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The Balanced Budget Amendment:

A Time Bomb To Subvert American Prosperity

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The balanced budget amendment is a time bomb that will lead to a disaster like that of the great depression of the 1930's when it "explodes" at the latest some thirty to forty years after it becomes effective. In the emotional rush to change the constitution there has been no serious discussion of the incompatibility of our current banking and monetary system and a permanent ceiling to the government debt that the amendment implies.

The rocks upon which our current monetary and banking system is founded are the *monetization of government bonds* by Federal Reserve and commercial banks and the *guarantee of deposits* at banks by the pledge of the government's credit to assure that the commitments of the deposit insurance funds are honored.

If a balanced budget amendment had been in effect the 1980's, when the Savings and Loan industry and many commercial banks went "belly up", the Federal Government's rescue of the deposit insurance agencies would not have been

possible. This rescue, accomplished by increasing the government's debt, combined with the positive effects that Federal Government operating deficits have upon the flow of profits, contained the repercussions of the financial excesses of the 1980's. As a result in 1991 the United States had a recession rather than a depression.

A balanced budget amendment makes the government's guarantee of deposits worthless: financial markets will not take the guarantee seriously.

Our economy is characterized by complex and ever evolving financial institutions. Such an economy is subject to debt deflations i.e. periods in which asset values, output prices, and output and employment spiral downwards, even as bankruptcies explode. Our last uncontained debt deflation took place between 1929 and 1933.

Since 1968 we have had a number of embryonic debt deflations which were successfully aborted by large scale open market purchases of government bonds by the Federal Reserve together with government operating deficits which prevented a collapse of business profits. In time a balanced budget amendment would make such interventions impossible: it is a recipe for disaster.

A great collapse of the financial structure did not take place in the 1980's because the Federal Government was able to go into debt on a massive scale to assure that the liabilities of our depository institutions would not go to a

discount. The stability of our economy is drastically diminished when the Federal Government is powerless to intervene to prevent a disastrous debt deflation.

American history shows that the stability of a monetary and banking system in which government debt is the major asset of the central bank and an important asset of commercial banks is superior to an alternative system in which the assets of the monetary and banking systems are a combination of specie and private debt. If the balanced budget amendment is not evaded after it goes into effect, then henceforth the gross debt of the Federal Government can only remain unchanged or fall. Once "The government debt can not increase." becomes the rule of the land then *before thirty or forty years elapse* the existing financial and economic system of the United States will almost certainly collapse.

Because our economy is intensely financial: it can have too little as well as too much government debt. Over the years a balanced budget amendment will lead to a decrease in the ratio of government debt to both private liabilities and to the gross domestic product.

Government debt is the main asset of the Federal Reserve System and the only asset of government trust funds. It is also an asset that suits the portfolios of risk adverse institutions and individuals. The willingness to take risky assets into a portfolio is positively related to

the existence of safe and secure assets. The debt of a government that is fiscally responsible is a safe and secure asset and as such it encourages the acquisition of the risky liabilities of private businesses.

In 1945, at the end of World War 2, the Gross Federal Government debt was 122% of Gross Domestic Product. Between 1945 and 1981, even though budget surpluses were rare in these years, this ratio bottomed out at 33%,. Federal fiscal policy was responsible over these years. In 1992 the ratio of government debt to gross domestic product was 68%. The increase in this ratio from 33% in 1981 to 68% in 1992 shows that fiscal policy was irresponsible during these years.

The Administration's budget for fiscal 1996 calls for essentially unchanging deficits over the next five years. The forecast holds that these deficits are small enough so that a small decrease in the ratio of the debt to Gross Domestic Product will take place. One may argue that the administration is programing too slow a reduction in the deficit, but in terms of the ratios, which is what really matters, the administration's budget clearly points in the right direction.

The monetary and financial history of the United States has not been smooth. One hundred years ago the monetary system was a combination of a gold standard and a currency

(national bank notes) that was collateralized by government debt.

As the economy expanded after the Civil War and the government paid down its debt the ratio of government debt to Gross domestic product fell from 33% in 1870 to 3.2% in 1910. As a result National Banks were not able to expand the issue of currency in response to seasonal needs and economic growth.

