EIR Economics

Second quarter shocks surface

by Chris White

A series of shock waves now building threatens to set off, at any point in the weeks ahead, the feared second phase of the Great Financial Meltdown which began in the run-up to the Oct. 19 stock market crash.

Leading elements in this picture include:

- Renewed instabilities in international bond and stock markets;
- Renewed tremors in currency markets;
- A new consensus among OPEC oil producers, to let the price fall to whatever level will sustain their output at 18 million barrels per day;
- The insolvency of the U.S. thrift system;
- The threat to the U.S. government-backed market in mortgage securities, building as a direct consequence of the insolvency of the thrifts, and the U.S. banking system as a whole.

There are those who still want to delude themselves, as they have with the erupting banking crises in Texas and California, that each such situation is isolated from all the rest, and susceptible to separate "macro" or "micro" management. In reality, these symptoms are the shock waves spreading from the collapse of the financial system as a whole. Shock waves, which, over the period ahead, will converge on some center, such as the New York-based money center banks, led by Manufacturers' Hanover, or the West Coast-based Bank of America, to devastate the tottering system as a whole.

Already European insiders are talking about the eruption, perhaps during the course of April and May, of "systemic," or "system-wide" crises.

Against the eruption of the Texas banking time-bomb, and the establishment of emergency federal credit lines to keep insolvent banks afloat, widely seen internationally as George Bush's friends in the government repaying favors to political cronies, like Texas GOP Chairman George Straike, board member of shattered First RepublicBank of Dallas, markets began to nosedive.

The first signal

The signal was the auction of Treasury bonds on Thursday, March 24. An increase in the yield on those bonds, the result of fears of federal bank support pump-priming of just one half of a percentage point, was sufficient to send the Dow-Jones index down to the new "circuit breaker" activation level, where losing 50 points in a day's trading, would shut the market for a "cooling off" period. Desperate efforts were made to keep the index above that trigger point. For if the "circuit-breaker" were activated, the reasonable surmise is that panic would catch hold, and the market would not reopen.

The decline in the bond market was the signal which we have been warning of. U.S. foreign creditors are not going to fund U.S. balance of payments requirements forever. From London financial circles, the report is that European financial circles have made up their minds which way to jump. The move out of the dollar is on. European big money is moving into cash holdings, what they call "core-bonds," German mark and Swiss franc bonds, and gold. The same thinking is reported from Switzerland on the basis of the assumption, as in 1929-30, so now in 1987-88. The Swiss point out that the 1930 second-phase financial crash happened six months after the first part. Such silly parallels aside, some Swiss have clearly decided to do what they have to do, to bring on that second phase in the period immediately ahead.

Behind these developments lies a set of question marks, over what Japan and Taiwan, holders of $82 and $77 billion

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of foreign exchange reserves, will do in the next weeks. Japan's new fiscal year begins April 1 and many see that as providing the opportunity for policy shifts from Japan.

The European-vectored move out of the dollar is being fed by two related matters: What in Europe they call "trepidation" about the U.S. banking system; and then, the fact that the expenses to be incurred in bank-bailout or foreclosure operations, have not been included in any public U.S. calculations of the size of the budget deficit. The reverse is actually the case; funding appropriations for the Federal Deposit Insurance Corporation were cut in this year's budget.

Their worries about these matters are more realistic than the bubbleheaded obsessions of the U.S. crowd, even if their solutions, reiterated demands for further budget cuts, and belt-tightening austerity are the same insane thinking which prevails inside the United States.

What's now under way in the United States is what will bring the budget deficit up to the $300-400 billion level warned of by presidential candidate and economist Lyndon LaRouche in the aftermath of the Oct. 19 stock market crash. And that's only for starters. "Trepidation" is actually a pretty mild characterization of the state of mind appropriate to what's now afoot within the United States.

The core of the financial bubble built by the two successive Reagan administrations, has been in the area of financial flows tied to real estate speculation. The bubble was made possible by Donald Regan's 1981 tax reform, when, in his capacity as treasury secretary, real estate speculation was freed of the tax man's bite. The growth in the paper assets tied to real estate transactions was later fed into the "securitization" stream, which from 1982 to 1987 took banks' so-called off-balance-sheet liabilities from zero to over $7 billion. The growth of the financial bubble was pyramided on the growth in speculative valuations of real estate, which provided the underlying collateral.

The case of Texas

The case of Texas is exemplary. First RepublicBank of Dallas, and First City Bankshares of Houston, moved lock, stock, and barrel into real estate after the collapse of oil prices in mid-1982-83. By last year, both banks had over 30% of what they called their "assets" in real estate loans. The preponderance of the book value of the loans was negative, because of the collapse of local real estate prices. All but one of the top seven Texas banks have been put through the bankruptcy reorganization wringer in the last year. Of the state's 250 or so thrifts, more than 100 are insolvent. A rescue package of some $25 billion or so would be necessary to put a floor under Texas banking alone. But then there comes a further problem; the liquidation of the insolvent institutions would involve demolishing what remains of the market for real estate.

But the real estate market is a national, and international market. Local transactions are packaged, for example, into mortgage pools, and sold, by government agencies like Freddie Mac and Ginnie Mae, as mortgage securities, to raise money on international markets to finance regional and local lending.

Texas threatens to bring this arrangement to an abrupt halt. So too does the case of the savings and loans unit of the Financial Corporation of America, American Savings and Loan Association, in Irvine, California. There it is actually worse. The thrift has been kept afloat since September 1987 by a monthly credit line of $12 billion, of which $5 billion has been provided, contrary to its federal charter, by Freddie Mac. That agency is supposed to raise money to finance mortgages, not lend money to bail out delinquents. However, American Savings and Loan holds 15% of the mortgages that have gone into the $80 billion or so funding packages put out by Freddie Mac. The collapse of the Irvine thrift would bring down the federal mortgage financing operation.

It is of course true that accounting incompetence, and political cronyism, by the regulators and their friends, have helped bring this situation about. They covered up for bankruptcy, they arranged reorganization plans which made things worse. They have acted throughout, not to defend the banking or thrift systems as such, but to defend the fiction of continually rising real estate and related valuations, on which the book value assets of the banks and thrifts depend.

Now they find that not only do they have no money to fund insolvent or bankrupt banks and thrifts, but that if they do, the pyramid of real estate values comes crashing down, with catastrophic effects on the banking system and federal government. Assets with book values into the trillions of dollars will come crashing down.

This dilemma is highlighted by the annual profit and loss statement of the savings and loans. That sector lost $6.8 billion net for the year 1987. The 1,000 thrifts, out the 3,000 total which lost money, lost more than $13 billion. It is now estimated, as we warned a year ago, that closing down insolvent thrifts, will cost the federal government something like $40-60 billion, funds which are not available. Some propose to use the $16 billion available to the FDIC for the task. What then is to be done with the commercial banks? The next storm on international markets may carry away Manufacturers' Hanover, Bank of America, or Continental Illinois, for the third time. What then? And if the money is provided, by resorting to the printing presses, what then happens to the book value of the assets?

Out of such a combination it is not difficult to see how the federal deficit will surge into the range of $300-400 billion in the months ahead. However, that would be achieved on the basis of the wreckage of the financial system as a whole, and the bankruptcy of the U.S. government. Neither outcome is an acceptable one.

Yet exactly that is what's now threatened, as other preshocks of the seismic disturbances that will most likely make themselves felt during the second quarter come to the surface.