Prime rate cut won't stop deflation

by Steve Parsons

One could almost hear the cheers echoing throughout financial establishments on Jan. 8 when several major U.S. banks dropped their prime rate one-half point to 10%. For several weeks, such a move had been anxiously awaited. The Federal Reserve in December had cut its federal funds rate nearly 1% in the face of a sharp economic "slowdown." The banks had delayed, milking the greater interest rate spread as long as they could. But as the economic statistics worsened, the banks finally moved, to the relief of businesses faced with mounting cost pressures and declining profits. Most delighted was the real estate business, which has pinned its near-term salvation on hopes that lower interest rates will spur home-building and purchases.

But the harsh reality is that the interest rate drop will do nothing to ameliorate the galloping economic and financial collapse. The speculative debt bubble is bursting, with red ink pouring out of everything from manufacturing to financial enterprises.

While it is no secret that manufacturing industries are being hit very hard, Wall Street analysts are insisting that other sectors are "slowing down," but that there is no recession. Cited are such sectors as the retail market, where they expected sales to do unexpectedly well over the crucial Christmas season. The line was that overall retail sales in December increased about 5% from 1988's level. "Five percent is a very acceptable number considering that inflation is less than 4%," said one analyst.

This line was destroyed on Jan. 10, when Commerce Department figures showed a mere 3.8% seasonally-adjusted sales increase, and only 2.3% when not adjusted. But even more telling will be the earnings figures when they are calculated in a month or so. The analysts are dismissing the disastrous effect that deep sales discounts and markdowns had on profits, maintaining that the various cuts and markdowns were "well-planned," and that superior inventory and cost control measures minimized earnings reductions. They say the clothing sector showed much better sales than others featuring durable goods and mass merchandise, which were, at best, disappointing.

The deepest markdowns, however, came in clothing, which make the higher sales figures meaningless in terms of profits. Furthermore, the inflation rate is much higher than the "official" rate. Thus, the negative net sales figure relative to the official inflation rate will turn out to be even worse. Combined with the sharp sales discounts, and slow sales outside of clothing, there are big profit losses that, no matter how masked, will soon result in bankruptcies.

One of the biggest retail bankruptcies may occur on Jan. 15: the Campeau Corp., an over-leveraged, debt-laden conglomerate of department stores that includes the Allied and Federated chains, and such notable stores as Bloomingdale's and Jordan Marsh. On that date, Campeau must certify to a syndicate of banks led by Citibank that it is solvent and can meet a huge $2.34 billion debt payment.

On Jan. 4, the National Bank of Canada seized 35% of Campeau stock after the company defaulted on $100 million of debt. But on Jan. 10, Campeau managed to avoid defaulting on payments owed to its suppliers, when the banks permitted the company to use its Christmas cash receipts to pay its vendor bills. That could be a signal that the banks will accede to some kind of debt restructuring, including stretch-out of principal and interest payments, to avoid a bankruptcy that would have a shock effect.

Such restructurings, or "workouts," have become the latest financial rage, as the boom of debt-ridden leveraged buy-outs and speculative mergers disintegrates into insolvency.

Fantasies of turning cascading collapses into a "failures boom" is being spread all across Wall Street and the financial press. "Failure is a growth business," one investment banker told the *New York Times,* summing up the newspeak propaganda for plucking the silver lining out of disaster. Wall Street brokerage houses, whose advice and managerial expertise have caused the spiraling collapse of these corporations, are, to quote the *Times,* "preparing to earn huge fees over the next few years correcting the mistakes they helped make. . . . Making a profit by undoing its own deeds is a rich Wall Street tradition."

These parasites are drooling over the imminent Campeau collapse. Investment houses like First Boston, which is stuck with $500 million in worthless Campeau paper, are aiming to recoup their losses by carving up their host victim and finding mickeys to reabsorb new debt, while sticking smaller creditors with the loss.

