

## **EIR Feature**

# **\$20 trillion debt fuels October crash potentials**

by EIR Economics Staff

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The U.S. economy and its financial system will experience a blowout sometime likely between now and the end of this year. The debt bubble in the United States is such, that no patching or adjustments within the framework of current economic policy could prevent that. The only question is, how high will the crash register on the Richter scale. Educated estimates of the timing for such a crash focus on the month of October, following end of September quarterly rollover and payment deadlines.

In what follows, we will examine the boundary conditions that have created the circumstances under which the upcoming crash potentials have matured, and will most likely shape its outcome.

Financial insiders, especially in Europe, have been warning since the middle of June that the question is no longer whether a crash will occur, but when. Ordinary people, in the same way, wonder, "When will it occur?" In framing the question this way, both the insider and the man on the street are really asking about the same phenomenon. What they generally are talking about, is some exceptionally catastrophic development, such as a run against the banking system, or a general liquidation of stock values, as happened in October 1987.

What they are talking about, is the end-result of the process of bankruptcy which has created the conditions for the crash. Since bankruptcy has been caused by the obsessive adherence to financial and economic policies that are, at their core, incompetent, it is as well to get the background out of the way first, before turning to the question of what may well turn out to be the triggers for the foreseeable crash.

The overall parameters are not at all obscure. In the middle of 1989, total U.S. indebtedness, of government at all levels, financial and non-financial corporations,



*Dollar collapse on Nov. 10, 1987, at the Frankfurt monetary exchange following the October crash. Since then, the refusal of Western nations and financial institutions to change their policies, guarantees that the next collapse will be far more devastating.*

and households, was running at \$12.3 trillion. Added to this has been a further pile of income-bearing paper, made up of various speculative categories, and itself totaling more than \$8 trillion. This amounts to in excess of \$20 trillion of combined debt and speculative activity to be rolled over or serviced during the course of this year. The quarterly debt service of rolling over the estimated \$4.5-5 trillion of annual claims riding on such indebtedness and speculation is \$1-1.5 trillion per quarter. That is a conservative estimate; the figure would be even larger if the full book value of offshore claims against the U.S. dollar were added in.

Secondly, since 1981-82, the physical economy of the United States has been functioning at around half the level required for breakeven. We can define breakeven as the level of investment in plant and equipment, and their maintenance, along with output of physical product for producers, households, and basic economic infrastructure, required to maintain functioning in a no-growth, steady-state mode. (In reality, such a mode is impossible, since without growth, any economy will collapse.) We can measure the shortfall from breakeven, as defined relative to the per capita and per hectare market basket standards of the late 1960s, in the collapse of the following: employment in operatives, the collapsing goods content of wage and salary income, the accumulated \$350 billion per annum deficit in spending on basic infrastructure, the collapse of educational and health services, and the goods content of the trade deficit.

Since 1983, total debt of all kinds has been growing by around \$1 trillion each year, and speculative activity at about the same rate. Both these categories have pyramided with respect to the collapse of the productive capacity to service

that growing debt. Indeed, annual service charges and claims by debt and speculation nearly exceed the already highly inflated measure of economic activity known as the Gross National Product. (Contrary to popular mythology, GNP does not ever measure the actual performance of an economy in terms of the production of real physical wealth; rather, it merely sums the net of all sales and purchases transactions and interest transfers in various sectors of the economy, aggregating it into what is called "value added"). The GNP counters allocate just under \$2 trillion to the productive economy itself. Thus, even using the distorted GNP measure, total output of economic activity in a year is currently less than half of what is required for the \$4.5-5 trillion annual service of debt and speculation!

Moreover, the total GNP is currently running at about \$5 trillion, which would indicate that the cost of maintaining economic activity at bare breakeven would approximate the totality of GNP. And even if the money for that level of activity were available, it wouldn't help, because the machinery, the qualified labor, and the infrastructure to support the expanded activity are just not there. With all the money in the world, you still can't buy what isn't being produced.

