The patches are coming loose in the banking system

by David Goldman

A 4% drop in the U.S. dollar's value on foreign markets greeted arriving finance ministers and central bank governors attending the April 8 meetings at the International Monetary Fund in Washington, D.C. European financial interests had already drawn the conclusion which became obvious after the first day of the IMF's Interim Committee meeting: The U.S. Federal Reserve will continue to print money as fast as it can, to prop up the banking system as long as it can, and other central banks will watch at arm's length.

Theoretically, the Fed may prop up the banking system indefinitely, until the dollar's course runs asymptotic to zero. But because we live in the real world, the Federal Reserve will have no such luck.

The Fed now confronts the same problem that the institution failed to solve during 1929-34. It can pump money all day and night, without braking the deflationary collapse of commodity, land, and other prices which now threatens the banking system. The Fed is "pushing on a string," in the old Depression phrase.

That is the issue underlying the otherwise trivial discussion of "coordinated interest-rate reduction," or "exchange-rate management," which heads the formal agenda at the current round of economic talks, which culminate next month in the six-nation Tokyo economic summit. Translated back into English, the question is whether the Germans, Japanese, and others will pump money out as fast as does the Fed, and thereby destroy their own banking systems. The answer, widely expected, was, "No."

Fittingly, the IMF meeting convened under the luckless star of the Mainland Savings failure in Houston. One of the largest U.S. financial institutions ever to fail, Mainland had over $1 billion in assets. Domestic news media ignored the turning-point character of the Mainland bankruptcy, but the London *Financial Times*, the daily newspaper of the multi-trillion-dollar offshore financial market, took notice.

"Normally, when a bank or savings bank fails in the U.S., regulators have provided de facto insurance coverage to all depositors, regardless of size, because of worries about effects on confidence if large depositors were allowed to lose their money. It was feared that other depositors would withdraw their money from other savings banks and precipitate a run on their deposits. However, the cost of rescuing the growing number of savings banks in trouble is putting a heavy strain on the savings banks' insurance funds, which protect depositors, and regulators are under growing pressure to allow big depositors to lose some of their money," wrote the *Financial Times* April 5.

Shock to Texas real estate

Mainland had already foreclosed on $109 million in Houston real estate, sending a shock through the already-crumbling commercial-property market. "We're out of the talking stage and beginning to take action," said Howard Montgomery, a state-appointed supervisory agent who took over day-to-day control of Mainland on March 5. Mainland hopes some of the property owners will pay up, rather than be foreclosed upon.

Texas banks have more than one-third of their loans in real estate, and a solid 40% of Houston and Dallas commercial property is sitting vacant. The combination of the oil-price collapse, and the spin-off effects in the shaky real-estate market, promises to take down the entire $200-billion Texas banking system, as *EIR* documented in last week's issue.

Only days before Mainland Savings closed its doors, the California-based Financial Corporation of America, one of the nation's largest, and worst-off, savings institutions, reported that its bad loans had grown to $2 billion as of the end of 1985. The bad news at the $40 billion institution also spells the end of the FSLIC's balancing act. Financial Corporation of America had been on the brink of failure during the summer of 1984, and its last-minute rescue was the FSLIC's flagship operation.

Regulators are projecting $22.5 billion in FSLIC payouts over the next five years, but the actual total will be at least $50 billion, according to financial press reports. Actually, a more realistic estimate is $80 to $100 billion. The Federal Savings and Loan Insurance Corporation is now much deeper in the hole than the bankrupt Maryland and Ohio state insurance funds, which were unable to prevent a freeze on withdrawals at thrift institutions in those states last year.

Against this, the FSLIC has only $2 billion of uncommitted cash left.

As of Sept. 30, 1985, there were enough troubled S&Ls in Texas alone to drain the Federal Savings and Loan Insurance Corporation of its entire $2 billion in uncommitted funds twice over.

