Why Tight Budgets Lead to Market Crashes

The GOP is proposing to reduce discretionary spending as part of their overall goal to balance the budget. The US ran a balanced budget from 1920 to 1929, which led to the crash of 1929. The US ran tight budgets as well in 1998 to 2001 and 2005-2007, which led to severe market declines.[1] As a mathematician who is very familiar with government data, I would like to explain why tight budgets, by which I mean budget deficits which are insufficient to fund the trade deficit, have historically led to market crashes. Since we currently have a trade deficit of $948 billion,[2] the GOP plan to "tighten up" and head towards a balanced budget would lead to a similar fiasco.

To understand the consequences of what the Republicans seek, imagine the world is divided into three groups: the US government, the public, and foreigners. Government data can be used to compute how their financial wealth changes each year. Because most bank deposits are invested in government debt, the average person effectively holds government debt while using their bank as an intermediary. We can measure the change in financial wealth of the public by measuring the change in the government debt they hold.[3]

For example, for the period from January 2009 through December 2022, the cumulative budget deficit was $16.986 trillion,[4] while the cumulative trade deficit was $8.250 trillion.[5] In other words, the US government lost $16.986 trillion and issued $16.986 trillion in IOUs to cover that loss. Foreigners as a group made $8.250 trillion, which they held in additional US government IOUs. The public (mostly corporations and the wealthy) received the other $8.736 trillion in IOUs — they made $8.736 trillion, which showed up as an increase of roughly $8.736 trillion in their bank accounts. Equivalently, they increased their financial wealth by $620 billion annually from 2009 to 2022. That enabled them to pay their debts and led to a surge in stock prices.

By concentrating on what happened to the IOUs issued by the federal government, we obtain the change in wealth equation: change in financial wealth of public ≈ sum of budget deficits – sum of trade deficits. When the wealth of the public has significantly declined, debt payments have been missed and financial fiascos have occurred. The process feeds on itself with more and more people and corporations being unable to pay their debts until the government is forced to run large deficits and inject money into the public's bank accounts to enable them to pay their bills. The change in wealth equation has accurately predicted all the major market declines and much of the rally from 2009 to 2021. For example, the change in wealth equation shows that the public's wealth declined by $2.280 billion[6] from 1926 to 1929,[7] $1.739 trillion from 1998 to 2001, and $1.535 trillion from 2005 to 2007. Major crashes followed each such decline in the public's wealth.

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1 https://www.whitehouse.gov/omb/budget/historical-tables/ Table 1.1
2 https://www.macrotrends.net/countries/USA/united-states/trade-balance-deficit
3 We do not need to consider the change in private debt held because that represents the public lending to itself, which will not affect the public's net financial assets.
4 https://www.whitehouse.gov/omb/budget/historical-tables/ Table 1.1
5 https://www.macrotrends.net/countries/USA/united-states/trade-balance-deficit
6 A large amount in those days.
7 Table 1.1 and https://www2.census.gov/library/publications/1960/compendia/hist_stats_colonial-1957/hist_stats_colonial-1957-chU.pdf

The Republicans are proposing draconian cuts in spending on the poor, purportedly with the goal of balancing the budget. There are several problems with their proposals. First, reducing spending to the poor by $100 will reduce revenue more than reducing spending to the very rich by $100. To illustrate, when the government pays a poor person $100, that person immediately spends that money — say on shoes. The shoe store owner then has an extra $100 and buys dinner. The restaurant owner then has an extra $100 and buys flowers for his wife. Each time the $100 is used to make a purchase, it represents income to the seller and creates another taxable event which leads to additional government revenues. When a very rich person receives $100, they typically deposit it in their bank account rather than spend it, so there is no multiplier effect.

Second, the change in wealth equation says that over time, the budget deficit must be large enough to fund the trade deficit with money to spare for the public's gains. Since the current trade deficit is $948 billion, the budget deficit must be significantly greater than $948 billion — not the Republicans' aim. The deficit was $3.142 trillion in 2020, $2.775 trillion in 2021, and $1.376 trillion in 2022.[8] The tightening deficits have clearly affected the market. Recent interest rate increases will require a larger deficit. Bringing the deficit down further will create a surge in missed payments by the working class and real trouble. The problem isn't spending, and particularly not spending on the poor. The problem is the trade deficit, which Republican proposals do not address. If the deficit must be cut, the best way is to increase taxes on the very rich.

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[8] https://www.whitehouse.gov/omb/budget/historical-tables/ Table 1.1