### **The 25-year slide into depression**

The U.S. economy and financial system have been sliding into bankruptcy since the incompetent decisions made during the 1963-67 period. At that time, President Lyndon Johnson, succeeding the assassinated John F. Kennedy, initiated his so-called "Great Society" program, emphasizing the apparent satisfaction of so-called "needs of consumers," while undermining the productive economy which could have



*The "junk bond" market of the 18th century was run by the Dutch-Venetian agent John Law, in collusion with George I of Britain and Philippe d'Orléans, regent of France. In this contemporary engraving, investors flock to the Rue Quincampoix in Paris to get a piece of the "Mississippi bubble," which was growing in tandem with the even larger "South Sea bubble."*

met those needs over the long term. Then, between 1967 and 1971, U.S. high-technology capabilities, as embodied in the Apollo Moon program, were shut down, and the dollar was driven into international bankruptcy, which was acknowledged on Aug. 15, 1971, when President Richard Nixon and his Treasury Secretary John Connolly took the dollar off the gold standard.

U.S. economic capacity was further ravaged between 1972 and 1979 by the combined effects of floating exchange rate policies, and by the first and second oil shocks of 1973 and 1979 respectively. The effect of both was to accumulate an offshore bubble of holdings of stateless dollars, recycled into lending secured against especially developing country raw materials assets. Federal Reserve chairman Paul Volcker's high interest rate regime of 1979-81 then plunged the world economy as a whole into bankruptcy and genocidal austerity, laying the basis for the financial and economic obscenities that have developed in the interim.

The period since September 1982 has been acclaimed as the "Great Recovery." In reality, these years have seen the development of the biggest speculative bubble since John Law's South Sea Company of the early 18th century. In order to buy time against the coming of the day of reckoning, between 1967 and 1979 a speculative real estate bonanza was created inside the United States, a binge which is ultimately secured against the faith and credit of the U.S. government, and therefore by U.S. taxpayers. The speculative structures associated with that bonanza began to come apart over the summer of 1987, leading to Black Monday on Oct. 19 of that year.

The two years since then have seen remarkable parallels to the interval between the October 1929 stock market crash and the collapse of the entire world economy in 1931. This autumn may well see the dissolution of everything that has

been accumulated on the accounts of usurious debt and speculation. Each of the principal potential triggers for the extinction of the the mass of \$20 trillion of indebtedness and speculation, corresponds to the swindling financial means by which the phony "Great Recovery" been perpetuated.

### **Which market will blow first?**

The largest role in triggering a crash will probably be played by one or all of three markets which have been experiencing explosive growth:

1) The junk-bond/merger and acquisition/leveraged buy-out market. Its debt now averages more than \$200 billion outstanding, and through leverage it supports more than five times that level in other forms of financing. This bubble has the potential to wreck corporate America, in the same way that U.S. savings and loans institutions and Third World borrowers have already been "bubbled" and wrecked.

2) The international trade in securitized paper and dirty drug-contaminated funds known politely as the "off-balance sheet liabilities" of commercial banks. In this market, hedges against foreign exchange and interest rate movements are sold back and forth by banks, at a commission, in order to maintain earnings levels lost as their traditional lending markets increasingly dry up.

3) The debt secured off-budget by U.S. government sponsored agencies and mortgage pools, like the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and so forth, which burgeoned in support of the speculative residential real estate market. In this case, the financial charges associated with real estate speculation were assumed largely by the U.S. government, as an inducement to maintain the pace of such speculation.

Added to the volatilities associated with these three mar-

kets, especially under conditions of declining values for underlying real estate collateral for lending, is the overall corrosive influence of the deregulation of the financial markets and the double-digit prime interest rate policy, which has been only slightly modified since it was initiated 10 years ago.

Each of these markets is now beginning to unravel. In mid-June, a financial services company known as Integrated Resources, which had been bought out in one of Drexel Burnham's leveraged takeovers, defaulted on payments on \$1 billion of debt. No one stepped in at that time to cover Integrated Resources' losses. Since then other companies victimized by leveraged buy-outs have begun to go into default, or have begun to notify the Securities and Exchange Commission that they will be unable to meet upcoming debt service payments out of their current cash flow streams. Companies like RJR Nabisco, Beatrice Foods, Federated Department Stores, and Owens-Illinois—each of which was bought out under arrangements that required corporate assets to be sold off to meet debt service claims in excess of revenues—have been unable to find buyers for the assets that have to be sold.

