How the US Treasury Can Avoid Default Regardless of the Actions of Politicians

Treasury will want to ensure no default regardless of the actions of the politicians. There are a couple of ways out.

1. They could do a voluntary exchange with the Fed, where by US T bills are exchanged for bonds. The old issue is retired at par. The new issue is a par instrument issued at 500 dollars, say.

    a. The debt ceiling is respected since the face value of the debt is constant.

    b. The transaction generates cash for the treasury.

    c. The Fed gets shafted but then its just more QE anyway.

    d. We have to worry about the legality of the transaction to see if any CDS will be triggered. My best guess is no. Even if there was a technical trigger, which I doubt, since the voluntary exchange actually disadvantages the participant (the Fed), under cram down rules, the other bond holders not involved in the exchange are actually better off than the Fed and therefore will have no legal recourse or cause for complaint under bankruptcy law.

2. Treasury could create an asset and sell it. I am slightly uncertain about the legality but I think it works.

a. A predetermined proportion of tax receipts is paid into a newly created, wholly owned subsidiary of treasury.

b. Equity in this subsidiary is sold for cash.

c. It could be argued that

    i. A pledge of future cash flows constitutes a debt obligation. However, since the obligation is to a wholly owned subsidiary, I think this argument may fall.

    ii. The pledge of current and future cash flows to the subsidiary may constitute fraudulent conveyancing under bankruptcy law. However, I would argue that US treasuries are senior unsecured claims that carry no covenants controlling the creation of senior or other liabilities in the capital structure of the treasury, and, that the solvency of the treasury is indeterminate anyway, since its largest asset is the capitalized cash flow from tax receipts.

    iii. In effect, what treasury is doing is selling assets to fund current liabilities. It, however, has to structure the asset into saleable form. In this case, capitalizing its tax revenues.

With the above 2 devices. Jack Lew would not have to worry that the strategies employed by the Republicans and Democrats may accidentally trigger a default. I cannot help but suspect that such contingencies are already in place. While nobody

wants a default, the strategies employed by the players may not be ‘trembling hand’ robust. Accidents can happen and we can’t very well have a silly mistake taking us back
to barter.