friend James Madison:

> "*[T]he earth belongs in usufruct to the living:… the dead have neither powers nor rights over it."*[3]

Jefferson was referencing the Roman law concept of a *usufruct;* that is, the right to enjoy property owned by another and to draw from that property whatever benefits it may produce during the term of the usufruct. But there was a catch: the person enjoying the property could not sell it, they could not encumber it, and *they could not despoil it*.

Jefferson was therefore expressing the belief that at any particular time the incumbent population is entitled to use and enjoy whatever property and territory they may possess, but only on the condition that they pass it on to their successors free from any lasting encumbrances or degradations. Jefferson even call this proposition "self evident", a phrase with which he had had some success earlier in his career.

In that same letter, Jefferson even speculated that "…by the law of nature, one generation is to another as one independent nation to another." In other words, our ancestors stand in relation to us, as we stand in relation to our own progeny, both as benefactors and as potential rivals. We have it within our power to inflict injuries — perhaps irreversible injuries — on our descendants. Through our ignorance, inadvertence or greed, we may commit an intergenerational sin.

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[33] *The Republic of Letters*, vol. 1, 631-36 (James Morton Smith, ed. 1995)

Justifiable Debts; Profligate Debts

I wish this afternoon, however, to focus on another activity that provides a potent temptation to intergenerational sin — sovereign debt.

When speaking about sovereign debt, it is important at the outset to distinguish between justifiable sovereign borrowings and what I shall call "profligate" sovereign debts. In the former category I would place government debts incurred for purposes such as infrastructure improvements, the conduct of defensive wars, the acquisition of useful or essential property, as well as borrowings to finance a government's response to a natural disaster, pandemic or economic crisis.

I reserve the term "profligate debts" for governmental borrowings whose proceeds do not, directly or indirectly, provide any benefit to succeeding generations. I would include in the category of profligate debts, for example, money borrowed to finance a government's current expenditures on subsidies, the costs of a bloated public sector work force, liberal donatives disbursed before elections, overly generous pensions and so forth. Profligate debts are in most instances just the politically expedient alternative to taxation. Politicians instinctively dislike taxing their constituents, just as their constituents can be expected to dislike paying taxes.

If taxation is off the table to pay for current expenses, however, there are only two potential solutions. Either reduce the government's current expenditures to match its income (also a politically unpopular idea) or else borrow to finance those expenditures. This second alternative does not *avoid* taxation, but it has the inestimable political advantage of taxing people that have not yet been born or are at least not yet old enough to vote.

I recall that I was asked in the spring of 2003 to give a talk to a group of students on the subject of Odious Sovereign Debt. That morning I opened my copy of the New York Times. On the first page, above the crease, was an article reporting that President George W. Bush had gone on television the previous evening to say that he was asking the U.S. Congress to approve $17 billion of funding for the war in Iraq to oust Saddam Hussein.

The article ended by noting that many of the people who would be obliged to repay that $17 billion did not hear the President's speech — their parents had put them to bed.

In these remarks I shall argue that the practice of an incumbent generation's incurring enormous profligate debts and bequeathing those liabilities to its posterity can amount to an intergenerational sin.

The Legal Context

The legal doctrine relating to inherited sovereign debts is particularly strict. Public international law requires governments to "succeed to" — that is, to assume and accept — the liabilities incurred by previous governments in that country. This obligation applies even if the current administration believes that the debts incurred by its predecessors were imprudent or that the proceeds of those borrowings were spent foolishly, even corruptly.

Moreover, international law requires a government to honor the debts bequeathed by previous political regimes in the country regardless of how different in political philosophy the current administration may be from its predecessors. So, for example, when the Bolsheviks took over from the Tsar of Russia in 1917, international law required them to assume the debts incurred by the Tsar and his predecessors. Napoleon had to pay the debts of the Bourbon monarchy that the French revolution of 1789 had (temporarily) removed. When Mr. Biden replaced Mr. Trump in the White House in 2021, Mr. Biden did not have the luxury of disavowing the debts incurred by the Trump administration, however foolish Mr. Biden may have felt some of those borrowings to be; just as the Trump administration was in its turn required to honor the debts incurred by President Obama.