Drexel Burnham and Kohlberg Kravis Roberts, the architects of many of the leveraged buy-outs, may well be among the first victims of the coming crash, when the leverage will work the other way. At least \$1 trillion in stock market and bond market paper can come unglued on this account.

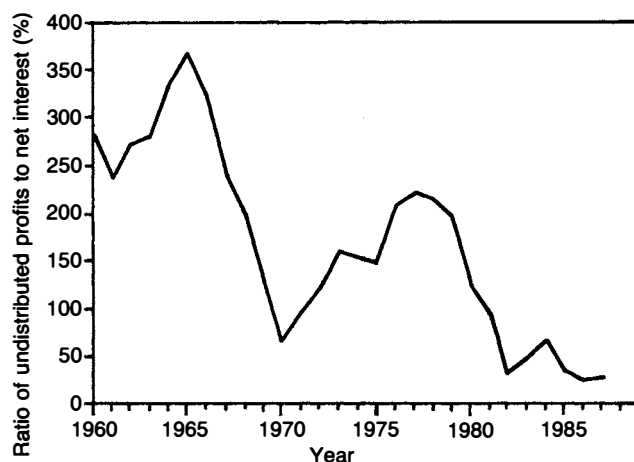
The recently passed so-called bailout of the savings and loan institutions calls into question the integrity of the government-secured mortgage market. S&Ls will now have to sell off secured mortgages to reduce their assets, such that new standards of capital adequacy can be met. How new buyers will be found for the assets that S&Ls have to dump, is another question.

As for the commercial banks, their combined on- and off-balance sheet liabilities run to between four and eight times their so-called assets; but their assets still include sufficient

Third World debt to bring down the entire system, and are increasingly shifting toward the speculative real estate holdings which brought down the S&Ls.

There surely will be those who, over the course of this autumn, will argue as they have before, that there is no need to worry, that the whole mass of paper coming due can be rolled over once again. And there will be those who try to do just that, lowering interest rates to throw paper at their \$1.5 trillion problem. It won't work. It would be much more sensible to accept the inevitable, that the whole usurious and speculative mess ought to be written off, and the credit system reorganized to make possible the necessary investment in productive capacity that will be required, if the United States and the world are to survive.

FIGURE 1  
**Undistributed profits\* of non-financial corporations as a percentage of net interest**



\* Undistributed profits are profits after taxes and dividends have been deducted. They are effectively retained earnings.

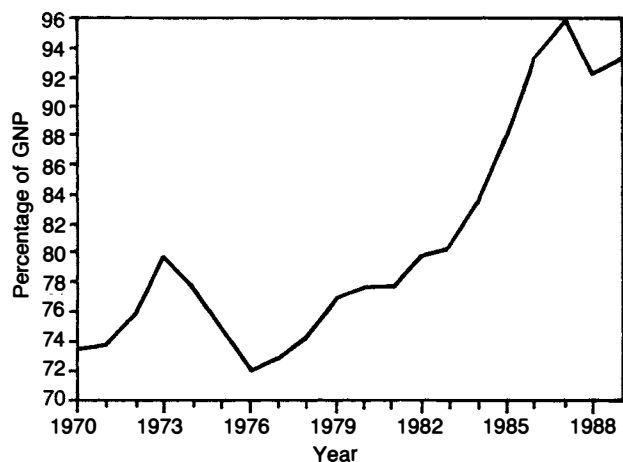
TABLE 1  
**Business debt**  
(billions \$)

Year	Financial business debt			Non-bank financial business debt	Total business debt
	Commercial banking	Non-bank	Total		
1973	23.1	100.4	123.5	960.1	1,083.6
1978	63.2	160.7	223.9	1,447.9	1,671.8
1982	130.8	238.7	369.5	2,157.2	2,526.7
1987	186.8	631.2	818.0	3,517.6	4,335.6
1988	169.5	752.4	921.9	3,792.6	4,714.5
1989*	188.2	799.6	987.8	3,859.8	4,847.6

\* First quarter.

