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EIR Economics

Financial house of cards is nothing to sneeze at

by Chris White

There's a story about Samurai-style executions in Japan. "When are you going to do it?" asks the brigand after the razor-sharp samurai sword has flashed past his ears. "Just don't sneeze," comes the reply from the executioner. The quarterly auction of Treasury debt, held in the second week of August, may well turn out to have been just such an execution, marking an irreversible turning point, according to top-level financial specialists in Europe, on the pathway toward the next ratchet-step of financial and economic collapse.

Contrary to their practice of the last years, Japanese investors did not snap up the lion's share of the financing. Instead, only between 10% and 15% of the approximately $30 billion of debt marketed or redeemed was placed with the Japanese, and that was concentrated in relatively short-term 247-day notes, rather than the 10- or 30-year bonds which were also part of the package. The Wall Street investment houses, which broker the sales for the U.S. government, have been left holding the debt for which buyers could not be found. The collapse of bond prices, since the ill-fated auction, leaves those houses now facing losses in excess of $200 million, as a result of the hole which has suddenly appeared in financing the indebtedness of the United States.

On the Japanese side, it can be assumed that the old men who rule that country have finally had enough of the continued and escalating pressure against their country and its government, which has been proceeding in unrelenting fashion ever since Henry Kissinger's "second Lockheed Affair," the Recruit Cosmos so-called political pay-off scandal, broke last October on the eve of the U.S. elections. After the Recruit scandal, the debacle with the FSX project, the arrogance of the Super-301 retaliatory provisions of the Omnibus Trade Act of 1988, the Moonie-managed "Tail-gate" attacks on U.S.-Japanese defense co-operation, and the disgrace of Prime Ministers Takeshita and Uno—after all this, Japan, it can be concluded, has decided to fight for its very life.

Were there not a growing military threat arising from developments in the Middle East and Eastern Europe, the Japanese decision to stay out of the Treasury debt auction would have already had a profound impact on the dollar. Even with these crises, Japan's decision is now becoming compounded with the emergence of the first signs of this fall's awaited payments crisis for the U.S. credit system.

Recent filings of corporate quarterly reports with the Securities Exchange Commission are bringing to light the impending collapse of Wall Street's leveraged buy-out/junk bond financial empire. Since the so-called income streams claimed from such financings have helped to leverage the growth of hyperinflationary credit in the banking system, the collapse of the so-called LBOs, like the Japanese withholding of funds, foreshadow what can be expected to develop this fall. And it is not only the LBOs. The limited partnership, publicly sold, to raise some of the finance for the takeovers funded through LBO junk paper are collapsing. And, now that the savings and loan bailout bill is law, we have the beginnings of a flight out of government-backed mortgage securities.

LBO mania

In recent years, leveraged buy-outs have become the rage of the merger-aquisition mania gripping Wall Street. Corporate raiders like Carl Icahn, with the aid of junk bond specialists like Drexel Burnham's Michael Milken, have grabbed headlines, snatching up large companies willy-nilly and reporting investment returns of 50-100% and even higher. The deals have been financed through "junk bonds," in which huge amounts of debt issues have been floated to buy these companies—in most cases, far beyond the ability of these acquisitions to finance that debt.

The chickens are now coming home to roost. Several of

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these companies have announced that they are unable to meet interest and principal payments on their high-yield junk bonds. These firms include SCI Television, Seaman Furniture, Integrated Resources, and Zapata Corp.—the Texas company founded by George Bush.

According to a Moody's financial report, the possibilities for large-scale junk bond defaults under conditions of a major U.S. economic downturn are far greater than in the last severe recession in 1982. Whereas in 1982 the corporate sector had some $23 billion of junk bond debt, today, says Moody's, the current figure is at least $210 billion, most of it held by companies acquired in leveraged buyouts.

