Take the crash now! Waiting will make it worse

by Chris White

A number of proposals has surfaced in recent days, from people who ought to know better, or institutions which should have other things to be concerned with, about what to do with the past few years' grotesque expansion of unpayable U.S. indebtedness. The combined effect of the proposals is to attempt to roll over the mass of debt which has to be serviced at the end of this month, around about $1.25 trillion, into the early part of next year.

Be warned: It would actually be much better to take the crash now and get it over with. If the monstrous pyramid of paper is rolled over again, for a few months, the delay will only ensure that the collapse, when it does come, will be that much worse. More damage will be done to the equity investment and savings portfolios of ordinary people, more people will lose homes, and more insurance policies and retirement accounts destroyed, than if the crash were taken during this autumn.

Perhaps the most dangerous among the current crop of proposals was floated on Sept. 7 by Comptroller of the Currency Robert Clarke, the Treasury Department official who is responsible for overseeing the nation's banking system. Clarke wants to see the capital reserve requirements of nationally chartered commercial banks sliced in half, from a ratio of 6% of assets down to 3%. According to Clark, the proposal was checked with both Alan Greenspan at the Federal Reserve, and officials in the Treasury Department, before it saw the light of day.

Cutting the banks' reserve requirements in half means doubling the volume of liabilities secured against the same margin of capital. So here we have the nation's top regulatory officials putting forward, in all seriousness, as an "improvement," a measure which would permit the banks to take on another $1 trillion of debt as on-the-books liabilities.

This is not the first time the regulators have changed the rules when the banks get into trouble. Back in 1982, in the good old days, before what became known as "creative" or "innovative" financing, banks could only carry debt on their books until it was 90 days in default; then they had to write it off. Then the rules changed, so they had to report delinquent loans. And then the time was stretched out. And then, in 1983-84, the regulators permitted the burgeoning of what are now called off-balance sheet liabilities.

Now they are more blatant. And now the court system is getting in on the act as well: A federal district appeals court ruled in the same week, that commercial banks are entitled to sell, as securities, government-secured mortgage paper. By Sept. 11, that decision was being interpreted within the banking community so as to permit the securitization, and thus sale, of all bank loans outstanding. This way, banks in really bad shape, like Bankers Trust, Manufacturers Hanover, Bank of America, and Citibank, can get a slice of the income stream of others like Morgan Guaranty.

The twice-bankrupt Continental Illinois led the way in this, packaging $300 million or so of banks' leveraged buy-out loans into a security for sale on the credit markets. The only problem with this, is that of the approximately 15 banks holding more than $1 billion in buy-out debt, the total of such loans outstanding, about $40 billion, is 25% greater than their paid-in capital.

It might well be asked why the regulators and the court system are coming up with these crazy ideas. The world is on the eve of the biggest financial catastrophe in human history. More than $20 trillion of indebtedness and speculation, based on the dollar alone, is overdue to blow. The best-informed estimates are that this mass of paper wealth could begin to come down around the second week of October. Such informed estimates assert an 80% probability that such could happen.

The kind of thing being put forward by Clarke and the appeals court are part of the hysterical efforts being directed to attempt to tilt the whole in favor of the residual 20%. Their plan: Increase the debt by some magnitude, up to a trillion dollars perhaps; redistribute the losses within the banking system, through securitization of liabilities outstanding, to provide those who are short of earnings with a whiff of income for the weeks ahead; and set up sales of assets, which may never be concluded, to appear to offset losses on the accounts.

If, through such means, the potential October blow-out is averted, hold on to your hats, and whatever else you can hold on to, because by January-March of next year, the thus-delayed crisis will erupt in more violent form.

Condemned to repeat history

The eruption that is about to occur will no doubt take the form of "runs against the banks." Some of the older generation, who remember the last time, back in 1933, after the previous summer's Kreditanstalt affair in Vienna, probably still remember the day when Franklin Roosevelt declared a bank holiday, and shut down the nation's banking system to stop people from pulling their deposits out. That's the kind of event that is looming.

Runs against the banks, requiring emergency action by the executive branch to avert breakdown and chaos, is the third and last level of bankruptcy. It is the phase which is waiting to happen. It should have happened in 1988. It was delayed by the wave of leveraged buy-outs, culminating in the $25 billion takeover of RJR Nabisco by Kravis Kohlberg Roberts, and the banks who bankrolled them. Many of the buy-outs of 1988 were organized such that interest did not have to be paid until one year or 18 months after completion of the deal.

The leveraged buy-outs of 1987-88 were the end of the second level of bankruptcy, the bankruptcy of the financial system as a whole. During 1985-86 the financial system had gone into technical bankruptcy, unable to generate the revenue to service and amortize debt. The growth of debt and speculation since then, of all kinds—government, household, financial and non-financial business debt—from about $6 trillion to over $20 trillion, is the proof. The norm for the last years has been not to pay down the debt, but to roll over the bulk of the claims outstanding, adding $2 trillion per year in new debt and speculation.

The financial bankruptcy took place on top of the first level of bankruptcy, the collapse of the physical economy below break-even capacity, which took place around 1981-82, after Federal Reserve chairman Paul Volcker's high interest rate policy had delivered the *coup de grace*. The collapse below break-even is represented by the increasing impoverishment of the population, the collapse of household formation and maintenance, the collapse of productive employment, to below 20% of the work force as a whole, obsolescence of equipment, deficit in production of goods, filled by imported products, and the accumulating deficit in maintenance of basic infrastructure.

Contrary to the fashionable babbling of recent years, the growth of the financial side of the world economy is ultimately collateralized against the growth in productivity and output of the physical economy. Now we have something very different: The current money costs of break-even functioning would be between $4 and $5 trillion per annum, against the $2 to $2.5 trillion paid. However, neither the trained labor nor the goods exist to be bought to sustain that level of functioning, even assuming the $5 trillion or so were available. Indeed, since 1984-85, the combined total of debt and speculation has been increasing annually by the amount allocated to cover investment, wages, and material supplies for the economy.

Ultimately the paper claims embodied in the mass of debt are only worth the goods they can be converted into. The economic side has stagnated and declined, the combined debt and speculative claims against goods have been increasing at about 14% per annum.

The run against the banks, which is waiting to happen, is the point at which holders of financial instruments scramble to turn paper claims into tangible goods, in whatever form that might take. At that point the pile of debt collapses down the line of leverage by which it grew.

This is the threat which Clarke and the other officials are responding to, when they propose to double the volume of liabilities banks can hold against a given level of paid-in capital. The idiocy is brought to absurdity when Clarke argues that this would put commercial banks on the same footing as the savings and loan banks. Back in 1982, Treasury Secretary Donald Regan and Paul Volcker permitted the thrifts that survived 21% interest rates, to cut their capital standards in half, too. But it won't take seven years to push the commercial banks over the edge like it did the S&Ls. The commercial banks are in much worse shape than the S&Ls ever were. The scramble began back in June with the $1 billion default of Integrated Resources, the financial services company. Integrated was the first of a steadily growing line of large leveraged buy-outs that have gone belly-up. Not surprisingly, for leveraged buy-outs seem to have been arranged on the strange principle that debt service charges should exceed the company's operating income, sometimes by as much as four or five times.

Clarke and company should learn that you don't stop a run on the banks by throwing paper at them; you have to deal with the financial bankruptcy, and the collapse of the economy, which consecutively brought about the conditions for the run on the banks. What's called for is a return to production, with a reorganized credit system to make it possible. Under those circumstances, the expected losses might be contained. It will still be much less painful to do that this fall, than it will be six months later in the spring of 1990.