The Government Will Default on Its Debts

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The governments of every major nation are going to default on their debts. There are two relevant questions: (1) How? (2) When?

Establishments around the world all deny this. They have gained power and wealth by means of the expansion of government. They have justified their success by insisting that the government-business alliance is the only way to establish economic growth and economic security for the masses. This claim rests on a more fundamental claim, namely, that an unhampered free market is destructive of economic stability and will inevitably lead to economic depression.

The Establishments are universally Keynesian. John Maynard Keynes' book, The General Theory of Employment, Interest, and Money, was published in 1936. It defended in theory what all Western governments had been doing in practice for at least five years, namely, running huge deficits. Keynes became as close to an academic high priest as any modern scholar ever has. He was the apostle of national government debt. His ideas today are more influential than they were at his death in 1946. We live in the age of Keynes.

I can think of only one major Establishment figure who has broken with the Establishment on the question of the great default: Peter G. Peterson, who was the chairman of the Council on Foreign Relations until 2007. He now runs the Peter G. Peterson Foundation, which focuses on the looming bankruptcy of the U.S. government. More than any other person of influence, he has warned of the bankruptcy of the Medicare/Social Security programs and their equivalents in the West.

Peterson a decade ago said that he had spoken with the major leaders of the West about the impossibility of funding these social programs. They all told him the same thing: "I will not be around at that time." In short, kick the can.

VOTE NOW, PAY LATER

Politicians lie. Voters believe. This is the great symbiotic relationship of democratic politics.

For older Americans, a single mental image above all others illustrates this perpetual relationship. It is their memory of the annual Sunday cartoon in the cartoon strip, "Peanuts," which was the most widely read cartoon strip – and therefore the most widely read anything – in the United States for at least three decades. The annual cartoon featured two children: the ever-mendacious Lucy, whose hand supported an upright football on the ground, who encouraged the ever-trusting Charlie Brown to run at the ball and kick it. He always believed her. At the last moment, she would pull the ball away, and Charlie would fly into the air, then land on his back. What changed each year was her argument on why she would not pull the ball away, and her final remark to Charlie, as he lay flat on his back. She thought he was stupidly naïve. He was. She always took advantage of him. Her philosophy was clear: "Never give a sucker an even break."

This scene is repeated every other November in the United States, when voters go to the polls. "This time, it will be different," cry the Congressional candidates. Then, for the next two years, they pull the ball away.

The only thing to top this exercise in mendacity in the United States is the testimony to each house of Congress delivered by the Chairman of the Federal Reserve System. Not even the President's annual State of the Union address tops this performance.

The voters never learn. Congress never learns.

The coin of the political realm is the promise. Not money, not power: the promise. Politics sometimes looks like prostitution, with money at the center. This is an illusion. The voters do not come to Congress demanding money. They demand faithfulness. Congress is to the voters what a philanderer is to a mistress. He may shower her with presents, but the presents have meaning to her only because of the promise. "I plan to divorce my wife. It's just a matter of working out the details." She likes the presents, but she believes the promise: "You can trust me. We'll grow old together." She thinks the presents are forever.

He borrows the money to buy her the presents. When interest rates rise, she will find out just how reliable his promises have been.

This is the heart of modern democracy. Politicians promise undying faithfulness. Voters believe them.

The first political campaign I can remember was the 1952 Presidential election. I recall only one event clearly. It was a singing group at the Democrats' national convention. They sang the following:

They promise you the sky.

They promise you the earth.
But what's a Republican promise worth?

Then came the chorus:

Don't let 'em take it,
Don't let 'em take it,
Don't let 'em take it away!

Eisenhower was elected. Both houses of Congress went Republican. This had not happened since 1928. It would not happen again until 2000. They didn't take it away. They added more.

The great advantage of political promises is that the politicians who make them will not be in office when the bills come due. The benefits are immediate: votes. The costs are deferred. The supply of promises increases.

These promises rest on assurances. "Treasury debt will continue to have a AAA rating." "Treasury debt is backed by the full faith and credit of the United States." "There is no alternative to the U.S. dollar as a world reserve currency." "We owe it to ourselves." "Deficits don't matter." "Inflation is under control."

With the exception of Austrian School economics, every major school of economic thought believes in at least four of these assurances. Keynesians believe all of them.

So, the supply of promises increases. So does the magnitude of these promises. For as long as investors buy the Treasury debt and the GSE debt (Fannie and Freddie), there will be no reversal of this process.

The advent of the day of reckoning is easy to describe: (1) the upward move of Treasury interest rates, or (2) the upward move of prices in response to the Federal Reserve System's expansion of its balance sheet – monetary base – to hold down rates.

Then will come the wail of the aging mistress: "But you promised!" Indeed, he did, but a younger mistress has come along, and she wants the presents that he had promised the first one. When lenders start tightening up, a philanderer has to pick and choose among his mistresses. Old ones lose.

But what of the faithful wife? When will she finally wise up and divorce the lying SOB?

I am writing this report for her.

WHY DEFAULT WILL COME

You know about the unfunded off-budget liabilities of the Social Security and Medicare programs. If you don't know the numbersgo here.

You know about the size of the on-budget Federal debt. If not,go here.

You presumably know about the size of the officially estimated deficits in the on-budget account: at least $900 billion a year until 2019. If not, go here.

Voters are oblivious. They do not care about anything beyond their next paycheck. Investors are oblivious. They do not care beyond the next quarterly report. Congress is oblivious. They do not care beyond the next election.

Am I saying that Congress has a longer-term perspective than investors? Yes. But why? Because investors believe two things: (1) the existing price of any asset reflects the best judgment of the smartest investors; (2) they will be smarter than all these other investors when it comes time to sell and buy gold.

