The Default Debate, Markets, and Selling Gold

Joseph E. Gagnon assesses some unusual options the US Treasury might choose, including gold sales, if there is no agreement to raise the debt ceiling.

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Steve Weisman: The debate over whether the United States will default in early August is heating up. This is Steve Weisman with Joseph Gagnon. Joe, some people say that the debate itself is already having an impact. Do you see that?

Joseph Gagnon: Only in a sort of perverse way and in the sense that long term bond yields in the US have been falling. [But that] doesn't indicate to me that investors are too worried about default.

Steve Weisman: Do they just not believe the United States will let this happen?

Joseph Gagnon: Yes, in part. I think default in the bonds is not going to happen. I think bond holders realize that. What we're really talking about in worse case scenario is the government shut down.

Steve Weisman: And Social Security checks not being paid.

Joseph Gagnon: And possibly not paying Social Security. And that would be horrible for the economy, which is why I think bond yields are falling.

Steve Weisman: Isn't that interesting. So it's not necessarily that they're optimistic?

Joseph Gagnon: No, I'm not sure that bond holders are more optimistic than the general public. But I think they correctly see, in my opinion, that there's no chance of default on the bonds. There is a chance of a government shutdown.

Steve Weisman: And non-payment of bills.

Joseph Gagnon: And non-payment of bills and Social Security checks and stuff. And that will be horrible for the economy, would slow the economy down. And that, of course, is always good for the bond market -- bond yields fall.

Steve Weisman: But credit rating agencies are saying that a failure to meet any obligation, not just a debt obligation, might persuade them to lower the US credit rating. Wouldn't that raise interest rates?

Joseph Gagnon: It might. But again the markets haven't priced that in yet. So I suspect it might not. Let's not forget Japan was downgraded some time ago. It doesn't have a triple A rating and its bond yields are much lower than ours.

Steve Weisman: Because its economy is so bad.

Joseph Gagnon: Yes. But again that's what we're talking about here, a bad US economy.

Steve Weisman: You've had experience at the Fed and in government. If the unthinkable happens and there is no deal to raise the debt limit, what options are available to both the United States government and the Fed?

Joseph Gagnon: I think that's where it gets interesting. I think, if a deal isn't reached by August 2, that's bad news and none of the options are good. But some are I think much better than others, even if we stipulate that they're all not good.

Steve Weisman: For example?

Joseph Gagnon: For example I think the worst option would be to not send out Social Security checks, to stop paying government employees, but that would be the worst option.

Steve Weisman: But that might be a politically attractive option to the government, because it would dramatize the situation for Americans.

Joseph Gagnon: You know, I don't think so. I don't want to take sides here, but I think that if you think one side is right and one side is wrong, and one side is going to make political gain out of this, I still think that the administration – to have the moral high ground – [needs] to do what is the least harmful option. Even if you want to blame the other side, you still should not take actions that are more harmful than need be.

Steve Weisman: What would that be?

Joseph Gagnon: One, if the Federal Reserve wanted to cooperate, the Federal Reserve could buy the gold from Treasury even while its sitting in Fort Knox. It's about $400 billion, which is about three months of the deficit. Not a permanent solution. For all the attention gold gets, it's really not that much. But there you have it. It's a three month delay of execution, which would prevent a really bad government shutdown. That's a possibility.

Steve Weisman: Explain to me how that would work. It would be like suddenly instead of defaulting you're selling your most precious asset.

Joseph Gagnon: That's right. But the beauty of this is that…

Steve Weisman: You can always buy it back.

Joseph Gagnon: Exactly. Presumably the understanding would be that the Treasury would buy it back once congress had acted, and wouldn't have to dump the gold on the market. You wouldn't move the market price, because this would all be done off-market. And so it would just be an accounting transaction that would allow the government to operate for three more months.

Steve Weisman: I haven't read about this. Is this the Gagnon plan?

Joseph Gagnon: It's my idea.

Steve Weisman: OK.

Joseph Gagnon: And I haven't read too much of other people talking about this. There are other options. Some scholars, and picked up by Bruce Bartlett at the Fiscal Times, have talked about whether the debt sealing itself is even constitutional. The 14th amendment says that the debt of the US shall not be challenged.

If that includes contracts and other explicit liabilities like Social Security payments etc., you might say, "No, you can't not do those things, because it's in the Constitution."

Steve Weisman: But I think the Justice Department has poured cold water on that theory.

Joseph Gagnon: Is that right? I haven't read that recently.

Steve Weisman: You know things can change.

Joseph Gagnon: I don't know if the administration views that as a legally defensive argument or not. That's one thought. Another thing that I just read yesterday, and I have unfortunately have not had time to check. I don't know if I should even say it.

Steve Weisman: Go ahead.

Joseph Gagnon: I'll say it's speculative. It's kind of wacky, but if true it would satisfy the letter of the law, which is that Treasury could mint a trillion dollar coin and deposit it at the federal reserve and then have access to a trillion dollars of federal reserve high powered money, which wouldn't count against the debt ceiling.

Steve Weisman: I'm not sure that would deepen American confidence in the political system.

Joseph Gagnon: None of these things are good but if you have to say, would an accounting fiction – or laying off three million government workers or whatever – be better? Or not sending Social Security checks to millions of Social Security retirees? I guess I'll take the accounting gimmicks.

Steve Weisman: Let's end on a serious note. You take the idea of defaulting seriously.

Joseph Gagnon: I think that the worst thing that they could do is to default on the debt. And for several reasons, because it would throw in doubt this most safe of safe assets. The fact that the Treasury is a safe haven, I think, is a good thing for America. It bolsters confidence. It's our underpinning of the whole financial system. It relies on Treasuries being safe. I think that will be the worst thing it could do.

Moreover if you default on the debt you don't solve the problem, because payment of interest on the debt is just a tiny part of the deficit, really tiny. So even if you default from the debt you still have to shut the government down. You still have to not send out Social Security payments. So why not not default on the debt? Because that's so much smaller than the other things government does. It would be better, I think, [to have] a partial government shutdown than to default on the debt.

Steve Weisman: Joe, thanks.

Joseph Gagnon: You're welcome.