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Banking by Kathy Burdman

The Fed's great crash of '81

The Volcker Fed predicts a banking crash—and the savings and loans institutions are meant to take the brunt.

Deep in the caverns of Paul Adolph Volcker's Federal Reserve, a band of feral little econometricians is busily producing scenarios for a banking collapse in the 1980s. But not all banks will go.

According to one of my sources at the Treasury, the plan is to "isolate" the effects of the crash among the nation's savings and loans institutions, and "let them die, let them take the brunt of the collapse."

It all began last June, when Federal Reserve econometrician Robert P. Flood, Jr. produced a study titled "A Systematic Banking Collapse in a Perfect Foresight World," which was published by the Chicago School's National Bureau of Economic Research (NBER) in Cambridge, Massachusetts. In the NBER study, Flood and his collaborator, Peter M. Garber of the University of Rochester built an econometric model for international banking collapses, and applied their model to the financial statistics of the 1920-1931 period. The Flood-Garber model predicted from the statistics exactly the sort of collapse which in fact ensued in 1931.

I found the Flood-Garber model on 1931 to be nothing more than an elaborate defense of the Fed's tight-credit policy. It was not the Fed, but rather *America's European allies* who forced the tight-credit policy of 1929, Flood writes, because they insisted on borrowing billions of U.S. dollars. No mere historical exercise this. Reached for comment, Mr. Garber informed a journalist that he has since run current data for this year through the Fed model and come up with a prediction of a 1980s bank crash mirroring the 1931 Great Crash.

It's the U.S. S&Ls that go first in the Great Crash of '81, Garber says. It starts when the Fed's high interest rates force dozens of S&Ls under, which has already begun to happen. According to Garber's latest run, the Federal Savings and Loan Insurance Corporation will try to bail out the failing S&Ls, but S&L losses will be so massive that the insurance funds will be emptied. Then an old-fashioned bank run will begin, as the public, fearful for its deposits, begins to remove them from the S&Ls. The Fed then prints money to try to forestall collapse, but this only causes more inflation. This is supposed to "further weaken all banks," causing a second bank run and general bank crash.

Is the Fed planning a real crash? Robert Flood's boss at the Fed, Robert Gemmel, associate director for international research, of course, denies that the Fed stands behind this study, when asked to go on record. So does Flood, and so does Garber. But I don't buy the cover story that this is just a nice "intellectual exercise" by Flood as a bright young econometrician.

First, although the 1981 model run clearly shows that the Fed's tight credit pulls the S&Ls under and starts the crash, the Fed insists it will go ahead with the credit squeeze.

Second, Volcker's ally Treasury Secretary Don Regan is already "thinking the unthinkable": why not have a "controlled crash" in which the S&Ls are let go, "to take the brunt of the collapse and act as a buffer to protect the commercial banks?" a source in Regan's shop asked me this week.

Commenting on the Fed model, this public servant was unfazed. "The Fed has a good scenario," he stated, "but why should an S&L run harm the commercial banks? Unlike in the 1930s, when the commercials held the bad bonds, today it's the S&Ls in trouble.

"We've isolated the thrifts from the rest of the banking system, and we don't need them anymore. They finance a sector no one wants—homebuilding," Why don't we just have a run on the thrifts, just let them go?"

Because the key in controlling a bank collapse is the psychology of the public, he said, the Fed and Treasury have "spent the last year isolating the S&Ls in the minds of the depositors. People are now aware, as they would not have been a year ago, that if S&Ls are in trouble, you pull your money out of S&Ls, but you stay in commercial banks.

"We've succeeded in making it clear to people that you can have a run on the S&Ls without a run on the commercial banks," he concluded. "In fact, a run on the S&Ls would *help* the commercial banks, because depositors, especially large commercial depositors, would pull money out of S&Ls and put them into commercial banks."

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