FIGURE 2

**U.S. business debt as a percentage of Gross National Product**



**A \$20.5 trillion bubble**

The growth of business debt is shown in **Table 1**. Column 3 of the table plots the growth of non-financial corporations' debt. This includes farms, corporations, and partnerships. This debt was \$670.3 billion in 1970, and rose to \$1,662.6 billion (\$1.6626 trillion) in 1979. Between 1979 and 1989 it increased 2.3 times to \$3.8598 trillion, with \$1.7 trillion of that increment coming between 1982 and the first quarter of 1989. Columns 2 and 5 show the levels of indebtedness of commercial banks and of non-bank financial companies, such as S&Ls, savings banks, and insurance companies. This number does not include the liabilities of the banks and S&Ls (i.e., the deposits of their depositors), but only the debt they contracted on the open market—and not even all the debt, because it doesn't include certain short-term IOUs, such as very short-term commercial paper.

Two-thirds of the debt of financial corporations was incurred since 1982.

The total debt of non-financial and financial U.S. businesses stood at a staggering \$4.8476 trillion by the end of the first quarter of 1989, which means that American business, which often has endorsed the bloodthirsty calls of the International Monetary Fund (IMF) for more austerity against the Third World, has at least double the combined total internal and external debt of all 100-plus developing sector nations.

The cash squeeze of paying interest is illustrated in **Figure 1**. This plots undistributed profits (what amounts to retained earnings) against *net* interest payments. Retained earnings are what are left of corporate profits after 1) taxes have been paid, and 2) dividends have been paid to stockholders. Note that the actual level of retained earnings shrank dramatically during the 1980s, starting in 1982. One of the major

TABLE 2

**Federal, state, and local government debt**

(billions \$)

Year	U.S. government	Federal agencies	State and local governments	Combined government debt
1973	478.3	77.9	193.3	749.5
1978	801.5	181.7	260.5	1,243.7
1982	1,229.3	383.9	323.7	1,936.9
1987	2,430.8	1,025.0	554.2	4,010.0
1988	2,690.0	1,161.1	589.1	4,440.2
1989*	2,824.0	1,204.0	595.2	4,623.2

\* First quarter.

reasons was that corporations were paying out more of after-tax profits to dividends and retaining less as retained earnings, in order to attempt to keep up even a 3-4% yield to stockholders on stocks whose face value had greatly inflated during the artificial run-up of stock prices after 1982. For example, in 1980 corporations divided their after-tax profits thus: \$69.3 billion in retained earnings and \$45.5 billion in dividends to stockholders; in 1987, they had \$27.4 billion in retained earnings and gave out \$83.8 billion in dividends—a reversal of the proportion in 1980.

*Net interest payments* are the total amount of interest a corporation must pay out, minus the total amount of interest it took in. Figure 1 shows that retained earnings of non-financial corporations are now about 25% of interest payments. By comparison, in the 1970s retained earnings were 140% of net interest payments, and in the 1960s were 250%.

Likewise, **Figure 2** shows that total business debt now equals over 90% of GNP, whereas in 1980, such debt equaled only 75% of GNP.

**Table 2** examines government debt. Column 2 is the important column, since it shows the total U.S. government debt outstanding, both in public hands and held by the U.S. government or its dependents. One thing is for certain: The Reagan-Bush Revolution, which had vowed to lower the budget deficit and bring about a balanced budget in 1983 and then a surplus thereafter, achieved the precise opposite. By destroying the physical economy, the Reagan-Bush team threw the budget wildly out of whack, destroyed the physical economy, ravaging the tax base, increasing the expenditure for unemployment benefits, food stamps, etc., and swelling the interest on the public debt. By adding \$1.7698 trillion to the U.S. Treasury debt outstanding, between 1981 and the first quarter of 1989, this team nearly *tripled* the existing debt outstanding that it had taken the U.S. 200 years to build up between 1787 and 1981.