In short, when one generation incurs sovereign debts that it cannot or will not repay, and those debts cascade down to succeeding generations, the inheritors of the debts will have no legal basis on which to decline that obnoxious legacy.

A Cautionary Tale — the United States of America

Let us take as an example the world's largest sovereign debtor — the United States of America. Total U.S. Government debt now stands at about $35 trillion (trillion with a "t"). What is astonishing about that figure is not just its eye-watering size, but the speed with which the debt has accumulated. Just twenty-five years ago, the national debt was $6 trillion. While GDP grew by a factor of 2.8 over this period, debt grew by a factor of nearly 6. As a consequence, the total debt-to-GDP ratio of the United States went from about 60% to 125% in a quarter century. The non-partisan Congressional Budget Office forecasts that public debt will continue to grow and will surpass 170% of GDP in the next 30 years.

In days of yore, many Americans would have found this behavior to be reprehensible. For most of the nearly 250 year history of the United States, public debts were incurred with reluctance and suspicion. And when military or economic crises required large government borrowing (as happened during the Civil War of 1861-65, the two World Wars of the 20th century and the Great Depression of the 1930s), the resulting high debt ratios were typically reduced either through prudent fiscal policy and/or inflation as soon as practicable after the crisis ended. This aversion to permanently high levels of public debt was thought to be a moral imperative; the duty imposed on each generation not to shackle its posterity with massive inherited debts. This implicit belief in the virtue of fiscal rectitude began to wane in the United States only in the 1960s and 1970s during the Vietnam War. It would be regarded in 2024 as utterly quaint.

Both major political parties in the United States share the responsibility for this situation. Neither party has demonstrated any enthusiasm for fiscal restraint. As a result, the U.S. budget deficit (the difference between what the U.S. Government spends and what it takes in through taxes and other revenue) this year, 2024, is expected to exceed $1.9 trillion, more than 7% of GDP. Looked at in another way, this year's deficit equals the *entire* nominal GDP of the United States in 1975.

To set this in context, the entire Gross Domestic Product of the Russian Federation stands at about $2.25 trillion. The United States is thus running a budget <u>deficit</u> this year nearly as large as Russia's entire annual GDP.

The administration that will take office in the United States next January will not just have to borrow to cover this year's $1.9 trillion deficit. It will also have to borrow to refinance the country's outstanding $35 trillion stock of debt.

This has profound effects on the rest of the world. When the world's largest sovereign debtor is sucking up that much capital, there is less liquidity in the system that could have been invested in private sector projects or in the economies of other countries. Moreover, to attract credit from international investors, those countries will inevitably be required to pay higher interest rates, tightening their own debt dynamics.

There are apologists. Several prominent economists subscribe to a "stay calm and carry on" philosophy about the U.S. debt. Some argue that stabilizing the U.S. government debt would require only a modest degree of fiscal restraint — if only U.S. politicians would permit it.[4] Other commentators take comfort in the belief that once interest payments on federal debt begin to crowd out other budget priorities, American politicians will be forced into some form of fiscal consolidation — either spending reforms or higher taxes or, most likely, both.[5]

My view? The political flesh is notoriously weak. Once the American moral repugnance at bequeathing massive profligate debts to our posterity was diluted — something that occurred in my adult lifetime — the United States quickly became addicted to running chronic budget deficits. On the current trajectory, even paying the interest on the accumulated stock of public debt will soon begin to crowd out other budgetary priorities. Actually *reducing* the size of the U.S. debt ratio, other than by inflation, would require an almost unimaginable feat of fiscal sobriety.

If sobriety does come to the United States, it will not, I think, be the gift of wisdom, discipline, statesmanship or foresight. It will in all likelihood follow a calamity of some form.