The open pump

The federal government injects liquidity into the savings bank system in three ways. First, the Federal Home Loan Board Bank can lend its vanishing resources directly to the S&Ls. Second, the federally sponsored "off-budget" agencies can buy their mortgage paper and repackage it for investors, complete with federal guarantee. Third, the Federal Reserve can raise the S&Ls operating margin directly, by reducing interest rates.

The most spectacular, and least mentioned, development on securities markets in the past two years is the staggering rate of increase of federal support for the mortgage market. During 1984, the "federally-sponsored agencies," such as the Government National Mortgage Association ("Ginnie Mae") and the Federal National Mortgage Association ("Fannie Mae") floated about $50 billion worth of paper net. During 1985, the figure doubled, to roughly $100 billion. This year, the agencies will probably double their borrowing again, to the range of $200 billion.

Ginnie Mae has been lending so fast that its $65 billion ceiling for guarantees during the September 1985-September 1986 fiscal year was already exhausted by April 7. The Reagan administration has had to apply to Congress for increased borrowing authority. That is all the more remarkable, since federally guaranteed borrowing of this type is indistinguishable from ordinary deficit financing. *The federal government is, in effect, borrowing an amount exceeding the Gramm-Rudman deficit target, in order to support the real-estate and related financial markets.*

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Meanwhile, the Federal Reserve has pushed down the interbank overnight lending ("Federal funds") rate to the range of 6-6¾% as of April 9, compared to an average rate of 7.39% during the week ended April 2. The banks are so flush with money that borrowing from the Fed's discount window, the usual measure of banks' liquidity requirement, has virtually disappeared. The Fed is providing all the funds the banks can absorb through the open-market desk.

For the thrifts, the Fed's largesse buys time. Since deregulation hit the industry in 1980, the savings institutions have been caught between their holdings of low-interest, fixed-rate mortgages, and their need to bid for funds at whatever the market demands. Lower interest rates increase their operating margins, by raising the "spread" between the thrifts' cost of funds, and their income from portfolios which include older, low-interest paper.

Meanwhile, the regulators are ignoring hundreds of savings and loans who are still losing money, and whose net worth is negative, hoping against hope that some additional income stream will allow them to creep back into the positive before depositors panic.

During the last week of March, the FSLIC stopped injecting capital into bankrupt thrift institutions, as it had previously done in order to enable them to keep their doors open. That is, 460 insolvent savings and loans are still operating, because the insurance fund does not have the cash to liquidate them and pay off their depositors.

Savings and loan stocks have soared as a result, exceeding the rate of increase in the overall stock market during the past two quarters. Purchasers of these stocks may be extremely sorry they did so; the thrifts' problems, as noted earlier, are now much, much worse than the mere unfavorable interest-rate spread of the early 1980s. We now have a generalized crash of real-estate values.

Shift in assets

Since 1980, the beginning of Volcker's banking deregulation, the composition of savings institutions' assets has shifted noticeably. Commercial mortgages went from 10% to 14% of total mortgages, while home mortgages fell from 80% to 76%. The portion of multi-family mortgages remained the same at 10%. Three-quarters of their total mortgage loans of $648 billion are home-mortgage loans. $1.2 billion of these home-mortgage loans are delinquent, a tiny fraction of the $32 billion in total problem loans reported by the S&Ls. The remaining $30.8 billion in delinquent loans stems largely from non-single-family mortgage loans or related loan categories. The delinquency rate on the commercial and multi-family residential mortgage categories (along with a small volume of non-housing consumer lending) is still traded at $28 per barrel. Throughout the southwest of the United States, land prices are crashing along with oil, and the cash flow to support highly leveraged real estate is evaporating with the oil flows.

That is to say, *no reduction in interest rates will have any impact on the real-estate disaster*. Paul Volcker is in the position of a doctor used to prescribing iron pills for anemic patients; they don't do much for a punctured aorta.

The dollar doomsday machine

How long can the Fed keep money rates down? There are three kinds of money. One, namely, monetary gold, was demonetized for the interim, when the United States closed its gold window in 1971. The second is primary bank deposits, i.e., real, earned money, such as the proceeds of sales in international trade. The third is the kind of money banks manufacture by re-lending these primary deposits.

