EIR Economics

Banking on disaster: $2 trillion in bad debt paper

by Kathy Wolfe

The actual bankruptcy of the $3.1-trillion U.S. banking system, now suddenly breaking into the open with the Ohio and Maryland collapses in a way as to terrify the unsuspecting average citizen, was predicted by *EIR* founder and contributing editor Lyndon H. LaRouche, Jr., in the late 1960s, as he had predicted that the U.S. dollar would have to be taken off the gold standard in 1971.

Behind this was no magic, but rather LaRouche's recognition that the Anglo-American financial oligarchy had adopted a "post-industrial" zero-growth policy for the nation, and that the U.S. banking system, especially the regional bank and savings & loan systems, were set up to *feed a stream of credit into the industrial economy: production, infrastructure, and family formation*.

The U.S. banking system was set up to be totally different from the British or Canadian banking systems, where five or six large banks created a credit-cartel monopoly over allocation of bank loans, to deliberately prevent the Crown's subjects from borrowing at will to found businesses, farms, and homes.

The U.S. banking system was to provide credit for the free play of production. Throughout America, a network of 15,000 regional banks was established to take local deposits and provide credit to farms, factories, transportation, and housing which sprang up everywhere.

Congress, in a moment of wisdom almost inconceivable today, created the Savings & Loan or "protected lender" system, modeled on the German "building societies," which by law had to make 80% of their loans for home and housing mortgages. To encourage workers' and other productive deposits to flow into these housing funds, savers by law could get an extra .5% interest only at S&Ls. By the 1960s, over 5,000 S&Ls had sprung up, in addition to the 15,000 regional banks, making America the "best-banked" country in the world.

But today, of the U.S. banking system's some $3 trillion in loan assets, at least $2 trillion is bankrupt. If an actual competent accounting audit were to be made of the "quality" of these bank assets, under the wording of existing U.S. bank law, "currently being repaid or having a reasonable prospect of being repaid," it would become clear that although some interest is being paid on these loans, there is *no possible repayment of the principal*. Indeed, in dozens of cases, the auditor would find that the assets securing the loans, such as the $120 billion in U.S. bank loans to heavy industry, are so old and decrepit that the *loans are worth less than half of their book value*.

First, the producers and homebuyers who were the reason for creating this productive sector of the U.S. banking system, have been bankrupted, because their economic activities have been shut down in the name of "zero growth." Directly as a result of this, most of the $1 trillion productive segment of the U.S. banking system, beginning with the visible S&L crisis, is actually closing its doors in a "rolling" bank panic sweeping from state to state. The figure, as **Table 1** shows, includes at least $215 billion in bad loans to farms, $200 billion in bad loans to the collapsing oil industry, $100 billion in bad loans to the manufacturing, utilities, and transporta-

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tion sectors, and perhaps as much as $500 billion in bankrupt S&L mortgage and other real estate assets.

Most embarrassing is the size of U.S. industrial loans, compared to the rest of the banking system.

Bank loans to industry are almost non-existent as a proportion of total bank lending. Out of a total $3.1 trillion in bank loans overall, there is a grand total of $472.4 billion in loans outstanding at end 1984 to the entire non-financial U.S. corporate sector, or only 16%. (This figure, not shown separately in Table 1, includes the loans to manufacturing, plus other loans included under other categories.)

But things get worse. The $472.4 billion figure includes all non-financial private corporations—not only manufacturing industry, but loans to the oil and energy, mining, transportation, and service industry corporations. Out of this, only $120 billion was loaned to the *manufacturing* sector per se. This $120 billion is the total outstanding, not per-year loaned, as of end 1984. "That's about right," quipped one Federal Reserve officer when asked by an astonished researcher why the manufacturing loans were so tiny. "Manufacturing is only a quarter of GNP, isn't it?"

In addition to the some $1 trillion in bankrupt loans to the productive sector of the economy, there is another $1 trillion in *non-productive* loans made by the New York-led top 100 "money center" banks, which is bankrupt. Less than $300 billion of this figure is accounted for by loans from these U.S. banks to Ibero-American and other Third World countries. The rest is $700 billion or more of rotten domestic loans, including $200 billion in loans to speculative real estate development, more than half of the $480 billion outstanding in consumer credit (which consumers are never expected to repay), more oil loans, and almost $100 billion in loans to foreign-exchange, commodity, and other financial market speculation.

