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The current crisis in U.S. government finances

by Christopher White

The federal government, as of this writing, may be in default on interest payments on its debt by Nov. 14 if the present deadlock between House and Senate over the so-called Gramm-Rudman balanced-budget bill is left unresolved. The bill has been attached as a rider to routine legislation permitting the increase of the federal government's authorization to borrow, the so-called debt ceiling.

Twice in late October and early November, the deadline to increase the government's power to borrow has been reached, and passed, without enactment of the necessary legislation. Each time the administration has stepped beyond the law, and beyond its own precedents to make up the gap—first borrowing funds from federal banking operations, then, dipping into the social security fund. Pundits argue that such violations demonstrate that the congressionally approved debt ceiling is no longer a limitation on what the government can do to secure its own financing.

Though Treasury Secretary James Baker has decried the congressional maneuvering which has prevented passage of the necessary legislative powers, and warned of the dangers of U.S. default, behind the congressional politicking the United States is steadily slipping into the bankruptcy arrangements which this magazine has warned of since spring. It may not be default this time, but the initial maneuverings in the biggest bankruptcy of all time have begun.

There are two features to this on the level of the government itself. Firstly, the formalities associated with the budgetary process: that is, the way the government finances its own operations, characterized by declining real income from the depression-collapsed revenue base and exponentially increasing debt-service requirements, hitherto regarded as sacred by all players in the game. Secondly, there is the related emerging bankruptcy, or insolvency, of the so-called government agencies, such as the Farm Credit System, the Federal Deposit Insurance Corporation, the Federal Savings and Loans Insurance Corporation, the Pension Benefit Guaranty Corporation, and the government agencies which insure, trade in, or guarantee mortgage debt, such as FNMA, GNMA, and others. The financing of such agencies is not included in the budgetary process of the federal government itself; they are legally independent institutions, empowered to finance their activities from their own operations. They are thus "off-budget," as far as their finances go, but can still bring down the whole shebang.

Such powers were fine, before Paul Volcker unleashed the third great depression of the century. Now that's no longer the case, and the question is, who will guarantee the guarantors? Here the precedent setter, over the next months, may well be the doomed Farm Credit System. The federal government has no formal obligation to come to the aid of that bankrupt system, but if it does not, then the entire alphabet-soup of agencies backing the nation's banking system, and mortgage market, will be left out to hang in the breeze, with liabilities of over $1 trillion.

A budgetary cul-de-sac

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The budget side of the situation is as follows. Sen. Phil Gramm (R-Tex.), and his colleagues, Sens. Warren Rudman (R-N.H.) and Ernest Hollings (D.-S.C.), have attached an amendment to the debt extension that would require the federal government to reduce its current deficit—estimated officially at $180 billion, but thought to be at least $50 billion more—to zero by 1991. The way it would work is this: If federal spending were to exceed guidelines set for each year, the President would be required to make cross-the-board budget cuts to bring spending within limits.

The United States government sustained a $204 billion deficit during the first 11 months of 1985, more than the deficit in any previous 12-month period. This occurred despite the fact that tax revenues, from both individuals and corporations, were up 12% compared to the previous year. Since the government's income was up 12%, what caused the worse deficit?

Not defense spending, contrary to Rep. Tip O'Neill's (D-Mass.) blather on this subject. Defense spending ran 10% higher than during the previous year—at a lower rate of increase than tax revenues.

Social expenditures of all kinds were only 2% above the previous year's total, far below the rate of increase in tax proceeds. In other words, the deficit *shrank* on account of social services.

The one important category of spending that rose far in excess of tax revenues was interest on the federal debt, for which the United States now pays $167 billion per year, or 17% more than last year. The government's deficit is rising, not because of excessive social spending, or an adequate defense program—spending on both is far lower than what the country needs—but because of what we pay to our (increasingly foreign) creditors.

The problem is that the increase in tax revenues represents pure inflation. The "official inflation rate" of 4% or so is a pure lie; the actual inflation rate exceeds 15%. Despite the President's "tax cut," both individuals and companies paid 12% more taxes so far this year, from incomes that buy less than last year.

U.S. under IMF conditionalities

The purpose of such a (temporary) breakdown in federal payments would be to subject the United States to the same sort of "conditionalities" that the International Monetary Fund has already imposed on most developing nations. The worst of this is that the United States is already in worse shape, as a debtor, than Brazil or Mexico.

The cuts would occur equally from discretionary spending, including defense, and from annual adjustments in entitlement programs, except for Social Security. Waivers would be permitted in time of war or recession.

At present, the government is paying $167 billion annually on its nearly $2 trillion debt. Under the best possible circumstances—that federal revenues continue at present level and there is no fresh outbreak of inflation—the Gramm amendment would increase the federal budget by another $500 billion over the next five years, and the debt service would be running by then at around $210 billion (assuming stable interest rates).

Thus, to comply with the provisions of the amendment, the federal government would have to cut from its budget the entire current deficit, estimated offically at $180 billion (but very likely closer to $230 billion), and include in its budget $210 billion in debt service. However, the situation is worse than that, because the increase in the debt service between now and 1991 would also have to be carved out of future budgets. Thus, the cost-cutting involved is not only the current deficit, but also the increase of some $40 billion. Hence, the budget-balancing amendment invites an actual reduction based on official figures of at least $227 billion (and, in reality, probably closer to $277 billion), while incorporating mandated debt service of $210 billion annually. This would require combined federal savings and interest payments totaling an amount 25% greater than the present defense budget. The effect of this legislation would be to devastate what is left of the U.S. economy.

The disruption of government finances, however brief, will further what IMF Managing Director Jacques de Larosière demanded in the closed Interim Committee meeting: swift, brutal, drastic action to cut U.S. government spending.