The growth of the debt of U.S. federally sponsored agencies and mortgage pools is shown in column 3 of Table 2. This increase represents almost entirely the growth of the issuance of debt paper by housing-related agencies such as the Ginnie Mae, Fannie Mae, and so forth. The government

TABLE 3

**U.S. public and private debt**

(billions \$)

Year	Household	Business	Government	Total
1973	666.8	1,083.6	749.5	2,499.9
1978	1,159.3	1,671.8	1,243.7	4,074.8
1982	1,655.8	2,526.7	1,936.9	6,119.4
1987	2,924.6	4,335.6	4,010.0	11,270.2
1988	3,177.1	4,714.5	4,440.2	12,331.8
1989*	3,236.2	4,847.6	4,632.2	12,716.0

\* First quarter.

assumed a good part of the risk for the housing sector, in the form of loan guarantees, etc. for the housing sector. That is, the Reagan-Bush "get big government off our backs" team used the off-budget powers of the United States to prop up the foundering real estate sector, especially during the past four years. Quite apart from everything else, when the \$2 trillion-plus housing sector goes, that alone could pull down the U.S. government, which is understood to stand behind Ginnie Mae and Fannie Mae paper, whereas 10 years ago that would not have happened.

**Table 3** sums up this whole process, adding household debt (largely \$2.1 trillion for housing and \$680 billion for consumer installment debt in 1989) to business and government debt of all levels, including state and local government. The sobering picture that emerges, is that by the end of the first quarter of 1989, the United States had total debt of \$12.716 trillion.

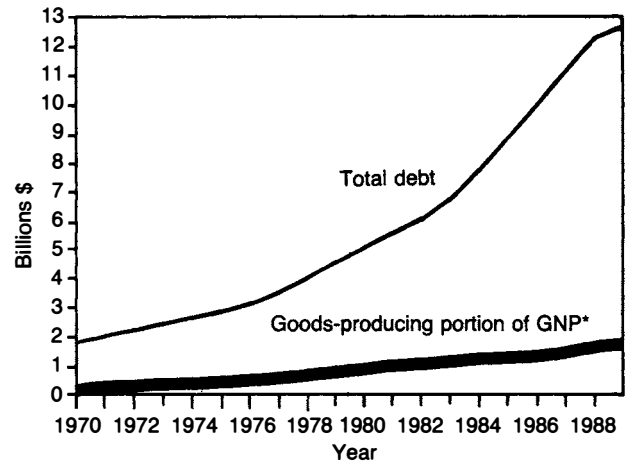
**How the debt grew**

Three phases of debt growth emerge. Between 1970 and 1976, debt growth averaged between \$100 and \$300 billion per year; between 1976 and 1982, it averaged about \$500 billion per year; between 1982 and the present, it has averaged approximately \$1 trillion increment per year.

This debt, which towers above that of any other nation, or any group of nations, cannot be assessed abstractly, but only in comparison to real processes. Two tests are valid. First, compare the debt service to the real physical goods output of the United States (**Figure 3**). The average maturity of the debt is seven years, which means that one-seventh of it, or \$1.714 trillion, must be amortized each year; the interest on the debt, at roughly 10%, is \$1.25 trillion. Total principal and interest debt service is \$2.954 trillion. That portion of Gross National Product that originates in real goods production is estimated at \$1.943 trillion. That is, *debt service exceeds the physical goods production portion of the U.S. GNP by \$1 trillion.*

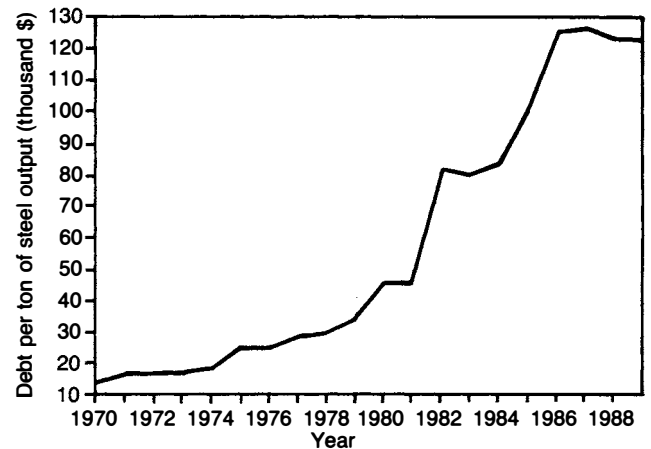
The second method is to compare debt per ton of steel and per household. The steel comparison appears in **Figure 4**; that for households appears in **Table 4**. Although 1989 data are not available, it is a rough estimate that each individ-

FIGURE 3

**Total U.S. debt compared with total goods produced**

\* EIR estimates.