This second trillion dollars in bad assets is, however, currently being protected from exposure by the conspiracy of federal bank regulators, run by Federal Reserve Chairman Paul Volcker and former Treasury Secretary Donald Regan. They are orchestrating the theft of these savings for the account of the bankrupt money-center banks.

It is no accident that since especially Paul Volcker's 1979 interest rate shock, and his subsequent bank deregulation reforms, there has been an ongoing "savings crisis" in the United States, a collapse of the S&L system so severe that even the average citizen has been made aware of it. During this time, the number of S&Ls in the United States has shrunk from 5,400 to under 3,500. Savings & loans with deposits and mortgages worth over $200 billion have gone out of existence.

Starting with the $20 billion regional bank, Continental Illinois, the nation's entire 15,000-strong regional commercial banking system is being shut down as well.

The ultimate result, if Volcker has his way, will be "nationalization" of the banking system, one former Carter Treasury official told *EIR* recently, such that *banks make no more loans to the average citizen for citizens to use freely, as they see fit, for housing, business, and commerce.* The top 100 megabanks will scoop up the deposits fleeing the collapsing S&Ls and regional banks, and control most deposits in the United States. Then, under Federal Reserve supervision, the banks which survive will be instructed to make almost no loans to the average Joe. These bankrupt banks intend to take over the government's tax base. They will mostly buy U.S. Treasury bonds to finance the government debt!

Paul Volcker, said Volcker associate John Mingo in an interview May 17, has been sending federal regulators into local S&Ls and regional banks to "get tough" and force them to write off entire groups of assets, which is the major reason that the Ohio and Maryland state S&L systems were brought down this year, he noted.

Volcker will crack down on state banks until "he has everything that calls itself a bank in the country under his thumb and they are all, in effect, nationalized, and regulated tightly like a public utility," said Mingo. "This crisis of confidence and runs will continue across the country until the public is taught that only things federally guaranteed are banks, and safe to put your money in."

"Maryland is the final euthanasia of the state insurance system," Mingo said. "Volcker has targeted these states for crackdown."

The purpose, he said, is to strip banks of the power to loan, to forbid any but his New York friends from making independent decisions on which citizens and industries receive credit. "Once they are run by the federal government,

Table 1.

U.S. bank loans outstanding by borrower, end 1984

(million $)

	Estimated Bad	Total
Total S&L lending for mortgages	500	1,100
Regional commercial banks		
Farm loans	215	215
Oil loans	200	300
Manufacturing	80	100
Other	10	85
Total	505	700
Money center commercial banks		
Third World loans	300	300
Real estate loans	200	200
Consumer credit	200	300
Money market speculation	100	100
Oil loans	100	100
Mortgages	80	280
Corporate/manufacturing	20	20
Total	1,000	1,300
Grand total	2,005	3,100

then the government can insure that they will not fail. The only way to do this, is to ensure that the surviving banks engage only in riskless loans, to make them into economic eunuchs. Banks will eventually have to drop everything but buying up Treasury securities. They will simply act as a Fed-controlled clearing house for the federal debt."

The real U.S. 'deficit' crisis

But things are far worse than the $2 trillion in bad loans threatening the banking system. Let us consider a series of "deficits" which occur because the nation has not been keeping up its road, rail, and other infrastructure, its housing stock, and the capital equipment of its industry. These deficits represent the "should have been" cost of actually replacing and servicing the country's entire productive plant and working population. The $2 trillion figure of bad bank debt is one large result of these huge "should have been" deficits, since it was precisely the failure to modernize that has caused manufacturing debt to go bad. The $2 trillion in bank debt is therefore properly accounted, as included in the deficits.

The frightening thing is that these deficits, which could be "marked off" against the total $5.8 trillion U.S. domestic debt, added up to $5-6 trillion by themselves:

1) Infrastructure deficit: $250 billion per year beginning in 1970, to a total outstanding of $3.1 trillion. To the extent the costs of covering infrastructure are not met, then the costs of production in capital-goods industry are not met.

2) Annual deficit on capital-goods sector: $100 billion per year, to a total outstanding of $1 trillion. These are funds that should have been expended to upgrade machinery, and were not spent, per year. Instead, over 70% of U.S. capital-goods plant and equipment is now over 10 years old and should be scrapped entirely and replaced from scratch. Over the 10 years since 1973, this adds up to another $1 trillion deficit.