The Victims' Options

Most people would say that the principal iniquity in profligate sovereign debt is that it forces our children and grandchildren to repay obligations incurred by us, their ancestors. Stated bluntly, the intergenerational sin consists in a collective decision to compel our progeny to curtail their own standard of living so that we may enhance *our* standard of living.

[4] See Paul Krugman, "*Why You Should't Obsess About the National Debt*", NYT, June 7, 2024 ("Given the political will, we could resolve debt concerns quite easily.")
[5] See Peder Beck-Friis, "*There is no need to sound alarm over government debt*", Fin. Times, July 18, 2024.

When we fetter our posterity to massive inherited debts, we effectively give them four options:

(i) If they are lucky, succeeding generations will simply pass on those burdens to *their* posterity, generation to generation.[6]

(ii) Should they be unable to pass the debts they inherit from us on to their own descendants, our posterity may have to tax themselves to pay those obligations.

(iii) And, of course, there will always be the temptation to inflate the debts away.

(iv) In the last extremity, our posterity may have no alternative but to default on the unsustainable debts that we have bequeathed to them and attempt to restructure those liabilities.

Let us look at each of these options in turn.

<u>Reprise the sin</u>. The first option — simply repeating the practice of passing inherited debt from one generation to the next — is probably the most benign outcome that a future generation can hope for. Under this theory, we aren't really asking our children to *pay* our debts, we are just asking them to pay the interest accruing on those obligations during their lifetimes and then pass the corpus of the debts on to *their* children.

The obvious flaw in this theory is that succeeding generations will not be able to push the mountain of debts further down the road unless their

[6] The 18th century Scottish historian and philosopher David Hume remarked on this pattern more than 270 years ago:

> [O]ur modern expedient…is to mortgage the public revenues, and to trust that posterity will pay off the incumbrances contracted by their ancestors: and they, having before their eyes so good an example of their wise friends, their wise fathers, have the same prudent reliance on *their* posterity; who, at last, from necessity more than choice, are obliged to place the same confidence in a new posterity.

David Hume, *Of Public Credit* (1752).

lenders are prepared to refinance those obligations as they mature. This solution to the problem of inherited debts implicitly assumes that subsequent generations will <u>always</u> be able to refinance those obligations. In this assumption, ladies and gentlemen, lies the single most important source of fragility in the sovereign financial system.

The sober truth is that in this century, no sovereign, whether a developed or developing country, borrows money in the expectation that it will ever pay the money back <u>IF</u> by "pay back" you mean "apply current resources to settle the obligation when it falls due".

Sovereign debtors in this century borrow money in the sure and certain hope that when the debt falls due, they will go back into the market and borrow from someone else to pay off that maturing obligation — in the jargon, they will "refinance" it. And when the new debt itself matures according to its terms, the sovereign will repeat the process, again and again, theoretically in perpetuity. Stated another way, the monetary reserves of a typical sovereign sovereign will be sufficient to continue normal debt servicing for a matter only of a few weeks or months if all sources of new credit dry up. Refinancing maturing debts is thus not a choice; it is a hideous addiction.

The problem is that this assumption of perpetual refinancing is just that, an assumption. Commercial lenders can sometimes shut a sovereign debtor off from new credit for a number of reasons, not all of them related to the sovereign itself. Markets may turn arthritic as a result of a "Lehman Moment," an unexpected shift in monetary policy in creditor countries, an alarming geopolitical development or even something as simple as another country falling into debt distress and reminding commercial creditors of the inherent risks of lending to all sovereigns.

Economists call this phenomenon of an abrupt loss of market access a "sudden stop."

Greece experienced a sudden stop in early 2010. Sri Lanka's time came in the spring of 2022.

If refinancing inherited debts becomes impossible or unsustainably expensive, our posterity will be forced to fall back on one of the other three options.

Tax and pay. The good citizens of a future generation could always start taxing themselves in order to pay off the debts they have inherited from us. But it is fatuous to believe they will do so. In many countries, including the United States, it has become politically impossible to increase taxes sufficiently to avoid running current government deficits. It is really plausible that our posterity will gladly tax themselves to pay *inherited* debts because, we, in our time, found it inconvenient to tax ourselves?