FIGURE 4

**Total debt in U.S. per ton of steel output**

ual household is currently burdened with an average of above \$140,000 of debt; in other words, each individual—man, woman and child—in the United States is carrying about \$90,000 worth of debt, almost four times average annual earnings.

Any way one looks at it, the debt far exceeds any capacity to service it. The United States cannot carry this debt, or even half its level, and survive. All that the last 12 years represent—the Carter-Trilateral Commission policy and its continuation under Reagan-Bush—is a massive papering over of the financial system and a paper increase of GNP. In the

first quarter of 1989, real goods production, estimated at an annualized \$1.943 trillion, even considering the dubious nature of some of the output included in this category, represents only 38% of stated GNP of \$5.1131 trillion.

On top of this debt bubble, there is, however, a second level of bubble, as shown in **Table 5**. When the \$12.716 trillion of American indebtedness is added to this \$7.780

overhang, the total bubble of debt and speculative markets is valued at \$20.496 trillion.

### Trigger-point #1: off-balance sheet liabilities

Off-balance sheet liabilities include such items as standby letters of credit, forward commitments, futures and forwards, interest rate swaps, and foreign exchange contracts. They are mostly guarantees, or, in fact, unofficial insurance policies for forward commitments, which the bank never expects to have any problems with, but for which it earns a fee that goes right into its profits.

**Table 6** summarizes our findings. Citicorp of New York, America's biggest bank, has \$203.7 billion in assets. Since, in the bookkeeping of banking, assets must equal liabilities, Citicorp has \$203.7 billion in liabilities. But Citicorp also has \$659 billion in off-balance sheet liabilities, or "contingencies," as they are sometimes called. Thus, Citicorp has on- and off-balance sheet liabilities of \$862.7 billion, balanced against only \$203.7 billion in assets—i.e., the bank's liabilities are 4.2 times greater than its assets. If only a portion of these liabilities explodes, Citicorp is cooked.

According to its most recent annual report, Citicorp's total stockholders' equity is currently \$8.8 billion. Were a crisis to strike, Citicorp could cover only 1% of its total liabilities out of the resources of stockholders' equity. How safe could one feel with money in Citicorp?

As for the other giant U.S. banks listed in **Table 6**, the Morgan-founded and controlled Bankers Trust takes the cake, with on- and off-balance sheet liabilities nearly seven times assets. A sharp fall in a currency, sharp movements in interest rates, the demand of a company to exercise a credit line with a bank that may realize the borrowing company is not in

TABLE 4  
**Total U.S. public and private debt, per household**

Year	Total debt (billion \$)	Number of households (millions)	Debt per household (\$)
1970	1,845.1	63.4	29,103
1975	2,895.6	71.1	40,726
1980	5,098.0	80.8	63,094
1983	6,825.0	83.9	81,347
1984	7,785.4	85.4	91,164
1985	8,946.9	86.8	103,075
1986	10,205.9	88.5	115,321
1987	11,270.2	89.5	125,924
1988	12,716.0	90.6	140,353

TABLE 5  
**Other liabilities of U.S. firms**  
(trillions \$)

American Bank off-balance sheet liabilities	2.812
American bank portion of Euro-dollar market	0.895
Commodity, option and other markets	0.500
American stock markets and mutual funds	3.573
<b>Total</b>	<b>7.780</b>

TABLE 6  
**Off-balance sheet liabilities of selected U.S. banks**

Bank	Assets (billions \$)	Off-balance sheet "contingencies" liabilities (billions \$)	Ratio of on- and off-balance sheet liabilities to assets
Citicorp	203.7	659.0	4.2
Chase Manhattan	99.1	308.4	4.1
Bank of America	92.8	209.4	3.3
Chemical Bank	82.1	365.8	5.5
J.P. Morgan	75.4	209.4	3.8
Security Pacific	72.8	133.9	2.8
Manufacturers Hanover	70.4	219.1	4.1
First Interstate	58.8	73.4	2.2
Bankers Trust	56.5	334.5	6.9
First Chicago	45.1	158.0	4.5
Wells Fargo	44.1	29.4	1.7
Bank of Boston	34.1	41.1	2.2
Mellon	30.7	38.1	2.2

Source: Salomon Brothers report, "The Status of Global Risk-Based Bank Capital Adequacy Guidelines," June 1988.

