

A Solution to the US Debt Crisis

By: Kirk Chisholm

This is a letter I wrote to the Federal Reserve earlier this year. The point of mailing it to them was to get it into the hands of decision makers who could enable change. I have not heard back from them, so I have decided to release this publically in order to get this idea into the public realm so it can be discussed. This should allow other decision makers to also work with the Federal Reserve Board to enact the necessary changes to alter the direction of our country's economic course. This idea applies to central banks globally since many other countries have similar problems of too much sovereign debt. If you find this idea is useful enough to pass this along, hopefully it will find its way to people who might have some influence in the decision making process, you have my permission to do so.

This is a copy of the letter sent to the Federal Reserve Board on April 4, 2011:

April 4, 2011

Dear Esteemed Members of the U.S. Federal Reserve and District Federal Reserve Banks,

I would like to commend you on doing an excellent job at managing the current economic conditions. This is probably one of the most challenging economic time periods we have experienced as a nation. I have been watching the actions of the Federal Reserve, as do the majority of the market participants, and I have noticed a dislocation after the announcement of QE2. It appears to me as that the Federal Reserve is pursuing an approach of inflation via reflexive action. Since your announcement of QE2, it seems as if we suddenly have inflation. This is odd considering the facts do not show this. I would agree with your public disclosure that there is no inflation. However the PR efforts of the Federal Reserve to create a media frenzy of inflationary talk seems to have caused commodity prices to rise since the start of QE2. Judging by the effectiveness of Treasury bond purchases, I can only assume that your efforts have also gone into supporting the stock markets and commodity prices. In theory, evidence of inflation should cause people to react to inflation. I assume these reactions to inflation are what you are looking to stimulate. This "reflexivity" in theory should work, however the current market environment is a bit too unbalanced to sustain these levels without a greater risk of market collapse. This attempt would work in an environment where the market is slowly declining or neutral. This type of action with an unstable market could cause a wide variety of unintended consequences. As I'm sure you realize, this plan can only be pulled off if no one realizes it is being done. I assume you realize this since I have not heard of this hypothesis in the media. This probably would have gone unnoticed, but one thing that tipped me off was the rising of bond yields in the headwinds of Fed buying. I would generally assume at this point that the Fed can more or less dictate prices of Treasuries, especially since the Fed is currently the largest holder of them. If my assumption holds true that the Fed is in control of pricing, then it is safe to assume that you find it an important part of your strategy in causing the façade of inflation to appear for the markets to see. If the market believes that you cannot control the bond yields, then this will give people the opinion that we are off to the races chasing higher commodity and equities prices. However, if this does not happen and the consumer and investor alike do not respond to these indicators in a Pavlovian way, then this will set up the commodity prices and stock markets alike for a tremendous fall once the façade is broken either by the Fed or by Mr. Market.

The point of this letter is not only to compliment you on your choice of strategy, but also to offer a solution to the Fed's and the US Government's increasing debt problem. Since the Federal Reserve is a private/quasi-governmental institution with the power to create money from thin air and the government backing to do whatever is necessary to accomplish appointed mandates, I might have a solution for you. The US Government is in a situation with an endgame in sight. The endgame has two choices and subsequently two outcomes due to those choices. Neither endgame is pleasant, but nonetheless unavoidable. The choices for the US at this point are: hyper-inflation due to excessive money printing in an attempt to inflate away the outstanding debts, or a deflationary collapse which will cause US Treasury and municipal bond defaults. The writing is on the wall. The last chance to correct this ship was in the early 2000s when Mr. Market was declining but stable. Now that worldwide debt is at unsustainable levels, well past an easy fix, there is no choice other than default or inflate away the debt. That being said, I would suggest there is a third option. Instead of causing worldwide turmoil and inevitably war due to trying to fix a broken system, there is a more peaceful solution. The first step is for the Federal Reserve to buy up as much of the outstanding US government (treasuries, munis, agencies, etc) debt as is necessary to accomplish this goal. This is an easy step since most people assume the Fed is going to do this anyway to prop-up the declining interest of debt buyers at such low rates. This will give the Fed greater control of debt pricing and "corner the market" on government debt. Then simply decide to forgo your entitlement to the treasury bonds held at the Federal Reserve exclusive of excess reserves. In case I'm not clear, eliminate the Federal Reserve's right to most of, if not all of, the US government debt, more succinctly put, a debt forgiveness. Now, I can imagine your first thought is this is a crazy idea, but take some time to think it through. What are the biggest hurdles to getting out of this mess the US and global economies are currently in? Excessive debt and unemployment. Although unemployment is one of the Federal Reserve's mandates, it shouldn't be. It is not within the power of the Fed to control the employment rate. Any hard look at the stagflationary period in the 70s and 80s will show you how ineffective monetary policy is with unemployment. Inflation does not cause jobs, corporate organic growth and technological innovation does. However, it helps pacify the politicians by taking the blame for a condition which is a natural occurrence to misallocation of resources. Excessive debt (and of course public entitlements) is the real elephant in the room. In a deflationary environment, the method Mr. Market uses to correct the misallocation of resources is to destroy companies with overleveraged debt and reallocate the remaining equity to more efficient producers. It is obvious we are in a deflationary environment since QE1 has been spent and QE2 is almost spent as well. I can only assume that the NEED for QE1 and QE2 was to save the US and global economy from deflation. The term deflation was never used, but obviously implied. Japan has not been able to escape from deflation nor will the US and other governments with the excessive amount debt currently in place. A deflationary cycle is absolutely necessary for the economy to recover on strong footing. This is a sound principal of economics. It has worked well for centuries.