3) Housing deficit: $1-2 trillion. This last is the most shocking. If the U.S. population were to have been housed properly since 1970, as it was not, there ought to have been built at least 25 million houses above and beyond those actually constructed. At a rational price of $40,000 per home, this is $1 trillion of housing that was never built. At the current, inflated price of $80,000-100,000 per home, the housing deficit would swell to an incredible $2 trillion.

In sum, the moment the Great Society policies of the Johnson era began the deliberate process of cutting production and living standards in the United States—the "Limits to Growth" program—entire sections of the U.S. banking sytem were deliberately doomed to wither away with the production processes they served. The same New York financiers who decided to cut U.S. population growth and production, knew this, and devised a plan to "triage first" that segment of the banking sector which is most oriented to the productive U.S. economy, the regional banks and S&Ls.

"*America has too much housing anyway*. John Mingo told *EIR* in December 1980, while he was still Deputy Treasury Secretary under Carter. "There's no law that says there have to be 5,000 S&Ls and 15,000 commercial banks. It's inefficient, expensive, and uneconomical. . . . These rich little S&L executives sit in their nice oak-paneled offices and enjoy terribly being president of the First Federal S&L of East Podunk. They don't know how to run a bank, and they know it. These CEOs should all be out of a job.

"*Do we really need S&Ls? Might we not have too much housing?* . . .We have too many houses, and scarce resources, especially scarce capital. We can't afford capital for housing."

Shortly after Mingo spoke, more than 1,000 S&Ls went under during the 1981-82 Volcker depression, and S&Ls have continued to collapse at the rate of several a week ever since.

The Ohio and Maryland collapses this year were important politically, because they created a panic in the population, but did not involve, in and of themselves, huge amounts of money. The Ohio panic closed state-insured S&Ls with $5 billion in assets; although they will be reopened, they are being taken over by the big New York banks and the Dope, Inc. banks such as Carl Lindner's Hunter Savings Association, and this amount of assets has been "lost" to the S&L industry. During the month of April, S&Ls worth $10 billion went under in California alone. The Maryland crisis, too, was big, closing state S&Ls with over $9 billion in assets.

Recently, following the Maryland crisis, Volcker put out the word that the entire U.S. savings and loan industry, and with it Americans' $1 trillion in home mortgages, are to be shut down. "Some in government say the problems of the overall S&L industry are so severe that within a few years, savings institutions will cease to exist," ran an article planted by Volcker in the May 16 *New York Times*. "The eventual cost to the U.S. government of bailing out the troubled system is expected to be extradinarily high, perhaps more than $100 billion. At the end of January, total assets of the nation's savings banks and S&Ls amounted to $1.1 trillion. The dire outlook was laid out weeks ago by William Isaac, chairman of the FDIC, who predictd that S&Ls would not exist within a few years. 'We have the potential for a very serious S&L crisis,' Chase Manhattan Chairman Willard Butcher said"—an understatement.

Oil and farm debt

The severe deflation of world commodity prices—touched off by British and Soviet dumping of oil and gold during the summer of 1984—has recently been renewed with more Soviet oil dumping during April and May. This new wave of Soviet oil dumping could break the back of the U.S. farm, oil producers, mines, metal smelters, and other hard-commodity producers, already fatally weakened by Volcker's

depression. As they go under, in particular, at least $200 billion, and perhaps as much as half, of the United States' $500 billion oil debt, plus almost all of the bankrupt $215 billion in U.S. farm debt, is set to collapse.

A farm debt crisis could cause a generalized collapse of U.S. regional (small- and middle-sized) commercial banks, which do almost all of the lending to these commodity sectors. The collapse would occur on the Continental Illinois model, which was brought down by the weight of its U.S. farm and oil-producer debt. More than 30 agricultural banks have already collapsed during 1985 alone.

The U.S. oil sector "will be the next big dry spot. Some oil patch banks in Texas are in real trouble," a Commerce Department official told *EIR* recently, "like Texas Commerce Bankshares, the same ones that have been on the Comptroller's 'watch list' for some time" as problem banks. More than nine major U.S. energy companies have run up losses of over $8 billion in the last four years. Texaco and Philipp Brothers took $765 million and $307 million losses, respectively, in the fourth quarter of 1984, and U.S. oil companies are closing refineries at the rate of two a month.

