World financial system back on the brink

by Chris White

The world financial system rolled inexorably back to the brink of financial catastrophe during the last week in October. Wall Street's paper-hangers, with their effort to sneak a $350 billion-plus expansion in outstanding bank credit through the markets, as the objective of the latest round of so-called Leveraged Buy-Outs (LBOs), found themselves out in the cold, as international and domestic bond market managers began the short walk out of U.S. corporate debt and into what they call "quality."

The prospect of devaluing all U.S. debt outstanding, by some ratio of the magnitude of debt taken on to finance the buy-outs, had proven to be too much for the international money-managers. The RJR-Nabisco buy-out looks to have been the straw that broke the camel's back. The announcement in the week ending Oct. 22 of the transaction which, with $17-25 billion in equity purchases to be financed, would leverage approximately nine times that amount through the banking system, prompted first a walk-out, supposedly led by the Swiss, from the Euro-bond market, and the sudden collapse of the U.S. market for corporate debt.

Holders of certain U.S. corporate bonds saw the face values of some of their holdings depreciate in amounts only comparable to last year's stock exchange collapse. Others saw premium-grade paper turned into junk bonds overnight. Mutual fund managers redivided their portfolios, recommending that holdings of corporate debt be reduced from 50% to 20% of the total. David Schultz of the Newton Income Fund told the *Wall Street Journal* Oct. 28, "If you get caught with one bond in your portfolio that goes down 20%, your year is over."

The collapsing bond market is merely one among the detonators ticking away internationally. Also to be included are: 1) the U.S. dollar, sliding downward since the end of September IMF meeting, now on the eve of a widely expected post-U.S. election sell-off organized by the Bank for International Settlements; 2) the international debt situation, facing a new Ibero-American initiative for mid-November; and 3) the bankrupt U.S. banking system. As the Wall Street sharpies triggered the bond market crash with their latest paper-pulping schemes, so did they begin to pull out the props from under each of those three crisis flashpoints.

Warnings from Greenspan and Phelan

The emerging dangers prompted both Alan Greenspan of the Federal Reserve and John J. Phelan, Jr. of the New York Stock Exchange to issue frantic warnings. In a letter to congressional leaders released Oct. 27, Greenspan warned banks to be very careful about making loans to finance Leveraged Buy-Outs. The Fed chairman also recommended that Congress change the tax code to introduce obstacles to the practice. His letter was thought to be the prompt for First Boston's rapid withdrawal of a junk-bond issue designed to provide part of the financing for Campeau's takeover of Federated Department Stores.

At a lunch hosted by the New York Financial Writers' Association, Phelan said he sees "great concern" about companies heaping on debt to finance huge takeover deals. If it keeps up, there will be "nothing but crazy paper in the world," he said. He warned of the consequences for debt-strapped companies if a recession should arrive. On Oct. 19, Phelan, along with Malcolm Forbes, had been the star attraction at a Merrill Lynch-organized coast-to-coast sales pitch to get investors back into the market. Then he had said that investors were "almost paranoid" about taking risks since the Oc-

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tober 1987 stock market crash. He told investors to treat their stocks and bonds as long-term investments, like their homes, and not worry about them.

The paranoia he warned about is obviously highly contagious, since it's not the financial situation so much that has changed, but rather Greenspan and Phelan who are perhaps beginning to realize what their combined, year-long effort to bail out the Titanic of the dollar credit system has actually unleashed. Their pump-priming has gotten to the point that it's merely sinking the vessel faster. David Ruder at the Securities and Exchange Commission is still manning the pumps. "I don't purport to be able to decide what the best debt/equity ratio is for America's companies. If market forces have moved to the point that there's greater leverage for the companies then that may be the right way," he said.

