

Secretary James Baker: 'Après moi, le déluge'

by David Goldman

The United States Treasury and congressional leaders July 29 announced a compromise agreement on what might be called the Louis XV Memorial Banking Bill, designed to postpone a global banking crisis until just beyond the 1988 elections. If Louis XV, to whom are attributed the words, "After me, the flood," had had advisers like Jim Baker, the French Revolution would have occurred a dozen years early.

Although the administration, faced with congressional power to override a presidential veto, was forced to withdraw its more extreme proposals for banking deregulation, the content of the bill is not much changed from Baker's conception: A federal government facing imminent bankruptcy will attempt to rescue a banking system, sections of which are already bankrupt, and the rest of which faces near-term bankruptcy, with the promise of additional borrowings from already-bankrupt federal agencies, which intend to foster stock market speculation in the paper of bankrupt institutions.

Who will bail out more than 500 "zombie" savings and loans with negative net worth and current losses? The Federal Savings and Loan Insurance Corporation, which has no cash in its coffers, and \$50 billion of unmet obligations to the depositors of bankrupt S&Ls.

Who will bail out the FSLIC?

Well, who will bail out the FSLIC? Not the federal government, which cannot persuade Congress to give it borrowing powers to meet next week's bills, without accepting scores of billions of dollars of spending cuts. The bankrupt FSLIC will issue \$12.5 billion in bonds on the open market, representing one-fourth of what it should, by normal regulatory standards, spend immediately, if the FSLIC can find anyone

stupid enough to buy these bonds.

Assuming that someone will buy the bonds, who will service them? The FSLIC will charge the savings and loans it regulates higher insurance premiums, for which reason the S&L industry association will attempt to sabotage the bill's passage. However, the industry as a whole has a 6.2% delinquency rate on its mortgage portfolio, three times its delinquency rate of two years ago, promising an accelerating loss rate for at least the next two years. In fact, the loss rate has only begun to worsen, as the combined effects of tax reform and foreclosure-related liquidation wipe out the commercial real estate market.

In fact, Mr. Baker appreciates the federal government's incapacity to bail out the S&Ls, and expects that while the government merely staves off the crisis with the scent of money, the big money-center financial institutions will take over the bankrupt regional institutions. For example, securities firms, i.e., Merrill Lynch or Salomon Brothers, may purchase thrifts under the proposed legislation. With more trouble, commercial banks may do the same thing.

Citibank's chairman, John Reed, actually believes that the big money-center banks will go on a buccaneering spree of regional takeovers. He also believes that Citibank will lead the repackaging of Third World debt into marketable securities. Regional bankers have worried about being taken over by Citibank et al. for some time. In fact, they have much bigger problems to worry about, e.g., who is going to bail out the commercial banks?

On Aug. 20, six months will have elapsed since Brazil ceased to pay interest on \$68 billion of bank debt, of which about \$25 billion is owed to American banks. A tiny fraction

of American commercial banks' collective \$10 billion loss during the second quarter reflects additional loan-loss reserves against Brazilian debt. Under the normal regulatory procedure, the banks will have to set aside reserves on more than \$20 billion of Brazilian loans.

That doesn't count all other categories of problems the banks might encounter. On the face of it, there seems no way that the banks might avoid a loss during the third quarter *twice as large* as their already-unprecedented losses of the second quarter, given Brazil's July 27-28 discussions with its banking creditors. Brazil told the banks that it will not consider lifting the moratorium unless the banks cough up \$7 billion in interest-free loans, either in the form of capitalization of old interest, or by some other means.

Banks already setting aside loan-loss reserves are hard pressed to find such new money. Worse, the American banks which cannot afford to write off their Brazilian loans face the additional problem, that Japanese and European banks which *can* afford to write them off, hold two-thirds of the debt.

For both reasons, the possibility of papering over the August deadline seems extremely remote. Developing-sector borrowers are getting no loans, whether they pay their interest or not. Although total international bank lending during the first three months of 1987 rose \$60 billion, compared with a rise of \$25 billion a year ago, only \$3 billion of this lending went to developing-sector borrowers.

In a July 24 editorial, West Germany's leading business paper, the *Frankfurter Allgemeine Zeitung*, argued that the continued accumulation of bank losses due to Third World lending raised the specter of a new 1929.

The plans of the Brazilian creditors' consortium do not seem less outlandish than the proposal of Drexel Burnham Lambert's junk bond king, Michael Milken, who told the *Washington Post* July 29, "Drexel hopes to capitalize on its research, sales, and trading expertise in the junk bond market to take a leading role in creating new financial instruments that could help to solve the Latin debt crisis. Drexel's edge in this market could be in structuring the new security so that its stable of investors who buy corporate junk bonds would also buy securities backed by Latin American debt." Milken has already spoken with the President of Mexico about this.

A greater danger

However, *EIR* has emphasized for some time that the Third World debt crisis, mortal as it might be for major American banks, does not represent the greatest danger to the system. Relevant is a July 29 report issued by the Bank for International Settlements, the central bankers' central bank in Basel, Switzerland. Noting that cross-border obligations among international banks had risen from \$1.3 trillion only two years ago, to \$2.2 trillion today, the BIS warned, "The market's potential for transmitting destabilizing influences across the world should not be underestimated."

Three generations of bankers have heard no warning so

harsh from that taciturn institution. The explosion of inter-bank obligations stems from foreign exchange speculation and securities trading, both major sources of commercial-bank income during the past two years. Both can turn into losses, and one bank's failure could provoke a chain-reaction of interbank defaults, crashing the system almost instantly.

What underlies the BIS's warning stands at the center of the London market's fears of the moment. Monday, Aug. 3, is an important settlement day in London, and some bankers fear that £6 billion (almost \$10 billion) will not be repaid. "People borrowed money to buy shares, securities, and other things; some share prices have gone down or some people shorted the market while the shares went up. The result is that they cannot repay—we question whether some of them ever intended to repay these loans. We could have something of a crash," resulting in a "domino effect" drawing in "some very good names," one banker warns privately. Whatever will have happened Aug. 3, the near-term potential for major trouble is evident.

"The equity position of some of these [money-center] banks, such as Bank of America and Manufacturers Hanover, is so thin that one major trading loss and they're in the tank. "You can't run a major institution without a cushion," Kenneth Cooper, a Touche Ross bank consultant, told the *Wall Street Journal* July 29. Most of the major U.S. banks' shareholders' equity has fallen to 2.5% of assets, from the 4% regulators generally insist on; and in the case of the banks mentioned, Brazilian loans still to be written off account for more than 2.5% of assets. Even if Brazil began paying on time, a major trading loss would wipe out these institutions notwithstanding.

So much for the commercial banks' capacity to bail out weaker regional institutions. The numbers don't compute: If the big banks do not have sufficient equity to operate safely, how are they expected to take over institutions with negative net worth? The notion that big institutions can absorb troubled smaller ones assumes an exchange of big-bank equity for "good will," i.e., established business presence, of the smaller institutions. That conundrum was the subject of the *Wall Street Journal's* lead article July 27, citing banking analysts to the effect that major banks would have trouble raising equity, let alone expanding into regional markets, although some of the larger regional banks with low overseas exposure might profit from deregulation of geographical barriers.

Baker's strategy amounts to a gamble that the promise that somebody will do something, will 1) convince pension funds to keep buying certificates of deposit in bankrupt S&Ls, 2) convince overseas depositors to keep their balances in American commercial banks, 3) convince everyone to keep buying common stocks, and, above all, 4) convince the Japanese to keep buying U.S. Treasury securities. There is no good reason for any individual component of his scheme to work, let alone the whole business.