Once the Federal Reserve decides to permanently forgo their right to the ownership of the debt on their balance sheet, it will accomplish four things. First, it will allow the US to default on their debt without actually defaulting on their debt. If the US defaults, then it will cause future problems in being able to borrow at reasonable interest rates and limit future growth. This solution is not a default. Destruction of debt is still going on due to foreclosures and toxic assets held on (or off) bank balance sheets. Instead of dragging this out for years, this solution would get rid of it all at one time. Second, it will allow the US government to keep spending. The politicians everywhere would love this solution because it gives them the ability to do what they love to do best, spend other people's money. This is not a preferable solution since it will not correct the bad behavior which is currently saturating many government institutions. However, it will allow the US to keep spending and retain its reserve currency status and power over the global economy. Also it would appease the growing calls to audit or even "end the Fed". Third, it will

stabilize the US economy. Initially the news will be a shock to the markets, but it wouldn't be much different than any other unanticipated shock. This quickly dissipates once people realize what the Fed has done. [It is probably best to do this over a long weekend giving people time to digest this. Also, this will have to be explained in simple terms so everyone will understand, without convoluted language only an economist will understand. Basically the Fed is taking it on the chin to help the US get back on track to economic growth.] Lastly, this massive destruction of debt will also accomplish the need to keep gold, silver and other important commodity prices low. Using this tool to bring stability to the asset markets and strength to the dollar will reduce the need for investors to seek the safety of hard assets. Currently the only solution to keeping gold and silver prices low is to show sustained actual organic growth in the US economy in essence providing confidence that the US Treasury, agencies and municipalities will not default due to overwhelming debt loads.

Initially you might think this amount of destruction of debt would be a huge deflationary event causing a further deflationary spiral. I would argue that if you plan this properly, and destroy enough toxic debt at one time, the US would forgo the deflationary spiral. A deflationary spiral is caused by a slow destruction of money supply and more importantly a slow reallocation of misallocated assets. Japan is a perfect example of this. However if the destruction of debt is large enough, so as to leave a void for the capital which is seeking debt instruments, it will cause an explosion of desire for purchasing US debt and increase spending. Take as an example, the US government decided to pay off every homeowner's mortgage in the US. What would happen? The US psychological mentality would be to go out and get a new mortgage and use that money to spend on goods and services. I'm not suggesting that this is a good thing, but it illustrates the point. The easiest solution to the current dilemma the US and global developed economies face is to destroy all the toxic debt at one time. It cannot be gradual, it cannot put investors of that debt on the hook for losses, and I think it goes without saying that this cannot be disclosed to anyone prior to the action or else there will be chaos in the markets. Additionally, I would suggest including as many other central banks as is appropriate so expand the effect of this event. More US debt could be included as well as other foreign sovereign debt. Worst case, this would extend the time needed to fix the global economy.

I hope this provides you with a reasonable solution for the dilemma you currently face as an institution. You are in a unique position to affect the lives of hundreds of millions of people in the US. I would like to help in any way I can. Please let me know if this idea is something you find of use, or you would like me to expand on it.

Sincerely,

*Kirk Chisholm
617-372-9033
kirk@nuaadvisors.com*

CC:

*Dr. Ben Bernanke, Chairman, Federal Reserve Board
Dr. Janet Yellen, Vice Chair, Federal Reserve Board
Ms. Elizabeth Duke, member, Federal Reserve Board
Mr. Daniel Tarullo, member, Federal Reserve Board
Ms. Sarah Bloom Raskin, member, Federal Reserve Board
Dr. Eric Rosengren, President, Federal Reserve Bank, Boston
Mr. William Dudley, President, Federal Reserve Bank, New York
Dr. Charles Plosser, President, Federal Reserve Bank, Philadelphia
Ms. Sandra Pianalto, President, Federal Reserve Bank, Cleveland
Dr. Jeffrey Lacker, President, Federal Reserve Bank, Richmond
Mr. Dennis Lockhart, President, Federal Reserve Bank, Atlanta
Dr. Charles Evans, President, Federal Reserve Bank, Chicago
Dr. James Bullard, President, Federal Reserve Bank, St. Louis
Dr. Narayana Kocherlakota, President, Federal Reserve Bank, Minneapolis
Dr. Thomas Hoenig, President, Federal Reserve Bank, Kansas City
Mr. Richard Fisher, President, Federal Reserve Bank, Dallas
Dr. John Williams, President, Federal Reserve Bank, San Francisco*

I thank you for spending the time to read this and hope it has sparked some additional ideas on how to fix our country's dilemma.

Disclaimer:

This article is the opinion of the author and does not reflect the opinions of the NUA Advisors, LLC. This is strictly an opinion piece and does not constitute financial advice and should not be treated as such.