Nobody believes that the states will eternally drag the burden of these interest payments. It is obvious that sooner or later all these debts will be liquidated in some way or other, but certainly not by payment of interest and principal according to the terms of the contract.

- Ludwig von Mises, *Human Action* (1949)\(^1\)

U.S. bankruptcy code defines insolvency for businesses as the “financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at fair valuation.”\(^2\) Although the federal government’s $18.2 trillion debt is commonly compared to U.S. GDP of only $17.4 trillion, a far more appropriate debt comparison would be to assets possessed by the U.S. government (since, after all, the “economy” is not obligated to pay the national debt).\(^3\) The values of such assets, liquid or otherwise, are inherently difficult to ascertain – some are unknown (e.g., real estate, mineral rights, offshore oil deposits) while others are of suspect value (e.g., student loans, U.S. Postal Service). Most reports estimate such assets at well below $4 trillion, so the net worth of the federal government would be negative $14 trillion. The Federal Reserve is a bit more optimistic: it estimates the U.S. government’s net worth at negative $12 trillion.\(^4\) Either way, the federal government is clearly insolvent under its own law, if it were a business.

The U.S. bankruptcy code contains another definition of insolvency; one which is in fact specific to government (municipalities).\(^5\) Here insolvency is defined as “generally not paying its debts as they become due” or “unable to pay its debts as they become due.”

Insolvency is not simply a balance sheet issue, but rather one of cash flow: illiquidity is another form of insolvency. Under this definition, except for the occasional (and short-lived) shutdowns, the U.S. government is thought liquid and solvent through its taxing power and printing press. But this will quickly change if expenditures skyrocket. With $18.2 trillion in debt, the easiest way this may happen is if interest rates rise.

What are interest rates? Given the recent history of massive intervention in the bond markets by central banks, few remember that interest rates are ultimately a product of the free market. At a fundamental level, they reflect the time preferences of various actors within the economy. Add in assessments of credit risk as well as expectations of future price levels, and a structure of interest rates over various time frames is revealed. All markets can be suppressed, distorted, or manipulated, but only for a limited time. The bond market is no different; ultimately interest rates will resort to higher levels.

How far must interest rates rise for the U.S. government to be “unable to pay its debts as they become due”? Currently, the federal government effectively pays only 1.3% on its debt obligations – a rate unknown since the depths of World War II.\(^6\) Over the last 75 years, there have been periods of far greater effective rates (the early 1980’s experienced 8%) with an average of over 3% - all while the U.S. government possessed vastly better credit worthiness. Even with record 2014 tax receipts of over $3 trillion, federal debt levels are almost six times

\(^2\) 11 U.S.C. § 101 (32(A)).
\(^3\) Federal Reserve Bank of St. Louis. [http://research.stlouisfed.org/fred2/](http://research.stlouisfed.org/fred2/)
\(^4\) Ibid.
\(^5\) 11 U.S.C. § 101 (32(C)).
\(^6\) Federal Reserve Bank of St. Louis. [http://research.stlouisfed.org/fred2/](http://research.stlouisfed.org/fred2/)

**The U.S. Government:**

**Adding Illiquidity to Insolvency**

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current receipts. It is no different than a household earning only $30,000 a year with $180,000 of debt. And this is the official debt level; include Social Security, pension funds, or any of the other myriad promises made, and financial obligations easily balloon to 30 or more times tax receipts. Given this financial condition, one can easily argue that an applicable market-based interest rate for U.S. government debt would be far, far higher – perhaps akin to Greece, perhaps worse.

What happens to interest payments as a percentage of tax receipts with higher interest rates, and thus the ability to pay other obligations? Currently at “only” 8%, they grow to 20% with the historical average interest rate. At interest rate levels experienced in the early 1980’s, they expand to almost 50%. All of these projections assume tax receipts are stable, but a recession would compound the calamity as tax receipts fall. The 2008 recession caused tax receipts to fall 18% over a two-year period. Combine 8% interest rates with a recessionary hit to tax receipts, and interest payments alone swell to 60% of total tax receipts. Well before reaching such high levels of interest payments, the federal government would lose the ability to pay other expenses “as they become due” – or otherwise.

For this reason, the U.S. government has suppressed interest rates for years: it simply cannot afford for them to rise. It will continue to do so by remaining reliant (and increasingly so) upon the printing press to purchase bonds to lower rates. But this strategy will only work for so long. Whether through a sober assessment of credit worthiness by investors or via rising price inflation, the market will compel higher interest rates. If the Federal Reserve then continues with proliferate production runs of the printing presses, expect Mises to be prophetic: bondholders will be “repaid”, but with a currency which hardly meets the “terms of the contract.”

As insolvency will eventually be answered with a de facto default – a repayment to bondholders with a substantially depreciated currency – all investors must prepare for price inflation. It may not develop within the next 12 months, it may very well be preceded by an asset deflation, but it will arrive. When it does, it may appear in 1970’s fashion: suddenly and substantially. Reflexively, all investors expecting price inflation seek protection with precious metals. While precious metal investments are perfectly prudent and will ultimately prove quite profitable, other inflation hedges should be considered – especially those providing income backed by hard assets such as certain types of real estate.

About the Author

Combining a degree in economics from the University of Illinois with a specialty in the Austrian school of economics, Mr. Casey advises clients on their investment portfolios in today’s world of significant economic and financial intervention.

Mr. Casey has served as a trusted advisor to a diverse range of business owners, advising them on financial issues impacting their companies and their personal wealth. Throughout his career as a Director with the national financial services firm Stout Risius Ross, he advised business owners from a variety of industries on the risk and return profile of their equity interests. In addition, Mr. Casey advised high net worth individuals and families related to their financial, tax and estate planning. At his previous firm, he was also in charge of marketing Private Client Services on a nationwide basis.

Mr. Casey has been a frequent speaker before a number of organizations and conferences, including USA Watchdog, GoldMoney, Freedom Fest, and various bar associations and radio shows, including weekly financial and economic commentary on The Edge of Liberty (WNJC 1360, Philadelphia). His writings have appeared in a variety of publications and websites including The Ludwig von Mises Institute, Zero Hedge, Family Business, Casey Research, and Laissez Faire Books. He is a board member of the Economics Development Council with the University of Illinois, a Policy Advisor for The Heartland Institute’s Center on Finance, Insurance, and Real Estate, and a Chartered Financial Analyst charterholder (CFA®). He enjoys cycling, cooking, reading, writing, and spending time with his children. Mr. Casey resides in Elmhurst, Illinois.

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7 Ibid.

8 It should be noted that while U.S. government debt should command substantially higher interest rates, the U.S. is not alone among developed nations in this regard, nor does it possess the worst financial situation.