

## Uncle Sam is insolvent: the \$5 trillion theft

by William Engdahl

With the U.S. economy sliding into depression, it is useful to look at an area which almost nobody is willing to mention: What is the state of the “full faith and credit” of the U.S. government today?

The answer is: Alarming.

The present depression is unlike any other in American history. In September-October 1989, the United States underwent a sharp contraction in bank lending as dramatic as the loosening of risk criteria which typified the “roaring '80s.” But, unlike 1930-32, today the solvency of the U.S. government itself is in question. How did this come to pass?

The government’s own budget, with an expenditure line of more than \$1 trillion, could be as much as \$400 billion in deficit in the next fiscal year, if the present known costs of the savings and loan bailout are added to the anticipated revenue shortfall. Beyond the operating budget itself, the government stands behind another more than \$9 trillion in obligations, of which more than \$3 trillion are accounted for by the accumulated national debt, and the balance by what are called “contingent liabilities.”

A novel report crossed my desk recently. Stanley Salvigsen, of Comstock Partners, points to a special aspect of the downturn. “There exists a gigantic web of legal obligations to pay money in order to make good on the many government-backed indemnifications and legal assurances spread throughout our financial system,” he notes in a recent client advisory.

As the economy weakens, foreign investors are abandoning the dismal U.S. economy, and the government of the United States will be forced to pay a *vastly higher interest rate premium* to honor its promises to pay. Who’s left holding the bag? The New York investment house Salomon Brothers

recently estimated that if the capital outflow from the United States in the first six months of this year were looked at as an annual rate, then foreign capital is leaving the country at a rate in excess of \$100 billion per year. Japanese and British fund managers have been liquidating U.S. assets across the board, including holdings of stocks, bonds, and other securities, and the debt of the U.S. government itself. For the first time, Japan has become a net seller of U.S. government paper. Yet, it is precisely such foreign flows of funds on which the U.S. government and banking system has depended, since especially 1982.

There is only one candidate, under present policy arrangements, for the task of picking up the tab. As you might suspect, it will be the U.S. taxpayer, if London and Wall Street investment bankers have their way.

### Off-budget shenanigans

Let’s look at just one tiny “off-budget” area that Washington has allowed to go out of control.

Some years ago, the U.S. Congress got the idea to manage the deficit by sleight of hand. Instead of paying for things directly on budget, it sponsored a variety of entities known in the jargon as Government Sponsored Enterprises (GSEs). Though most have never been tested in bankruptcy courts, they tend to convey the impression that the agency—such as the Federal National Mortgage Association or “Fannie Mae”—is backed by the legendary “full faith and credit” of the U.S. government. That’s normally strong assurance. The problem is that these off-budget obligations have exploded during the last 10 years of Reagan and Bush “voodoo” economics.

The largest single contingent liability is the controversial

Federal Deposit Insurance Corp. Created during the Great Depression to restore public confidence and stop bank panic by depositors, the FDIC is today at its lowest level of insurance reserves since 1934. Officially it has \$13.2 billion to cover total insured bank deposits of slightly more than \$2 trillion. If even one large bank, say of the size of Chemical or Chase Manhattan or even the Bank of Boston, were to require government bailout like the 1984 Continental Illinois bailout, the FDIC would be out of funds.

If depositors begin to withdraw funds and invest in gold or other commodities, ultimately the U.S. government could be forced to guarantee \$2.7 trillion, a sum that makes Treasury Secretary Nicholas Brady's incompetent S&L bailout look like chump change.

The signs that this is what is coming are already visible. On Sept. 20, Resolution Trust Corp. chairman William Seidman presented yet another set of proposals on how to deal with the S&L mess. What Seidman now wants to do epitomizes where the country is headed. He proposes that the government now *lend* money to finance purchases of assets of failed S&Ls. The original, and obviously unworkable idea, was that the government *raise* money to finance the cost of closing the bankrupt part of the system through such sales. Now, to help keep the costs of disposal down, and encourage buyers, the government is proposing to lend them the money to do it. Funny, isn't it, that the congressmen who have made so much noise about the way the Southwest Plan of 1988 was financed, with government giveaways to sharks like the Basses and Perelmans, have had nothing to say about this one. Seidman is also in charge at the FDIC.

### **The crisis in real estate**

Other GSEs, such as the National Mortgage Association or the Federal Housing Administration, guarantee tens of billions in home mortgage loans, or an estimated 88% of all U.S. housing credit outstanding today. The FHA in the last two years has begun to lose money for the first time in its history, and the fund may soon be bankrupt, experts say. Again, the government must make good on these obligations. Real estate prices continue to fall nationally and mortgage defaults are rising to scary levels.

Since real estate investment has provided the collateral for bank lending, troubles in the real estate sector spill over very quickly into the banking sector. As with the banks themselves, this process could go quite quickly now. For example, the largest private holder of commercial real estate in the United States is the Canadian-based company Olympia and York, owned by the Reichman brothers. The Reichmans are partners of Henry Kissinger and Lord Carrington in the Hollinger Corp. Now, they want to sell some 20% of their U.S. holdings of commercial real estate. Lazard Frères from New York has been retained to handle the sales. Their intent, it seems, is to raise money within the United States to finance their shaky operations in Great Britain.

What the Reichmans are actually setting up, is the first major test of what U.S. real estate markets will now bear. The sales will establish real price levels, not just on the commercial property directly affected, but in all market segments. The price levels thus established will have their impact in turn on the book values of the assets held by banks which have extended property loans. The Reichmans' test will then feed back into the kind of process that Slavigsen and Seidman are talking about.

### **'Reckless banks, absent-minded students'**

Or take the Guaranteed Student Loan program, which gives banks a 100% guarantee against student loan defaults totaling some \$100 billion. Unemployable ex-students cannot repay these, so, more for the government. And of course, President Bush and his administration, perhaps on advice from son Neil, the family financial wizard, decided to bailout the S&Ls off-budget by, you guessed it, creating yet another GSE, the Resolution Funding Corp.

Added up, the United States has legal obligations to pay, in event of default on all GSEs, theoretically as much as \$5.7 trillion, according to the FY 1991 budget.

As Slavigsen points out, in a deepening depression, with defaults on the GSE loans multiplying, the U.S. Treasury will be forced try to issue more Treasury bonds to, in effect, pay for a useless asset a second time. "The government has," he says, "by lending its credit rating and good name indiscriminately, created a situation in which its credit is being dragged down to the levels of those whose transactions it is backing, whether reckless banks or absent-minded student borrowers."

When the government credit rating is down, it must offer a higher return for its paper to attract investors. Never has the United States gone into a depression with such high interest rates and immediate prospects of far higher rates down the road. No wonder Federal Reserve chairman Alan Greenspan is terrified to mention the "R" word, let alone "D" word.

What this would add up to is devastating. It would mean a combination of higher interest rates, as primarily the government scrambles to borrow more, and hyperinflation, as more paper values are created to back up and cover for those which the government is committed to stand behind. Out of this, the U.S. government's "full faith and credit" guarantee would rapidly become the biggest inflation-generating engine the world has ever seen.

But this cannot be the reason why Alan Greenspan continues to insist that inflation remains the biggest problem facing the U.S. economy. If it were, he would have insisted on changing the policy a long time ago. Nor has the Bush administration anything more sensible to say. Among the proposals coming from that quarter, are that all such government-sponsored enterprises be required to maintain not less than a AAA-grade credit rating. What kind of absurdity is that, under the kind of conditions now emerging?