This has happened because U.S. oil prices have fallen below world levels to an average of $26 per barrel. This drop of 28% since 1980 has totally wrecked the book value of oil companies' reserves, their most important asset. Since bankers to the U.S. oil industry value their loans to the industry at $500 billion based largely on the old 1983 price of oil, when most loans were made, we know that the real value of the loans, just from the oil price drop, is 28% less or at least as low as $360 billion only.

The difference between the two figures means that at least $140 billion of the oil debt is worthless paper valuation. The rate of losses and oil-field closures in the rest of the industry easily brings the total value of worthless oil loans up to the $200 billion range.

Capital-goods debt

As with oil, most of the book value of U.S. industrial loans is overvalued.

It will be seen from **Table 2** that only about 50% of corporations' total financial requirements come from the U.S. banking system; the rest is stocks and bonds. That may have lead to as much as 30-40% of U.S. corporations' total assets being bought out by foreign financial interests over the last 10 years. Each year's corporate sector financing in bonds and stocks issued, is thus heavily weighted to depend on foreign takeover money.

For the capital-goods industry, there are only some $40 billion in total bank loans outstanding. That means that the entire capital goods industry has been getting bank credit to the tune of less than $1 billion per year! As to major sectors of capital-goods producers, *total* bank loans outstanding at end 1984 to primary metals (SIC 33) were $7.42 billion; to fabricated metals (SIC 34), $7.9 billion; to non-electrical machinery (SIC 35), $11.84 billion; to electrical machinery (SIC 36), $6.39 billion; and to transportation equipment (SIC 37), $5.9 billion.

Behind these banking figures, is the actual collapse of the capital stock value of the U.S. corporate sector. The state of the U.S. manufacturing and capital-goods sectors has been horrendous over the past 20 years, but especially in the period 1973-84 (see **Table 3**).

Table 3 compares the "capital stock" of U.S. industry, as reported by the U.S. Department of Commerce, in the first column, with the actual number of machine-tools used in that industry, and with the average age of the machine-tools.

By 1984, the number of machine-tools in use in the United States had stagnated terribly, at the 2.4 million level, then rose briefly to 3 million, and then collapsed in 1984 by a full 33% to 2.1 million tools. The age of this machinery, furthermore, fell to an average where at least 65% of all sectors' machine-tools were more than 10 years old.

This means that these machine-tools should virtually be retired from the factory equipment shelf as useless, and under competent valuation of factory productivity, would have to be discounted as useless. Certainly from a banking standpoint, to the extent that they represent capital against which loan assets are valued, they are worthless, making that proportion of loans bad.

For the U.S. corporate sector as a whole, first of all, Table 3 shows that against outstanding bank loans to that sector in the range of $472 billion, with another $500 billion or so in bond and stock financing, the capital stock of the entire corporate sector, was valued by the Commerce Department at $550 billion in 1984. However, the real value of this capital stock is actually worth no more than $117.9 billion, when the collapse of plant and equipment, and all of the equipment 10 or more years old, is discounted.

That is, not only is the capital stock of the United States worth a mere 20% of what it's cracked up to be, but the U.S. banking sector is sitting on $472 billion worth of loans, and the financial sector sitting on about $1 trillion in loans, stocks, and bonds, which is all pyramided upon a mere $118 billion or so in actual hard assets!

EIR took the Department of Commerce's reported "Capital Stock" billions-of-dollars value, which are already "deflated dollars" by Commerce's calculation, and depreciated the stock by two broad factors. First, as Table 3's third column shows, *EIR* examined the number of machine-tools used in the sector, and took the catastrophic drop in their number during the period 1973-84 as a rough measure of one real order of magnitude, of the sector's lessened worth.