Which will narrow the alternatives down to the last two options — inflation or default. Both alternatives are grisly.

Inflation. Without doubt, inflation can be a very efficient method of reducing the value of a sovereign debt. Borrow $100 today and pay it back in five years in a debased currency worth at that time perhaps $70. But there are three huge obstacles to relying on inflation as the tool to address a sovereign debt crisis. First, a government can only inflate away debts denominated in its own currency. Borrow in a foreign currency, like U.S. dollars or Euros, and you must hope that the monetary authorities in those jurisdictions will be prepared to countenance chronic inflation.

Second, in economic terms, inflation is just another form of taxation and a particularly regressive form of taxation at that. It hits the most economically vulnerable sectors of the society the hardest.

Third, as we have witnessed in many countries over the last two years, even mild inflation can carry a stark political price. Indeed there are some who believe that the relatively brief bout of inflation that the United

States has endured over the last 18 months may strongly influence the outcome of the U.S. presidential election this fall.

Default and restructuring. Unable or unwilling to inflate away their inherited debts, our posterity will be forced to consider the last option — default and restructuring. Like inflation, defaulting on sovereign debts has a superficial appeal. After all, what remedies do the creditors really have? Unlike a bankrupt corporate debtor, a sovereign's assets in its own country will not be subject to mandatory seizure by its lenders.

No one in this room, however, needs to be reminded of how deeply unpleasant a sovereign debt restructuring can be. Sovereign debt crises never come in isolation. They may be accompanied by an economic crisis, a currency crisis, a banking crisis, a social crisis and a political crisis. Even when a sovereign debt problem is addressed with discipline and courage — such as the discipline and courage shown by Sri Lanka over the last two and a half years — the effects can be devastating and long lasting.

Finally, do not assume that a modern sovereign debt restructuring will result in an outright cancellation of a significant portion of a country's debt. It probably won't. Recent sovereign debt workouts have been characterized mainly by extensions of the maturity of the affected debts, often coupled with some near term interest rate relief, rather than what are called "principal haircuts". Official sector creditors in particular show a deep aversion to *forgiving* any part of the principal of a sovereign borrower's debt. The result? A modern debt restructuring pushes the obligation to repay the debts further into the future. Such a restructuring does not avoid the intergenerational sin of bequeathing unsustainable debts to one's posterity; it compels the commission of that sin.

Devouring Fiscal Space; The Myth of the Golden Age

Forcing our posterity to select among these unpleasant options is one consequence of saddling them with profligate debts. But there is another — to my mind even more pernicious — consequence.

All countries will have the ability to borrow money on the public credit, *up to a point*. No sovereign, however, will have an *unlimited* capacity to borrow. That capacity will be constrained by the lenders' perception of the risks attending the extension of credit to the sovereign. The more acute those perceived risks, the higher the interest rate the lenders will demand for assuming the risks. And in the final stage the market will refuse altogether to extend any credit, regardless of the interest rate on offer.

The amount of money that a sovereign debtor could borrow before reaching the point where its lenders begin to demand a higher risk premium or shut off the flow of credit altogether is part of what economists call the country's "fiscal space". In this context I shall use the term "fiscal space" to refer to a sovereign's *unused* capacity to borrow.

My thesis is this — the intergenerational sin of saddling successor generations with colossal inherited debts has two consequences. First, it forces those involuntary legatees, if they cannot reprise the sin of passing the debts on to *their* posterity, either to pay, to inflate away, or to default and restructure those obligations. Second, the very existence of those inherited obligations will inevitably encroach upon the fiscal space of our posterity. In other words, it will constrain their ability to borrow money on acceptable terms during their own tenure on the planet.