Bad money drives out good. To the extent that the Federal Reserve props up worthless bank assets by pumping money into the banking system, real money will avoid the dollar. Ronald Layton-Liesching of Chase Manhattan's Investment Banking division points out that there are two, distinct money markets. The Federal Reserve presides over the first, in which solvency is measured by whatever the regulators say it is. But the Fed has little direct influence over the second, namely, the large overseas private interests who ultimately must lend the United States what it needs to finance a $150 billion annual payments deficit.

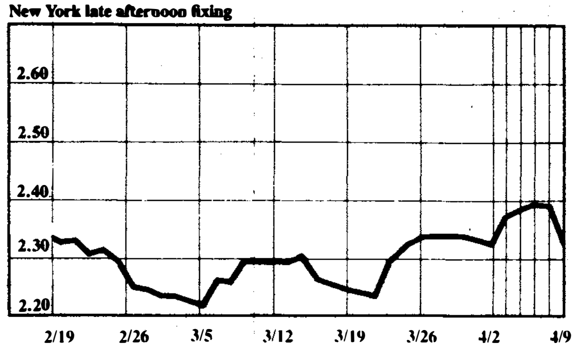
Holders of real money now dominate the international markets. After the collapse of most developing-sector debtors, the large international banks have virtually stopped lending. The international lending market is now dominated by the offshore "Eurobond" market, i.e., the market for securities purchased anonymously in Europe or elsewhere. The market is funded by about $500 billion annually in "black" or "grey" money, including proceeds of international drug traffic, flight capital, and so forth.

Dollar Eurobonds have already begun to fall in price, as European money grows suspicious of the dollar. Previously, major American corporate names paid the same interest rate in the Eurobond market as did the U.S. Treasury. Now the corporations pay about 1% more. "The people who buy Eurobond and the people who buy Treasuries are different people," Layton-Liesching explains. "European investors expect the dollar to fall, and are more hesitant to buy U.S. paper."

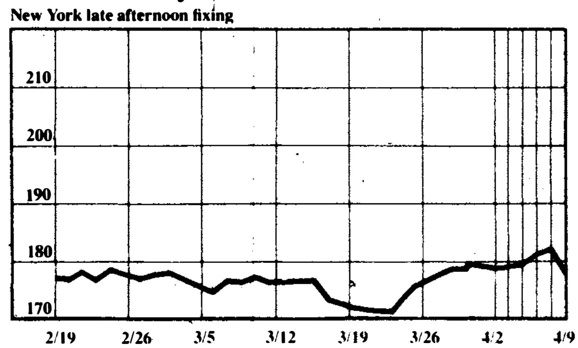
The United States now borrows $150 billion a year, most of it from these sources, to finance its payments deficit. A run against the dollar will pull money out instead of bringing it in, forcing up American interest rates. If the banking system has not crashed before a run against the dollar, despite the open pump at the Fed, it will crash then. The IMF meetings have merely confirmed that the rest of the world has decided to leave Paul Volcker and the American banks to their fate.

Currency Rates

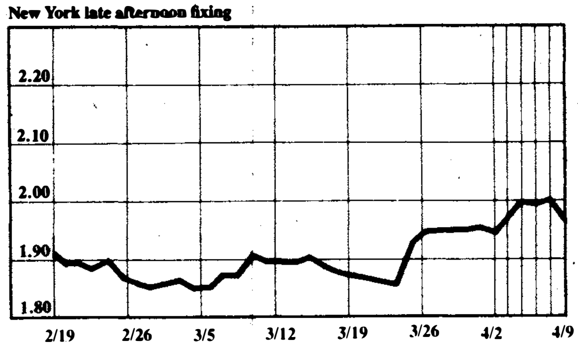
The dollar in deutschemarks
New York late afternooon fixing



The dollar in yen
New York late afternoon fixing



The dollar in Swiss francs
New York late afternoon fixing



The British pound in dollars
New York late afternoon fixing