TABLE 7

**Growth of junk bonds, mergers and acquisitions, and Dow Jones Industrial Average**

Year	High-yield junk bonds		Mergers and acquisitions		Dow Jones Industrial Average (30 stocks)
	Par value outstanding (millions \$)	New issues (billions \$)	Number of transactions	Value (millions \$)	
1975	7,720		961	n.a.	802.8
1979	10,675		1,526	34,177	844.4
1980	15,126		1,565	33,057	891.4
1981	17,362		2,326	66,957	932.9
1982	18,536	2.8	2,295	60,382	884.4
1987	136,952	31.5	3,950	177,900	2276
1988			3,687	231,600	2061
1989			1,607*	94,500*	2271 **

\* Through June 15, 1989.

\*\* Estimate.

sound shape, but must lend the money because it has already collected a fee for the promise of a line of credit—these are the possible scenarios which could puncture \$2.812 trillion of off-balance sheet liabilities on the books of America's 20 largest banks, which have not one cent of reserves behind them.

Since the banks have lent to many high-risk areas on the books—real estate and leveraged buy-outs—the possibility of the banks experiencing even a fraction of the volatility and risk off the books as they experience with on-the-books loans, would doom them, even were their capital base three times as large as it is now.

## Trigger-point #2: Junk bonds and acquisition market

This market is a “criminal enterprise”—not the individuals working in the market, not even individual firms, but the market itself is a criminal enterprise. Anyone entering the market who looks at the ground rules for a few minutes, will say to themselves, “I get it: You can do anything you want in this market!” What else can one say about a market where it is perfectly legal and within the rules to take over a company in which the interest cost on the debt incurred on the takeover will immediately exceed the revenue stream of the acquired company which must pay the interest cost?

The total size of the “junk bond” market is reportedly \$210 billion. In the average takeover, junk bonds comprise, usually, only one-fifth the financing package for the takeover as a whole. The other four-fifths of the takeover financing package are made up of either: 1) internally generated funds of the company making the takeover; 2) bank borrowings; 3) the funds of partnerships started up for the purpose of the takeover (in which banks also participate); 4) the floating of regular- or investment-grade bonds (as opposed to the below investment-grade junk bonds); or 5) drug money, conduited in various ways. If this is true—and to the best that can be determined, it is—then the \$210 billion junk bonds outstand-

ing represent but one-fifth of the total amount of takeovers that they generated and helped cement, valued at \$1 trillion. Thus, for every \$1 of junk bonds, \$4 has been spent on takeovers. If so, then the collapse of the junk bond market brings down \$1 trillion worth of deals.

The total value of all stocks and mutual funds in the United States is \$3.5 trillion; the \$1 trillion figure is thus about one-quarter of the total valuation of all stocks. Therefore, if the junk bond market becomes unglued, it pulls down larger deals, whose valuation represents one-quarter of all stock values in the United States. This would bring down the stock market for certain, and given the shape the commercial banks are in, the largest of those as well.

The signs that this is about to happen are ubiquitous. As mentioned above, on June 15, Integrated Resources, a “financial supermarket” company, headed by one Arthur Goldberg, defaulted on \$955 million in short-term bonds, most of them junk. But the press, probably following instructions, treated it as a minor occurrence. It wasn't. Drexel Burnham, the firm's sponsor, rushed in with \$30 million to keep Integrated Resources' doors open. The liquidity had dried up around the edges of the market; no one would heed Integrated's distress signals, and Drexel, which already had a bundle riding on the company, had to rush in with even more.

There are other distress warning signs about the imminent bust of the junk bond market, including the way the leading makers of the market have been trying to unload its stock on unsuspecting grandmas and grandpas.

But let us pass to the broader market for a second. A leveraged buy-out (LBO) is simply a merger or acquisition which is financed heavily, or wholly, with borrowed funds. The borrowed funds can be wholly or in part, mostly in part, “junk bonds.” Junk bonds are below investment grade, high coupon rate bonds, rated BB or below on the Standard and Poor's rating system.