Of these two consequences the second — the premature consumption of fiscal space — I view as the more grievous sin. For one thing, it tends to be imperceptible and largely incalculable. There is no arithmetic formula for determining a country's untapped borrowing capacity at any given time. That capacity will depend on the health of the country's economy, the perceived prudence of its fiscal and monetary policies, the market's general tolerance for risk, the internal and external political environment, and a host of other factors.

No sovereign debtor knows in advance the precise point at which its lenders will begin to insist on higher risk premia triggered by a perception that the country is approaching a state of over-indebtedness. It is even more difficult to make such a prediction about a country's debt carrying capacity twenty, thirty or forty years down the road. But while we may not be able to predict the precise point at which a country's borrowing capacity will reach the point of saturation, we know that such a point will eventually be reached if sovereign debt accumulates relentlessly.

There is also the question of remedy. Confronted with a mountain of inherited debts, our posterity will have the four options we discussed a moment ago. None of them are pleasant, but at least one should be effective. No such remedy, however, will easily restore a country's exhausted borrowing capacity. Indeed a cathartic debt restructuring will at least temporarily stain the country's credit reputation and thus further impair its ability to borrow on tolerable terms.

A sovereign's untapped borrowing capacity is a precious commodity. It will determine whether the country can respond with financial vigor to future exigencies. With adequate fiscal space, a sovereign can borrow to fight a war, recover from a natural disaster, cushion its citizens from the effect of a pandemic or stimulate an economy in the wake of a financial collapse. But in the absence of adequate fiscal space, the sovereign's response to any of those calamities may be, at best, feeble and, at worst, wholly unsatisfactory.

Which brings me at last to the title of this lecture. Many societies cherish a myth about their Golden Age. For the ancient Egyptians, the

Golden Age was what has been dubbed the "fabulous" 18th dynasty. For the ancient Greeks, it was mid-fifth century BC Athens. The ancient Romans found their Golden Age — at least according to Edward Gibbon — in the second century AD.[7] The zenith of British influence in world affairs fell in the century between the battle of Waterloo (1815) and the outbreak of the First World War (1914). For their part, Americans speak proudly of the Spirit of 1776.

In the realm of sovereign debt, we too cherish a myth about a Golden Age. But in our case, that Golden Age is not in the past, it is in the future. Judging by our willingness to devour the fiscal space that ought rightly to belong to our posterity, we seem to have convinced ourselves that our descendants will live in a time of universal benignity. We are behaving as though we believe their lives will be blessedly free from natural disasters, wars, financial panics, pandemics, economic depressions and all of the other misfortunes that have befallen our species over the last million years. In other words, we are acting as though we believe that our posterity will not *need* the fiscal space that we are now consuming prematurely.

But of course they will.

<u>A Parthian Shot</u>

I began these remarks by describing environmental degradation as an intergenerational sin that may, on its current trajectory, have existential consequences for our posterity. I would like to end by observing that these two intergenerational sins — despoiling the environment and bequeathing gargantuan debts to our posterity — are closely related.

When they occur simultaneously, as they are now, they transmit to the next generation a particularly noxious legacy. Our posterity, and I mean

[7] "In the second century of the Christian era, the empire of Rome comprehended the fairest part of the Earth, and the most civilized part of mankind." Edward Gibbon, *The History of the Decline and Fall of the Roman Empire*, vol. I (i).

our <u>immediate</u> posterity, is going to need all the fiscal space it can get in order to finance the projects that will reduce and ameliorate the effects of planetary climate change. What these people are about to discover, however, is that their fiscal space has been severely curtailed by the profligacy of their parents, grandparents and great-grandparents.

Why, that succeeding generation may ask itself, did our venerable ancestors choose to injure us in this way? Was it ignorance? Myopia? Excessive optimism? Lethargy?

The answer, of course, is that those venerable ancestors — that would be us — merely found it disagreeable to curb our own appetites during our tenure on the planet. We consumed the fiscal space of our descendants because (i) we could, and (ii) it was more pleasant than controlling our current expenditures or taxing ourselves to pay those expenses. Thus, the simple but discreditable explanation is that we are committing these intergenerational sins because we find it convenient to do so.

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