The Kohlberg, Kravis story

The financial press sounded the alarm during the third week of August. The lead in the business section of the *New York Times* was headlined "Cracks in House That Debt Built," and featured the growing insolvency of companies taken over through leveraged buyouts engineered by Wall Street's superstar buyout specialist, the firm Kohlberg, Kravis Roberts and Company. KKR has engineered some of the biggest LBO deals, including the huge RJR Nabisco takeover. Its founding partner, Henry Kravis, was finance chairman of George Bush's New York State campaign committee last year.

With the impending insolvency of SCI Television and Seaman Furniture, KKR investors are on the verge of absorbing big losses. Two other KKR takeover companies will likely follow suit, and other sensational deals are turning sour. Deals involving Owens-Illinois and Beatrice Foods are said to be among them. The *New York Times* mooted that these reversals could result in congressional legislation to curb junk bonds and LBOs, particularly to revoke interest deductions for junk bond debt. By then, of course, it will be too late. The mickeys who were suckered will be cleaned out. The banks, and others who extended the credit to finance the arrangements, will end up with the equity from the deals. Middlemen like Kohlberg and Kravis will go the way of the 18th-century architect of the South Sea Bubble, John Law.

KKR's unscrupulous machinations are also touched upon. In recent years, KKR has put a decreasing proportion of its own funds as risk capital into the buyouts, while tremendously expanding the use of investors' money and taking out huge fees and service charges. In the past, KKR would emphasize "restructuring" the takeover companies and management streamlining; now, with the debt mountain crushing companies, they engage in unabashed asset-stripping to raise the cash to frantically cover payments. This has resulted in an increasing number of companies on the brink of insolvency, with returns to investors tumbling down from the lofty levels of 60% or more to 20% and less.

Resorts International

Resorts International, onetime superstar of the gambling casino business, is now verging on bankruptcy. Taken over last year in a leveraged buyout/junk bond deal by entertainer Merv Griffin, Resorts is facing $130 million in debt payments this year, with a cash flow of only $60.2 million. Its losses have increased in almost every quarter for at least the last two years.

Resorts International attributes its bad fortune to "a declining market, higher operating costs, eroding market shares," and just plain bad luck at its own gambling tables. One brilliant "solution" being floated to its bondholders, who have already been taken to the cleaners, is an offer to exchange some or all of its $930 million in junk bonds for equity in the losing company.

In each of the cases cited, the income available from the company's current cash flow is not sufficient to maintain payments against interest and principal of debt coming due. The absurd example of Resorts suffering from lowered gambling income is merely the reflection of what is otherwise seen in the construction and automobile industry. Sales and orders are down, because people cannot afford to buy. People cannot afford to buy because of the continued refusal to create productive jobs or pay decent wages. Meanwhile, debt service obligations have grown past the point at which current income, from current production of physical wealth, can continue to be supported.

Two years after the 1987 crash, one is reminded that two years after the stock market crash of 1929 came the banking collapse of 1931. The Herbert Hoovers of 60 years ago insisted that "the fundamentals are sound," that all that was needed was belt-tightening, budget-cutting, and austerity. Overlooked, now as then, is the reality that gutting wealth-production, while increasing outstanding paper obligations, leads to disaster.

A Brookings Institution report issued during the third week of August highlights an aspect of this. The report points out an ominous similarity between events leading to the S&L debacle, and the current situation with commercial banks. To indicate just some of the specifics:

- Almost one-third of all bank assets are held by banks with less than the 6% capital considered the minimum for a properly run bank.
- Approximately 48 banks with $43 billion in assets have capital ratios under 3%. The risk-adjusted capital ratios of three major banks—Bank of America, Chemical Bank, and Manufacturers Hanover—are below 2%. With its significant portfolio of troubled domestic loans, Bank of America is realistically at or near market value insolvency," says senior Brookings economist Robert Litan.
- Since accounting methods permit banks to overstate the market value of their assets, the magnitude of bank insolvency is much worse.

The combined effect of the Japanese withholding of funding, and the beginning collapse of the LBO house of cards, are just two of the detonators ticking away on that upcoming disaster.