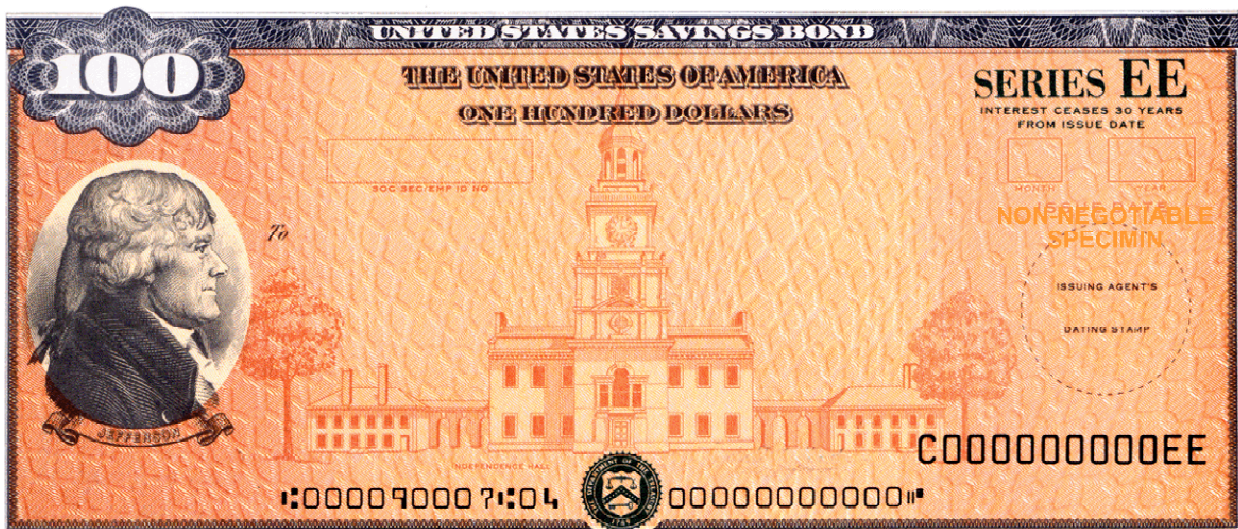


Paths to Repudiation

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As readers of this blog and my newsletter are aware, I have laid out the case whereby the United States eventually repudiates its public debt. The means by which this happens is unclear. There are several paths to the same place however, and it's not necessary to choose only one method of ultimate default. All the usual methods will do, and I am now confident we'll witness most of them in the next five years.



For example, we now know that an industrial depression will collapse tax revenues to Washington. This is already in the pipeline, as States from California to Kansas cannot even issue their own tax refunds. So the first path to repudiation comes from a collapse of GDP.

We also know that flagrant monetization will not be allowed to go on forever. That too is in the pipeline, as the FED has expanded outright non-sterilized purchases of financial assets. They have backed-stopped trillions in assets already with Treasury lending, but have since moved on to outright purchases. It's likely that any month now they will start classical monetization of Treasuries. The FED has told us so. Thus, the second path to repudiation will come via quantitative easing, and inflation.

Now comes the populist response to the financial crisis. This is the third pressure that will come to bear on both tax revenues to Washington, and Washington financial policy. One face of the populist response is Liquidationist. The other face is Keynesian and Interventionist. The Liquidationist movement, to the extent its successful, will promote default in the private sector. (It will also be associated with Tax Revolts). The Interventionist movement will seek to move default into the public sector. In the end, it doesn't really matter which pipeline is the conduit for default. And here's why...

Default in the private sector deepens the crisis, and further reduces tax revenues to Washington. Default and losses in the public sector forces increased monetization and Treasury borrowings. The result is obvious: an ever greater quantity of Treasury securities, backed by ever decreasing cash flow to the government, and topped off by ever increasing monetization of both Treasuries and Agency debt.

Nationalisation of financial entities such as Fannie Mae, AIG, or the impending takeover of Citigroup and Bank of America are no longer that important. The only dynamic that is altered with nationalisation is how exactly the debt will be mitigated. Again, in the private sector it's liquidated. But in the public realm it's mitigated politically. Fannie Mae and Freddie Mac are already political vehicles that will be used to mitigate private debt through rescheduling. If Citigroup is taken over, then all commercial loans, credit card loans, and other debt held by Citigroup will be mitigated by Congress.

Let's be clear: United States house prices, as one example, will now and for years to come be known as "The Prices of the Previous Era." There will be no restoration of those price highs for a long time. Accordingly, Congress once it is in control of Citigroup and Bank of America will do just as they are doing now with Fannie Mae and Freddie Mac—they will reschedule the debt.

The private sector debt in the United States exerts the same power over the banking system as the public debt of the United States exerts over our international creditors. Collectively, the debtors are in control. Not the creditors. This is why the the Creditors, not the Debtors, will be making most of the concessions in the years ahead. Whether the US public debt is inflated away, rescheduled, or repudiated—or some combination of all three—it doesn't matter much. The process is already underway. And only an improbably quick return to a very high GDP in the United States could halt the process. We'd need a pace of growth that the United States has not experienced in decades. I don't see a quick return to high GDP in the US anytime soon, do you?

-Gregor