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Dr. Doom shies away from the edge of the economic abyss

by David Goldman

"The magnitude of the debt problem itself suggests that it would seriously undermine the ability of the economy to revive quickly from the next business recession. Consequently, until there is solid evidence of a significant economic rebound, monetary policy must take the risk and err even further on the side of accommodation. Lower interest will ease the debt burden in the United States and, particularly, in developing countries. Further monetary ease will give marginal borrowers the opportunity to survive. We must stretch out the period in which debts can be written off by creditors and in which debtors, therefore, can recoup earning power. To be sure, this monetary policy approach runs the risk of rekindling inflation, but the alternative—deflation—is also punishing and is the more immediate threat to our economic stability. On the one hand, the monetary throttle can always be pulled back if need be, but on the other hand, once a deflation is under way, even large reserve injections may not immediately halt the decline in economic activity and the contraction in income flows."

—Dr. Henry Kaufman, at a Kansas City Federal Reserve seminar, Aug. 28, 1986

Poor Henry Kaufman, known colloquially as "Dr. Doom." Salomon Brothers' chief economist, doubtless the most influential Wall Street seer, warns of an uncontrollable deflation, 10 months after such a deflation began with the crash of oil prices, followed closely by the collapse of farmland prices, urban real-estate prices, and the price of commodities in general. While oil prices are now 60% below their 1980 level, other commodity prices have not done much better. Using the International Monetary Fund's index of non-fuel commodities, we project prices to have fallen 40% below their 1980 levels by the end of the present year.

In two respects, Dr. Doom's prescription is incompetent. The first is merely a matter of timing. The point was reached before the turn of the year, after which large reserve injections would do nothing for the decline of economic activity. The banking system can no longer lend, and the borrowers can no longer borrow.

In fact, borrowers from the U.S. Treasury on down, now depend upon two principal sources of funds: the largesse of America's creditors, led by Japan, and the availability of the $200 billion per year conduit for anonymous international money, known as the Eurobond market. The collapse of the dollar to barely over 2.00 deutschemarks during the past few weeks indicates what the *anticipation* of Dr. Doom's program has already done. Why should foreigners invest over $200 billion a year in the U.S. economy, which is the minimum the United States must take in from abroad to cover its overseas deficit, if the Federal Reserve is paying the nation's bills at the printing press?

Kaufman's report in the cited speech is otherwise accurate regarding the debt crisis. "Most noticeable," he said, "is the rapid growth of debt. At the end of 1985, total credit market debt—mainly households, businesses, and governments, but also including the financial sector—totaled $8.2 trillion, compared with $4.6 trillion at the start of the decade and $1.6 trillion in 1970. . . . Debt rose annually by 7.25% in the 1960s, by 11% in the 1970s, and has increased by almost 12% at an annual rate thus far in the 1980s. . . .

"A significant deterioration in the quality of credit has accompanied this swift debt growth. In the United States, this has been most noticeable in the business sector. . . . [The number] of AAA-rated industrial and utility corporations has been cut to 25 from 56 a decade ago. . . . Currently, the size of the high-yield high-risk bond market is about $100 billion, or roughly 21% of outstanding corporate bonds. In 1976, the size of this market was nearly $19 billion, or 9% of outstanding holdings. At present, only the paper of one large bank holding company is rated AAA. Ten years ago, this numbered 14. . . .

"This credit quality deterioration is also evident in other sectors. In the state and local government market, overall credit quality eroded for the seventh consecutive year in 1985, the latest year for which we have complete data. In the agricultural sector, the value of farmland, after peaking in 1981, has fallen by 25%, while farm debt has continued to mount. As a result, over the past five years, farmers' net worth has fallen by 30%, and many farms are in disrepair.

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Even households do not show the financial strength they enjoyed a decade ago.

"Both the ratios of household debt to disposable personal income and to net worth are at record highs—they were 25% and 15% lower, respectively, 10 years ago. . . . In the past four years, for example, while disposable income has risen by 32%, households have taken on 42% more in mortgage debt and an extraordinary 73% more in installment debt.