But this only covers the public side of government finances, and implicit financial commitments. Undiscussed, as Gramm and Rudman chop their way through federally funded projects to satisfy the nation's creditors, are the off-budget agencies mentioned above. This includes the federal government's role in underwriting the more than $1 trillion endebtedness of mortgage market institutions.

First in line, in this connection, after the Pension Benefit Guaranty Corporation, which is already in deficit and unable to cover repudiated pension plans by corporations like Wheeling-Pittsburgh and LTV, are the two bank insurance corporations, FDIC and FSLIC, and the Farm Credit System. Of the three, the FDIC is said to be in the strongest position, but not necessarily for very long. Then come the government-backed mortgage finance and insurance institutions like FNMA and GNMA. The reserves available to both the FDIC and FSLIC to cover the accelerating bank collapse, are minuscule compared to the amount they could be called on to cover. Their respective clienteles are not far behind the bankrupt Farm Credit System already. As the "faith and credit" of the government in those institutions is called into question, so too will be the already shaky trillion-dollar mortgage market.

In the first quarter of 1985, home-mortgage loan delinquencies were the highest in the 32-year history of the periodic survey done by the Mortgage Bankers Association. The

survey showed that 6.2% of home-mortgage loans were delinquent at least 30 days in the first quarter of 1985. This is up from 5.5% a year earlier. During the second quarter, a drop of .38% was recorded in the surveyed rate, still maintaining a delinquency level above a year earlier. This survey covers VA, FHA, and conventional source mortgages. The savings and loan institutions report a somewhat lower rate of delinquency, attributable to their more stringent requirements, but S&Ls themselves are failing at crisis rates.

The proportion of mortgages entering foreclosure proceedings is also high. As of the end of the second quarter, for example, "Fannie Mae"—the Federal National Mortgage Agency (FNMA)—reported 7,800 repossessed homes, over double the 3,400 from a year previous. And the third quarter will be even higher. Most of the FNMA repossessed homes—which the FNMA prefers to call REO's or Real Estate Owned—are based in the darkened Sunbelt. The worst area is Houston, and other hard hit areas are southern Florida and parts of California.

On Aug. 5, FNMA announced new standards effective Oct. 15 for FNMA mortgage purchases in the secondary market, for purposes of countering the increasing delinquencies. Among the requirements: raise downpayments, reduce the ratio of housing expense to gross income, prohibit adjustable rate mortgages (ARMs) that lack a cap on total interest rate chargeable, prohibit negative amortization (where the loan outstanding can rise), graduated payment loans, and seller "buy downs."

The budget-cutters are backing themselves into a corner where the federal government, or the Federal Reserve, will have to pick up the tab on the biggest collapse of paper instruments in history.

For the first time ever, U.S. mortgage-backed securities are being shopped around abroad for foreign investors. As of this year, home-mortgage backed securities are now sold abroad by Freddie Mac—the 15-year-old Federal Home Loan Mortage Co., owned by the Federal Reserve Home Loan Bank Board—the agency of the savings and thrift organizations. In 1984, Fannie Mae began selling its securities abroad.

FNMA has a $90 billion mortgage portfolio, and in addition, a $50 billion mortgage guarantee book. FNMA is annually the biggest borrower in the United States after the federal government. FNMA is a congressionally chartered organization, mandated to provide mortgages for low-middle- to moderate-income housing needs. It is therefore technically an "agency" that can borrow money at a somewhat cheaper rate. But in 1970, it technically became private. It has 33,000 shareholders.

The orientation of most of the national regulators and money-center bank officials is to force the write-off of delinquencies, and force the elimination of large numbers of savings and loan institutions, the traditional home lenders. Moreover, the lending deregulation allowances of recent years encouraged S&L loans in non-housing areas, some of which are even shakier than housing loans during this depression.

During 1985, the savings and loan failures in Maryland and Ohio got the most publicity, plus the failures of large, individual thrifts in California and Florida. However, fully one-quarter of the nation's savings and loans are ready to go under.

Testifying before the Senate Banking Committee in July, Federal Home Loan Bank Board Chairman Edwin Gray warned that one-quarter of the nation's S&Ls are in the red, and that bad assets are being uncovered at a record rate. "The escalating strains evident . . . imperil the very foundation of our financial system—the public's confidence in federal protection for their deposits," Gray said. For the past two and a half years, all income generated by the Federal Savings and Loan Insurance Corp. (FSLIC) has been spent on problem cases, and the $5.6 billion fund, for the first time in its history, is shrinking rather than growing, and covers only 0.76% of all deposits. This is a much smaller percentage than the Ohio and Maryland state insurance funds.

At the recently concluded conference of the United States League of Savings Institutions in Texas, the discussion repeatedly returned to a proposal made earlier in the year, to merge the Federal Savings and Loans Insurance Corporation with the Federal Deposit Insurance Corporation. Supported by the former chairman of the FDIC, Bill Isaac, the proposal was rejected by current Chairman L. Bill Seidman. "Frankly, we already have plenty to do at the FDIC," he said. Instead the FSLIC established an "Asset Disposal Association," to sell off the assets inherited from the collapse of its member institutions.

One of the little-noted consequences of the Gramm-Rudman budget-cutting package, with its permanent, self-imposing cycle of cuts, would be to remove the financial instruments from the federal government which would enable the Executive branch to deal with the upcoming insolvency of its "faith and credit" agencies.

This has not gone unnoticed by Donald Regan's former employers at Merrill Lynch, who gloat that, under foreseeable emerging conditions, it is Paul Volcker's Federal Reserve System which would have the power to reorganize the U.S. financial system, not the constitutionally empowered executive branch. In this view, the functions of the U.S. government would be reduced to collector of tax revenues which Paul Volcker and his friends would allocate and distribute as they please.