For example, for total manufacturing, the number of machine-tools as a whole fell from 3.066 million in 1973, to 2.192 million in 1984, a drop of 33%. We applied this 33% drop to the $200 billion Commerce Department figure for

Table 2.
Overall corporate sector financing
(billion $)

	1979	1980	1981	1982	1983	1984	Total end 1984
Bank loans	45.9	29.1	42.9	41.5	18.9	70.4	472.4
Bonds	17.3	26.7	21.8	18.7	15.7	40*	300.0
Equity	−7.8	12.9	−11.5	11.4	28.3	20*	200.0

*Estimated

Table 3.
The real value of U.S. capital stock
(deflated billions of U.S. dollars)

Year	Capital stock ($)*	Machine tools (mn)†	First adjustment	Over 10 years old (%)	Real capital stock ($)‡	Bank loans ($)
Total corporate						
1984	550.0	2.192	368.5	68	117.9	472.4
Total manufacturing						
1953	35.9	2.474	35.9	56	15.7	
1958	55.8	2.217	32.1	60	12.8	
1963	69.6	2.809	60.1	62	22.8	
1968	106.3	2.870	60.5	64	23	
1973	149.7	3.066	90.2	70	27.1	
1984	200.0	2.192	133.0	68	42.9	120.0
Total capital goods						
1984	130.0	2.192	87.1	68	27.8	40.0
Of which:						
Primary metals						
1958	8.8	0.246	8.8	60	3.5	
1963	10.5	0.170	10.5	69	3.3	
1968	20.8	0.167	20.8	71	6.0	
1973	22.4	0.163	20.8	73	5.6	
1984	27.0	0.117	19.4	71	5.6	7.4
Fabricated metal machinery						
1958	5.8	0.518	5.8	61	2.3	
1963	6.2	0.634	6.2	65	2.2	
1968	8.1	0.656	8.1	65	2.8	
1973	9.9	0.638	8.1	69	2.5	
1984	15.0	0.518	12.1	71	3.5	7.9
Nonelectric machinery						
1963	7.5	0.952	7.5	67	2.5	
1968	10.6	0.913	10.6	64	3.8	
1973	13.8	1.104	10.6	65	3.7	
1984	25.0	0.805	18.2	65	6.3	11.9
Electrical machinery						
1953	3.2	0.260	3.2	52	1.5	
1958	4.2	0.164	4.2	57	1.8	
1963	5.2	0.328	5.2	54	2.4	
1968	7.9	0.398	7.9	58	3.3	
1973	10.9	0.399	7.9	60	3.2	
1984	18.0	0.245	11.1	65	4.0	6.4
Transport						
1963	6.2	0.450	6.2	66	2.1	
1968	9.5	0.363	9.5	68	3.0	
1973	13.5	0.401	13.5	69	4.2	
1984	45.1	0.303	34.4	71	9.8	5.9

*Capital stock value of all machinery as estimated by the U.S. Department of Commerce.
†Number of machine-tools available in the industry, million units.
‡The actual value of the capital stock of the sector, after deflation for collapse of numbers of units in use, and for age of machine-tool equipment.

capital stock, resulting in a "first depreciation" of $133 billion only. Then, given the fact that a full 68% of the machine-tools were 10 years old, or older, and therefore useless from the modern standpoint, we removed another 68% of the value, ending up with a figure of $42.9 billion "real capital stock" value for the manufacturing sector as a whole.

This $42.9 billion has to be compared with the $120 billion in bank loans alone (plus stocks and bonds) outstanding to the manufacturing sector. *That means that at least 50% or so of these bank loans are completely worthless, since the assets upon which they are based are, on average, worth only about 50% of the stated value of the loans.*

Data readily available from the National Machine-Tool Builders Association (*Economic Handbook of the Machine Tool Industry,* p. 126) demonstrate that the Association believes there to be even less "real capital stock." Their data show at most a $34.4 billion worth, compared to our figure of $42.9 billion worth. This figure is the same order of magnitude.

In Table 3 can be seen the collapse of machine-tool equipment and the aging of each of the major capital-goods-producer sectors of the U.S. economy, from primary metals to transportation. The pattern of drastically low "real capital" worth obtains throughout the U.S. capital-goods industry, which has, as a whole, only some $27.8 billion in real capital stock, compared with $40 billion in bank loans on the books.

For example, the huge industry which produces non-electrical machinery claims to have a capital stock value of $25 billion worth of equipment. In fact, the number of machine-tools collapsed from 1.1 million in 1973 to 805,000 in 1984: Entire chunks of the industry were shut down. That alone brings its capital stock value down to a mere $18.2 billion. If you junk the equipment 10 years old and older, the sector has only $6.3 billion worth of real capital. Yet, the industry has $11.9 billion in bank loans.