"In addition to the ongoing deterioration in these sectors of the economy, there is a relatively new area of weakness—commercial real estate construction. We are just beginning to realize the extent of this problem. Significant real estate loan losses have been reported at a number of large banking and thrift institutions, not only in the Southwest, but nationwide, reflecting the fact that rental income is insufficient to support the debt service of many office projects."

Hidden landmines

Dr. Kaufman does not bother to mention the hidden landmines in the debt picture. For example, there are more than $500 billion of loan guarantees floating around the U.S. economy, part of a $3 trillion global total of so-called "off-balance-sheet liabilities" of commercial banks. Much of the debt of weak corporations turns out to be also debt of weak banks, and so forth.

Then there are hundreds of billions of dollars of so-called "unfunded pension liabilities," which the retirees of Wheeling-Pittsburgh Steel and LTV Steel discovered, when those bankrupt corporations stopped paying benefits.

Whether the debt amounts "only" to the $8.2 trillion the Fed reported for the end of 1985, or exceeds $10 trillion, which is probably the case, does not matter much. The problem is that debt is huge, and "huge debt will add a very troubling dimension to the next business recession," as Kaufman puts it—in other words, when it can't be serviced, it will all come crashing down. This remarkable insight had already become apparent to steel companies, airlines, energy producers, real-estate developers, farmers, and their bankers, even before Dr. Kaufman decided to tell us about it.

Bankrupt borrowers can no longer depend upon the help of the federal government, which has its own problems, Kaufman adds. "In addition to the immediate monetary policy quandary in dealing with the debt explosion, there is the serious question of appropriate fiscal policy. Since the U.S. government has accelerated the rate of its borrowings more than any other sector, it would seem at first blush that a sharp reduction in the budget deficit would be appropriate. Here, we face a serious judgment problem in policy, because a drastic pullback in the deficit would contribute to fiscal drag just when economic growth is seriously lacking in vigor. . . . The fiscal quandary and its implications for debt growth and economic and financial stability are deeper still. A large reduction in the deficit over a short time span weakens economic activity even further, while small reductions would do little to solve the 'deficit problem.'
take place with a large deficit at the outset, it will be extremely difficult for our legislators to quickly opt for an even higher deficit. Thus, the legacy of the debt explosion that we have experienced may well be that the next recession will have to be overcome mainly through monetary ease with little help from fiscal policy."

Print a lot of money and bail us out, Kaufman says. "Until there is solid evidence of a significant economic rebound, monetary policy must take the risk and err even further on the side of accommodation. Lower interest rates will ease the debt burden in the United States and, particularly, in developing countries. Further monetary ease will give many marginal borrowers the opportunity to survive."

Second, Kaufman demands, turn the regulatory agencies over to us: "Centralized monitoring and regulation of our financial system should be established. . . . Financial institutions should be required to report their assets and the lower of cost or market value. . . . Official regulatory agencies should be required to rate the creditworthiness of the financial institutions under their jurisdiction. These ratings should be made public after a delay. . . ."

In other words, Kaufman wants both the money for a bailout, and the chance to use this money to buy up whatever bankrupt financial institutions Salomon Brothers and its fellow sharks want to.

That, however, is not enough in a world where the United States is borrowing over $200 billion a year to pay its import bills with other countries. The United States itself must come under the jurisdiction of a "new official international organization," run by the sharks'

Specifically, "To contain the debt problem, international cooperation and coordination must be strengthened. A new official international organization, consisting of a key central bank and other officials, should be established. This organization should work toward achieving uniform accounting, capital and reporting standards of major financial institutions. It should monitor more closely international capital flows by promulgating better reporting standards. In a world with a rapidly growing web of financial linkages, such improvements are essential not only to rein in debt growth, but also to achieve effective monetary policies."

Of course, "The changes that need to be made to prevent a debt crisis from causing major damage are difficult to engineer, because the many vested interests involved will attempt to limit the necessary legislative initiatives." To date, the resistance among such "vested interests" has been less than heroic. Faced with the general failure of their banks and savings institutions, Texas, Oklahoma, and Louisiana have all opened the doors to interstate takeovers, and the federal regulators have hastened to subsidize the yard sale, on behalf of the sort of major banks which employ Salomon Brothers as their adviser in acquisitions. The problem emerges as those major institutions themselves go into the barrel.