The average American faces his day of reckoning on the first of every month. Congress faces its day of reckoning in November of even-numbered years. Investors do not believe that they, individually, will ever face a day of reckoning. They think they are smarter than the smartest guys in the room, or else they think Ben Bernanke is, and all those other FED economists are, who will see the crisis coming next time and will take steps to evade it.

Congress also thinks that the FED's economists will find ways to evade the day of reckoning.

Investors and politicians are united. They trust the ability of central banks to evade the costs of political promises. This has been true since 1694, when Parliament granted a monopoly over money to the Bank of England. Parliament wanted a lender of last resort. That was what the head of the Bank of England promised.

The political promises of every nation rest on faith in central banking. The politicians and the investors are united in a confession of faith. This confession of faith rests on an assumption: with fiat money, there can be a free lunch, indefinitely. Every school of economic opinion except the Austrian School also affirms this.

There is a problem with this confession. It is not true. There is no such thing as a free lunch. Fiat money is counterfeit money. It does not create wealth. It destroys wealth.

Congress has promised money. It has also promised wealth. Congress will default on at least one of these promises.

We are back to my original two questions: (1) How? (2) When?

Default has four major forms. We need to consider all of them.

1. OUTRIGHT DEFAULT

This scenario assumes that the central bank refuses to buy the government's debt. This has not happened since 1694.

At some point, the government will not be able to find buyers at low interest rates. Rates will rise. The economy will sink into a depression. Revenues will decline. Expenditures will rise. The government will not be able to pay all of its obligations. So, it will raise taxes. The depression will get worse. Revenues will again fall.

Investors will know that the government is likely to default. No credit-rating service will have the courage to downgrade the government's debt, but rates will rise as if they had. The government will reach the day of reckoning. It will default on all of its debts.

Every institution that has government debt in its portfolio will suffer a loss. Its share price will fall. The depression will get worse. Insurance companies will be hit hard. The largest banks, which swapped their toxic debt with the FED at face value in late 2008 will find that they own the most toxic debt of all.

Foreign central banks will refuse to buy any more American Treasury debt. Technically, their portfolios fall to the extent that they held Treasury debt. Then those governments must decide. Should those banks be allowed to inflate to overcome these losses?

The inverted pyramid of debt will topple. The great default will produce the great depression. Unemployment will rise. Depositors will finally go to their ATMs to draw out currency. The banks will default: no withdrawals of currency.

The division of labor will contract. Everyone will get much poorer.

Because a default on all Treasury debt would have such widespread consequences – immediate consequences – economists have argued that this will not be allowed to happen. The central bank will buy the debt. But if it does, at some point it must stop buying or else create hyperinflation. Hyperinflation has the same consequence as default and deflation: a contraction in the division of labor.

I know of only one economist who predicts an outright default: Jeffrey Rogers Hummel. On August 3, 2009, he published an article on the free market site, Library of Economics and Liberty: "Why Default on U.S. Treasuries is likely." His argument is simple: the only alternative is the Zimbabwe option: hyperinflation.

He goes through the numbers. He makes an impressive case. He does not discuss the level of interest rates that would bring on the crisis, but at some point, the Treasury will have to offer high rates unless the FED intervenes.

He says that the welfare state is going to die, all over the world. I think he is correct. I am not convinced that outright default is likely – not before much higher price inflation arrives.

The strategy of the FED is the same as the strategy of Congress: kick the can.

SELECTIVE DEFAULT

Hummel admits that selective default is a possibility. I think it is more than a possibility. I think it is likelyHe writes:

> *The Zimbabwe option illustrates that other potential outcomes, however unlikely, are equally unprecedented and dramatic. We cannot utterly rule out, for instance, the possibility that the U.S. Congress might repudiate a major portion of promised benefits rather than its debt. If it simply abolished Medicare outright, the unfunded liability of Social Security would become tractable. Indeed, one of the current arguments for the adoption of nationalized health care is that it can reduce Medicare costs. But this argument is based on looking at other welfare States such as Great Britain, where government-provided health care was rationed from the outset rather than subsidized with Medicare. Rationing can indeed drive down health-care costs, but after more than forty years of subsidized health care in the United States, how likely is it that the public will put up with severe rationing or that the politicians will attempt to impose it? And don't kid yourself; the rationing will have to be quite severe to stave off a future fiscal crisis.*

The rationing will have to be severe. The promises will not come true.

INFLATION

There are two forms: mass (up to 50% per annum) and hyper (the sky's the limit).

Mass inflation seems more likely over the next decade. If the world's central banks can coordinate the expansion of money, thereby funding the national welfare states, the public will not be able to escape. They will pay the inflation tax.

The ways around this are limited to investing in real goods: commodities, small farms, used goods stores, small-town real estate. Not many people will see this in time. Of those who do, few will take action. These escape hatches are for people who are hedging against default. The average voter has no financial reserves. Of the 20% who do have reserves, 80% will be stuck in conventional investments. They will believe the Establishment's Keynesian line. "The government can fix it if you just hang on."

Inflation means the erosion of money. It means a hidden default on the political promises. Why hidden? Because the politicians will blame speculators. They will not blame the Federal Reserve for having bankrolled their promises.

CONCLUSION

Ultimately, it is either the great depression or the Zimbabwe option. Ludwig von Mises called this the crack-up boom. It means the destruction of money and the collapse of the division of labor. It would mean devastation.

I think central banks will at some point refuse to fund governments any longer. They will bail out the largest banks instead. Foreign politicians may force hyperinflation on their central banks, as agents of the government. But as long as the Federal Reserve System maintains its selective independence, it will not adopt hyperinflation as a policy. That would not be in the interest of the largest banks. It would also not be in the interest of central bankers. Their retirement promises would die.