Real estate is detonating

But despite the hype, as the Campeau case demonstrates, if bankruptcies and debt write-offs are avoided through such "workouts," the banks and investment houses are not only postponing and extending yet again the insolvent debt, but are saddling themselves with an even larger and more unmanageable debt load. This is what is happening in the biggest bubble of them all—real estate.

Many real estate companies and analysts privately admit that the relatively low rates of mortgage delinquencies and property foreclosures are fictions being maintained not just by lack of reporting of the real situation or by banks not declaring or writing off their non-performing real estate loans. Increasingly, private agreements between lenders and borrowers are being made in which debt is "restructured." That is, banks are agreeing to smaller mortgage and debt payments over a longer term, with effective interest rates often cut sharply. As in the home sales market in Texas, developers and landowners, as well as homeowners, are in effect just walking away from their properties, dropping the deed off at the banks, who then "buy" the properties for the value of the mortgages. The statistics may look good—mortgage delinquencies and foreclosures stay low—but the banks are getting loaded with so-called assets that are deflating faster than ever.

Despite the rhetorical nostrums from the likes of the National Association of Realtors that further interest rate cuts will reverse the real estate downturn, no amount of interest rate cuts, short of a hyperinflation that will totally shred what is left of the economy, will prevent the impending cascade of collapse. Things have gone too far.

Real estate debt is simply too enormous, both in the commercial and homeowner markets, and the income levels of business and individuals is insufficient to maintain the huge bubble. Some key statistics highlight the looming debacle.

Officially, real estate loans, as a proportion of commercial bank assets, have risen from 23% in 1974 to 37% in 1979, according the William Seidman, chairman of the Federal Deposit Insurance Corp. And it's going up, at a time when actual market values are, at best, stagnating, and when 30,000 parcels from savings and loans are about to be dumped on the market by the federal government.

At the same time, inventories of unsold homes in major market areas are skyrocketing, and the listing period for selling homes is doubling and tripling. For example, in the heretofore hot California markets, in the recent past there were three buyers for every house. Now, there are three houses for every buyer. In the San Fernando Valley, listings now exceed 11,000 in what has been typically a 6,500-7,500 listing market. In 1988, homes sold every 45 days; toward the end of 1989, it doubled to 90 days. Realtors in boom markets like metropolitan Washington, D.C. report the worst situation they have ever seen, at a time when defense and other federal budget cuts haven't even hit yet.

In Massachusetts, prices of raw land for development are down 20-30% in Greater Boston and central parts of the state, with several *years'* supply of building lots on the market. Plymouth has a three-year inventory, Ashland has a six-year inventory. Even worse, three times the current number of lots are about to be dumped on these markets.

In many cities, office vacancy rates are running at 30% or more. In the prime Center City area of Philadelphia, vacancy rates this year are expected to be 20%, a 5.8-year surplus, nearly double from the 3.2-year supply at the end of 1989. Inducements are effectively lowering rents 25%.

Mortgage debt as a percentage of personal income is simply unmanageable. From 1965 to 1973, mortgage debt comprised between 54% and 62% of personal income. Since 1983, it has zoomed from 53% to an impossible 76%, at the same time that consumer installment debt has gone from about 12% to 16% of personal income. In other words, debt alone now takes nearly every penny of individual income.

It should be no wonder that bankruptcy filings, both personal and corporate, are accelerating. For example, in Massachusetts, 1989 bankruptcy filings nearly doubled from levels of two years ago, and rose 59% last year alone compared to 1988. While the number of major corporate bankruptcies in 1989 have risen only moderately from 1987 and 1988 levels, the assets involved are skyrocketing. Through Dec. 11, some 133 companies had filed for Chapter 11, and the assets of these firms totaled $70 billion. In 1986, there were 159 companies that filed, but only $12.7 billion in assets were at stake.

Even though delinquent real estate loans overall are reported to be low at just 4.7% nationally, they are beginning to increase dramatically. From the end of 1988 to mid-1989, delinquencies in 10 states, 8 of which are in the Northeast, have increased 55%. Delinquencies in Massachusetts have nearly doubled (up 94.5%), and have risen 85.7% and 82.7% in New Hampshire and Connecticut.