Meanwhile, corporate equity was liquidated at a $140 billion annual rate during the second quarter of this year. Corporate borrowings from domestic and international bond markets have been running at or below the same level. Nonfinancial debt outstanding, in the form of bonds, mortgages, bank loans, and other credit instruments, at the end of last year, was $1.89 trillion, according to the Oct. 28 *Washington Post,* 56% of the $3.356 trillion supposed net worth of the corporations. When the net worth collapses back to the levels indicated by an 800-point Dow Jones Index of early 1982, the debt, a year later, is going to be more than three times the net worth. That means little or nothing; since the economy as a whole is a net losing proposition, dependent on imported goods for about 25% of net throughput, and expected to support the claims of $15-20 trillion of paper, the net book worth of the U.S. corporate sector is more or less irrelevant.

'Creative financing'

The epitomes of financial orthodoxy, paragons of the methods they called "creative" or "innovative" financing, are the ones who get left holding the proverbial bag—one which they themselves made. The size of the "bag" was estimated by Oppenheimer and Co. in the Oct. 28 *New York Times*. Beyond the latest round of LBOs, banks have financed $48 billion worth so far this year; this brought the total for the last two years to about $150 billion, approximately twice the ridiculously low figure for banks' exposure on account of Third World debt. The doubling rate of this type of debt is converging on that of the AIDS virus.

For Bankers' Trust, buy-out loans are reported to be 104% of paid-in equity; for Wells Fargo 138%; for Manufacturers' Hanover 98%; others like J.P. Morgan and Chase Manhattan are in the range of 50%; Citibank is estimated at 43%. With exposure to the Third World, even at the reduced levels of the last year, sufficient to wipe out banks' equity, it is easy to see that the banks are bankrupt many times over.

Specialists argue that there is no cause for concern, even while Greenspan and Phelan are raising the warning flags. You see, the issuing banks do not hold on to the loans issued; therefore, they are not at risk. The loans are broken up, and distributed in smaller portions throughout the banking system, with banks paying each other commissions for the privilege of taking in each others' dirty laundry. Far from "nothing to worry about," the practice has contributed to undermining the banking system as a whole. This, after all, was why the latest round of Leveraged Buy-Outs was launched in the first place. In part an electoral tactic to keep things going through Nov. 8, the envisioned $350 billion-plus pool of new credit was to be the means by which the sharpies in the banking investment community kept their shell-game going for a few more months, by providing an outlet for the $75-300 billion worth of CDs that mature this fall.

Since the shell-game has to keep growing, at an the kind of accelerating rate implied by the last two years' worth of LBO financing, merely to survive, failure to grow means that the game collapses in on itself, and the leverage that banks had built up through their debt financing becomes leverage reversed against the banking system itself: the collapse of one dollar's worth of financing bringing down anywhere from 100 to 1,000 times the magnitude in paper devalued as the book value of assets evaporates.

Shearson Lehman Hutton is part of the team that is looking to raise the funds required for the RJR-Nabisco buy-out, the $20 billion whopper. Shearson also holds about $146 million of preferred stock and debt of MCorp from Texas. MCorp has let it be known that it intends to seek Chapter 11 bankruptcy within the next 30 days. The bankruptcy will knock out Shearson's holdings. They could lose the whole thing, and they are not alone in that. The loss will leverage through the whole pool of securitized assets. Small it may be, it also may be enough to set off one or two of the detonators that are hooked up to the whole $15-20 trillion in unsecured paper.

Greenspan and Phelan really needn't worry about the growth of debt. It's way too late for that. The time to worry was this time last year, not now. They were the ones who insisted, against the reorganization plans put forward by Lyndon LaRouche and his friends, that the shell-game could be kept going, week by week and month by month, to avoid a repeat of October 1987. They happened to be wrong. But worrying about the present consequences of mistakes made a year ago won't help deal with the problem. They insisted then that mistaken policies be continued, which, it was clear, would make the ultimate day of reckoning worse, when it did occur. Now they run the opposite risk. In acting against the spread of the debt canker, they surely act also to precipitate the collapse of what they insisted on building up in the first place. Only this isn't like a kid's game, where you can kick over the board because you don't like the way things are going, and start all over again. It's the lives of entire nations and regions of the world, and the existence of whole cultures. Maybe they are incapable of learning that there are other ways of doing these things, ways which work without leading into the biggest financial catastrophe in human history; hopefully, others are not.