A financial crisis in 1907 and the depression that followed led to a concensus that the National Banking Act no longer sufficed. Lengthy public discussion, the input of a remarkable national monetary commission, and serious debate in the Senate and House led to the National Banking Act giving way in 1913 to the first Federal Reserve System. The Federal Reserve system was to provide currency responsive to the needs of trade.

With the Federal Reserve Act of 1913 the country made a 180 degree turn, going from a currency collateralized 100% by government debt to a currency collateralized by gold (40%) and "eligible" private debts (60%). The "eligible" private debts were defined as bank loans which were accompanied by documents which showed that goods in the process of production or distribution were being financed. Member banks holding eligible paper were able to gain reserve deposits by rediscounting these loans at their district Federal Reserve Bank.

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Over the great debt deflation of 1929-33 the gold plus private debt banking and monetary system broke down. The 1933 bank holiday marked the final failure of the 1913 Federal Reserve System.

In 1935 a new Federal Reserve System replaced the failed 1913 Federal Reserve System. This second Federal Reserve System allowed Federal Reserve Banks to use Federal Government debts as the asset offsetting Federal Reserve notes. The monetary system of the United States made another 180 degree turn. It returned to a currency that monetizes government debt.

As a result of the 1935 changes the main policy instrument of the Federal Reserve became open market operations in government debt, rather than the discount rate on "eligible" paper. A large publicly held government debt, above and beyond that held by the Federal Reserve System, commercial banks and government trust funds, is essential for the proper functioning of a Federal Reserve System that uses open market operations.

At mid year 1994 commercial banks owned some $750 billions, the Federal Reserve System some $350 billions, and government trust funds some $1,000 billions of government debt. The order of magnitude of the current gross government debt is $4,500 billions. About a quarter of the total government debt has been monetized, another quarter is owned by government trust funds, and only half is in private

and foreign portfolios. The Gross Domestic Product is $7,000 billions this year.

Let us assume that the above current United States situation is the initial condition when a balanced budget constraint takes effect. If Gross Domestic Product in current dollars grows at about 3.5% per year it would double in 20 years, if the growth is about 4.7% per year it would double in 15 years. Let us assume it averages out someplace in between these numbers. Then between 30 and 40 years from now the Gross National Product will be about $28,000 billions. If the total government debt remains frozen at $4,500 the ratio of the gross government debt to Gross Domestic Product will fall to 16%, 1/4th of the present ratio.

If we assume that monetary institutions remain as they are and that the money supply grows at the same rate as Gross Domestic Product then in thirty to forty years the Federal Reserve and the commercial bank holdings of government debt will need to be some $4,800 billions, $300 billions greater than the maximum allowed government debt of $4,500 billions. Government trust funds now own in excess of $1,000 billions of government debt. If government trust funds are restricted to holding government securities then they certainly will be larger in a $28,000 billion dollar than in a $7,000 billion dollar economy. Let us assume that

the value of government bonds in the various government accounts only doubles to $2,000 billion.

The minimum government debt needed by institutions as they now are in thirty years will some $2,300 more than the ceiling that a balanced budget amendment sets. Well before this happens the monetary and banking system will break down.

If we assume that the 1982 ratio of government debt to Gross domestic product of about 33% is appropriate, then the gross government debt in 2025 - 2035 should be about $9,000 billions. Gross government debt would have to double even as Gross domestic product quadruples. The owners of a $9,000 billion government debt would be the Federal Reserve System and commercial banks $4,800, government trust funds $2,000, and private and foreign accounts $2,200.

It behooves the supporters of a balanced budget amendment to explain what type of banking and financial system they have in mind for the United States when the quantity of government debt is too small to support the currency needs of an economy four times as large as the economy is now. It also behooves the Federal Reserve to explain how they would operate without a broad, deep and resilient market for government debt. It also behooves the sponsors to inform the American people what assets they propose the Government trust funds to hold when there is no government debt for them to hold.

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A balanced budget amendment will force serious changes in the monetary system and in those institutions, such as our Social Security System, which are the owners of government trust funds. The balanced budget amendment will force profound changes in our banking and financial systems. It does plant a time bomb which, when it goes off will lead to economic an disruption reminiscent of what happened over 1929-33.

King Louis 14 is reputed to have said "After me the deluge". A Congress that ties the hands of future governments with a balanced budget amendment is as autocratic and irresponsible as Louis 14 of France.