The Squeeze is On-
Budget Surplus Portends Big Trouble!

Many have attempted to explain recent financial stress. Some say that the Asian problem is spreading to the rest of the world. The Long Term Capital hedge fund problem has others pointing to an overleveraged condition due to careless banking activity. The Russian collapse is said to be the result of a lack of tax collection. And all, including Latin America, are falling prey to falling commodity prices.

What is never blamed as the main, fundamental culprit, is the US budget surplus. In fact, President Clinton is still pointing to the budget surplus as a reason he still deserves to be President. This week the administration publicly celebrated the current budget surplus, claiming a new era of public debt reduction had begun. Ironically, both history and monetary fundamentals tell us that nothing could be more fiscally irresponsible than the current US fiscal balance.

History

In 1969 the strong US economy resulted in a tiny, technical budget surplus that led to a severe recession in the early 70's. All 6 previous US budget surpluses were immediately followed by the only 6 US depressions (see Professor Fred Thayer's article on my website). In the late 80's the Japanese budget went into surplus as the strong economy generated tax liabilities that exceeded government spending. This preceded their stock market crash of 1990. The Japanese economy has yet to recover. The Tokyo stock market sank to twelve year lows this week, after 8 years of decline.

Fundamental Analysis

The $US is a floating exchange rate currency. It is not directly pegged to anything by the Federal Reserve. To understand how it works, let me first use an example I recently obtained from Edward Nell, Professor of Economics, head of the New School Graduate Faculty in NYC, to illustrate how our currency functions.

In France, in the 1300's, one particular lord issued leather coins. The coins had value. He was able to spend them in the local market place and use them to hire people to work for him. Why? Because he accepted only his leather coins as for payment of rent for living on his land. Four very simple yet long forgotten points of simple logic can be readily deduced from this example:

1. The lord of the castle was the only issuer of his leather coins. Therefore, he could not, from inception, collect more of his leather coins than he spent. In fact, he would likely be able to spend more leather coins than he would collect in rent payments, as some coins would likely be desired to be held for transactions and as savings, and some may be simply lost during the normal course of business. All of his leather coins in circulation had to have been spent by the lord and not yet collected as rental payments. This means a budget surplus- collecting more than the amount spent- from inception is technically impossible, and deficit spending the 'neutral' outcome of such a system. Clearly, any attempt to run a cumulative budget surplus would necessarily result in a situation wherein someone would be forced to default on his rent. For example, if the total rent roll was 1,000 leather coins per year, and the lord only spent 900 leather

coins, he could only collect 900 and rental payments of at least 100 coins would be in default.

2. The reason lord required that rent be paid only in his leather coins was not because he needed the coins to spend. He had all the coins to begin with. The reason he demanded his leather coins was to create a need for them in his community. That need resulted in sellers of the real goods and services he wanted to purchase with his otherwise worthless leather coins.

3. Since the lord was the single supplier of his leather coins needed to pay rent, he was in position to set the terms of exchange for the coins when he went to spend them. The prices he was willing to pay was the source of the price level of his coins. For example, if he wanted more goods and services from his tenants, he could cut the prices he was willing to pay.

4. The lord had no need to borrow leather coins to fund his spending. Furthermore, if he did attempt to borrow leather coins, he could only do so after he had spent the coins. Any such borrowing would therefore function to provide the holders of those coins an interest bearing depository- not to fund the lord's expenditures.

Now contrast this to the same lord using an external currency (some other money that he doesn't issue). In that case, he would have to collect taxes or borrow in order to be able to spend, just like you and I do when we use $US. And he would not have control over the general price level. Nor would he be able to arbitrarily administer the interest rate. The issuer of a currency is in a very different position than the other users of that currency!

Substituting 'government' for 'lord' and 'taxes' for 'rent' describes a modern floating exchange rate currency. The driving force of the currency is the need of the tax payer to obtain $US that the government spends. (And the purpose of government borrowing of its own currency is interest rate support, not funding. To keep this a short version, I refer you to my website- http://www.warrenmosler.com- for essays with more detail about how the banking system and government borrowing and spending interact.) The fundamentals and imperatives of the government remain the same as those of the lord when he utilized his own currency. It is not necessary that all of us need to get $US to pay taxes, only some of us. As soon as someone needs the currency, he attempts to get it by selling something. The rest of us then see those things for sale, causing us to desire that currency to be able to spend it.

A functional macro policy does not guarantee success, as structural (micro) problems can lead to economic inefficiency and failure. But a dysfunctional macro policy, like a budget surplus, can make systemic failure a certainty. That is the case with the $US today. The land lord of the previous example can not spend fewer leather coins than his subjects need for rent payments, without triggering financial stress among his tenants. Yet that is exactly what the US government is doing today, as it is attempting to collect more in taxes than it is spending.

It is the US budget surplus, widely lauded as responsible fiscal policy, that is directly responsible for the world financial crisis that began last year. Notice that the trouble began with currencies tied to the US dollar, and no economy tied to the US dollar has escaped. There is a world $US shortage. Borrowers of dollars are getting hurt. World prices have been deflating in $US terms. The US will slip into recession and probably depression as the induced shortage of $US necessary to pay US taxes continues.

The $US shortage can only be offset by some sector going into deficit. With creditworthiness now on the decline, the only sector that can deficit spend is the government itself. Wynne Godley, all star forecaster and currently visiting scholar at the Levy Institute, estimates a need for a $300 billion budget deficit for the US economy to function near its potential. All the taxed advantage savings plans, pension funds, insurance reserves, and the desire of foreign central banks to hold $US are desired net savings that can only be satisfied by deficit spending by other sectors.

The $US surplus will be spent in the traditional manner- unemployment compensation in the depression that inevitably follows. Look forward to continued financial implosion during the process.