Wall Street wants to pull the banking plug

by Richard Freeman

The U.S. banking system, stretched to the limits of its own illiquidity, is now set to experience a new round of bankruptcies, which could send the entire American financial system up in smoke. All the important ratios of the banking system, from the so-called "illiquidity" ratio to the fixed interest charge ratio, are in the danger zone.

Now the *Wall Street Journal*, the most widely read business daily in America, comes along and recommends, in the name of "free-enterprise" banking competition, a plan that will guarantee the collapse of the banking system by shutting the doors on its most troubled entities.

'Close the bank'

The *Journal* states that the agencies responsible for insuring commercial banks (the Federal Deposit Insurance Corporation) and S&Ls (the Federal Savings and Loan Insurance Corporation) should stop insuring the deposits of the most troubled institutions. These agencies, says the *Journal*, "have been bailing out banks which have no business staying in business. . . . It's a habit they'll have to break if banking deregulation is ready to restore a level playing field to the financial industry."

The *Journal* continues: "And the next time a bank with a portfolio of unmatched maturities shows its face at a federal agency, the punishment ought to be swift and sure: Close the bank. . . ."

Perhaps, a reader might think, the *Wall Street Journal* is merely trying to improve the competitive position of the American banking system. Let us examine the consequences of the Journal's recommendations.

The U.S. corporate sector has borrowed up to its ears from the banks. These corporations are paying interest debt-service through the nose. Close the door on the troubled banks, and there will be an immediate calling-in of loans to corporations, which will send some of the latter into bankruptcy.

This jeopardizes hundreds of borderline financial lending institutions, which will suddenly have to get insurance coverage from the federal government to meet their bills. In other words, a chain reaction of bank failures will be touched off, and, according to the sly *Wall Street Journal*, the government should refuse "any bailouts."

The illiquidity of the American banking system is indisputable—and hardly a secret. The adjusted illiquidity ratio for the banking system is at an historic high.

This ratio is calculated by measuring a bank's loans and loan-like obligations against the bank's assets. That is, in the numerator, one places the loans of the bank, plus commercial paper. The growing volume of commercial-paper borrowing is backed by bank lines of credit, and thus qualifies as a bank loan obligation, which the bank would have to answer for in the event of crisis. In the denominator, there are the bank's assets, which includes loans as well as investments in securities, cash, etc.

At the start of 1976, the adjusted bank illiquidity ratio for the entire banking system stood at 73 percent. By the start of 1979, it stood at 78 percent. By late 1981, after Paul Volcker had been Fed Chairman for 30 months, the ratio was up to 86 percent. A dwindling share of banks's assets are now cash; instead they are in the form of loans whose value is becoming more and more dubious.

Fixed-charge ratio

Another tool for describing the same problem is the banks' fixed-charge coverage ratio. This measures earnings before interest and taxes, divided by preferred dividends plus interest charges. As interest rates rise, pushing up the interest charge portion, the denominator gets large and the ratio falls.

In 1961 the ratio stood at 11.65. It declined steadily over the next 15 plus years, until in 1979 it was 6.20. But by the end of 1980 it had fallen to 5.01, and it is below 4.0 today. And the ratio of cash and equivalents to current liabilities fell to 0.15 in 1981, meaning that banks have 15 cents in cash to cover every dollar of their liabilities.

This sort of illiquid banking system cannot survive the cutting off of federal government insurance programs. The *Wall Street Journal*, whose principal allegiance is to Swiss-centered anti-growth financial circles, rather than to the United States, is deliberately courting a financial blow-out.

Note from the editor: The debasement index introduced in our Feb. 23 issue, which shows the combined rate of change of official U.S. inflation and industrial output, will appear monthly. *EIR* is in the course of preparing further monthly indices, including a measure of the real rate of U.S. unemployment. Also coming up are studies based on computer projections employing the LaRouche-Riemann econometric model, including a study of the Soviet economy and an examination of the historic correlation between industrial growth and investment in national infrastructure.