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Donald Regan topples the U.S. debt pyramid

by David Goldman

Federal Reserve chairman Paul Volcker succeeded in lowering commercial banks' prime lending rate by 2% between January 1985 and 1987, delaying a crash of several trillion dollars' worth of bad debt in the U.S. economy, through one means: The United States imported $150 billion worth of capital from abroad in each of the past two years. In real economic terms, the United States must import, net, one-fifth of its physical consumption; in financial terms, it imports two-fifths of what economists inappropriately call "savings."

It is fair to expect that the cessation of capital inflows, let alone a mass exodus of foreign funds, would knock U.S. interest rates back up by 2% almost immediately, and that mass withdrawals of foreign capital could push U.S. rates well into the double-digit range that Volcker introduced during 1979-83.

That is the sort of fire with which White House Chief of Staff Donald Regan, Treasury Secretary James Baker, and, indeed, President Reagan are now playing. Either no one has explained to Regan that the real estate market, the thrift institutions, major portions of the commercial banking system, and other categories of debt, will come crashing down with a 2% rise in interest rates; or he is doing all of this on purpose. What is unique about the emerging crisis is the fact that trillions of dollars worth of debt are in immediate jeopardy.

A vast transformation of the dollar-based financial system has taken place during the past four years, in which ordinary commercial bank or thrift-related lending has disappeared, in favor of the polymorphous substitution of tradable securities. The premise of this activity is simple: The capital base of the banking system is exhausted by bad loans, and the banks are terrified of depositor runs. To avoid raising additional capital, or becoming more dependent on short-term deposits, the banks have constructed a multitrillion-dollar detour. That is what Donald Regan, one of the principal architects of this system, has thrown onto the fire, through the competitive devaluation of the dollar.

The detonator: S&Ls

Edwin Gray, chairman of the Federal Home Loan Bank Board, made the issue especially poignant in testimony before the Senate Banking Committee on Jan. 21, in which he revealed that the deposit-insurance reserve for the $890 billion savings and loan system had fallen to a mere $1.9 billion—less than one-fifth of a percent of insured deposits. In fact, the FSLIC is insolvent, Gray explained: The shrunken fund guarantees over $2 billion worth of loans to bankrupt savings and loan institutions made by the regional Federal Home Loan Banks. If the loans are not repaid, the regional banks will call the loans, and the FSLIC will be unable to make good on its guarantee. Matters are even worse than that: 347 savings and loans are now losing $2 billion per year, and there is already an additional $2 billion worth of emergency requests on Gray's desk.

Estimates of what the FSLIC must pay out to depositors to wind up the affairs of bankrupt S&Ls vary enormously; last year, it paid out $1.5 billion, by postponing billions of dollars worth of problems, merely through permitting insolvent institutions to continue to function. However, the $25-75 billion estimates in circulation will change according to interest-rate levels. S&Ls began failing in the early 1980s, when the combination of banking deregulation and astronomic interest rates threw them into losses. Most of them hold substantial portfolios of old low-interest mortgages, and when

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their average interest-income falls below their cost of funds, they bleed to death.

The Treasury is currently lobbying for a plan to recapitalize the FSLIC "off-budget," that is, by issuing bonds against the FSLIC's assets in troubled S&Ls, and by assessing healthier S&Ls a higher insurance premium to rebuild the FSLIC's reserves. Ironically, the savings and loans bitterly oppose the plan. Under banking deregulation, an S&L that wants to avoid higher premiums to the bankrupt FSLIC, can switch to commercial-banking status, and leave the system entirely. (At the same time, commercial banks which want to deal in securities can give up their banking charters, as Chase Manhattan and Morgan have threatened to do, and become finance companies.)

It is not clear that the Treasury's plan will work in any event, for the simple reason that the remaining solvent thrift institutions have already threatened to desert it; whether anyone would buy the bonds is another question entirely.

However, the unstated premise of any discussion of this trillion-dollar problem is: Will $150 billion in foreign capital continue to enter the United States each year? Washington's suicidal behavior respecting the present competitive devaluation of the dollar indicates a strongly negative answer. If the Japanese and others stop replenishing the U.S. capital markets, and interest rates shoot up, the Treasury's proposed $25 billion over five years, will have about as much impact as a pea-shooter against a charging rhinoceros.

The real estate crash

EIR's first *Quarterly Economic Report* of 1986 calculated that at least $100 billion of bad commercial real-estate assets were sitting on the books of savings and loan associations, and that an additional $150 billion stood to go sour after "tax reform" eliminated most of the reasons such projects were built in the first place.

An unofficial calculation of the thrift industry's performance during the third quarter of 1986, conducted by the Federal Home Loan Bank Board in early October, shows a net loss for the entire industry of $257 million. What the actual loss might be is far from clear; an early FHLBB projection showed a net profit of $500 million. The three-quarter-billion-dollar swing into the red was attributed to the late arrival of data from the devastated Texas thrifts. However, a wave of billion-dollar bankruptcies in Texas, California, and Florida during the fourth quarter, will increase the losses drastically. Virtually all of this is due to collapsing real-estate values.

The price of prime commercial property—including the Manhattan market—will fall by at least 25% in the next year, and perhaps considerably further. The only reason values have not already collapsed, is that lower interest rates have lowered the carrying costs of bad real-estate debt; a return of interest rates to January 1985, let alone January 1980 levels, will cause a crash.

The worst of it is that the S&Ls, as major holders of problem properties, have maintained real-estate values at artificial highs, by keeping bad loans on their books. As they are forced to liquidate such loans, they will force more property onto the market, collapsing the value of other properties, and forcing rents down. The self-feeding cycle will make life exciting for the bank regulators for some time to come.

In fact, the effect on the savings banks' own portfolios, terrible as it is, may be trivial compared to the problems for the federal government, which has guaranteed almost $1 trillion of paper backed by home (as opposed to commercial) mortgages. Although commercial real estate is much worse off than residential real estate, the collapse of the entire market will rapidly engulf first multi-family, then single-family, real-estate values as well.

Uncle Sam gets the bill

The capitalization of the federally sponsored agencies is trivial relative to the potential demands upon them. The Federal National Mortgage Association has $92 billion in debt, and only $1.3 billion in capital. Losses in excess of that will presumably be borne by the Treasury.

A study released Sept. 25 by the Committee on Government Operations of the U.S. Congress warned that "faulty and fraudulent appraisals on the real-estate loans of federally insured financial institutions" endangered the thin capitalization of the federally backed agencies.

As long as the thrifts (and other lenders) are able to maintain the conspiracy of silence concerning bad real-estate debt, such problems can be postponed for future reckoning. A rise in interest rates, however, will force them out overnight.

But the likely collapse of the federal mortgage-guarantee agencies is only where the trouble begins. More than two-fifths of savings banks' total portfolios now consists of mortgage-backed securities, rather than mortgages as such. Supposedly, the securities, which can be sold on the market at a moment's notice, give the banks more liquidity. But a security that can be traded at a moment's notice, can also lose most of its value at a moment's notice, should purchasers decide that the federal government's "full faith and credit" might not be all it is supposed to be. A sharp rise in interest rates, and a significant increase in the default rate for home mortgages, could collapse the value of these securities, and destroy much of the assets of the savings banks almost instantaneously.

Now, they will be in the same position as the commercial banks, which are covertly selling off loans to developing-sector borrowers on a gray market, at 20-60% on the dollar. Rising consumer loan delinquencies, combined with rising interest rates, will wipe out much of the value of the "securitized" assets, and the financial institutions holding them will have to report the decline in value on a quarterly basis. That will trigger hundreds of simultaneous insolvencies.