Below investment grade debt has existed for years, but mostly these were bonds which had been downgraded from



originally higher ratings. But it was in approximately 1977 that the idea of original-issue junk bonds, i.e., issuing the bond below investment grade at the start, mostly for the purpose of a takeover, was conceived. The idea did not really catch on until 1982, when it took off with a vengeance.

Table 7 shows the par value outstanding of high-yield, below investment grade bonds. While figures are not supplied for 1988 or 1989, one report states that the par value outstanding is now up to \$210 billion. Column 3 shows for selective years the amount of new below investment grade bonds issued. The new issued figure cannot be simply added to the outstanding figure, because there are constant redemptions, exchanges, and so forth going on. In 1982, there were \$18.536 billion of below investment grade junk bonds outstanding. The market has grown by one order of magnitude in less than seven years.

Column 5 of Table 7 is the value of mergers and acquisitions. Since 1984, up through June of this year, mergers and acquisitions have cumulatively totaled \$981 billion. This is a gigantic figure. One author who writes about this field reported that each year, one in five of all publicly traded companies is involved in a merger or acquisition, either as a bidder or as a target. Column 6 of Table 7 shows the value of the Dow Jones Industrial (30 stock) Average. This is the average for the year of the 12 monthly averages. Cause and effect is clearly demonstrated: In 1982, the market was in the doldrums. Reagan was suffering through an economic depression. The Dow index averaged 884 for the year, but at one point it was as low as 750.

Then the administration pushes through the deregulation of the markets; off-balance sheet liabilities are permitted; the off-budget U.S. government agency and mortgage pool lending is cranked up to revive a housing market that was at historical lows in 1982; and junk bond-driven mergers and acquisition are turned loose to bull the Dow Jones. Price earnings ratios go from twelve to one up to twenty or twenty-five to one on paper, and much higher in reality, when the thin source of corporate earnings is considered.

At the same time as Integrated Resources defaulted in June, other signs pointed to serious strains and possible dissolution of chunks of the market. Drexel Burnham snookered a number of people into investing in its "unit trusts." Unit trusts are like mutual funds; but whereas when one invests in mutual funds, one is investing in the competence of the fund manager to buy and sell stocks at the best price for the fund, a "unit trust" has a fixed number of stocks or bonds which never vary. Drexel decided to unload some of the junk bonds of its debt-strapped companies into a unit trust it calls High Income Trust Securities funds or HITS. The HITS unit trust owns junk bonds of: 1) Resorts International, 2) Meshulam Riklis's Rapid American Corp., 3) John Blair Co., controlled by Saul Steinberg, and 4) Scovill Corp., now controlled by the Vancouver-based Belzbergs. Now that Resorts has announced that it is bankrupt, while several of the other com-

panies are close to bankruptcy, the people who invested in the trust have taken heavy losses. The story made the *Wall Street Journal* in July.

A recent Harvard University study on original issue high-yield bonds rips to shreds the widely believed lie that high-yield bonds are safe. One such pack of lies was put out by the Alliance for Capital Access, the junk bond lobbying group. They hired the consulting firm Data Resources, Inc. to do a study on the relative stability of junk bonds even under depression scenarios. The DRI study, replete with page after page of econometric graphs, purports to show that only about 2-5% of junk bonds have defaulted, and that this is all that is ever likely to do so, or maybe only a few percentage points beyond this. The Harvard study shows that the methodology of DRI, Morgan Stanley, and the U.S. government is to say how many of the junk bonds issued in 1977 defaulted in 1977, how many of those issued in 1978 defaulted in 1978, and so on. But it does not ask how many of those bonds issued in 1977 defaulted later on, in 1978, 1979, or any subsequent year. That such a simple question was not asked, is beyond comprehension.

The Harvard study showed that for a buy-and-hold investor, who bought junk bonds issued in 1977 and 1978, 34% of those bonds would have now been in default. Another quarter of all such bonds would have been called in by now. And, driven by their own insanity, the issuers of junk are testing how much lower quality junk they can get away with: In 1977, 43% of all junk bonds issued had at least a BB rating, and only 1% had a CCC rating or lower. But now the proportion has shifted: Only 13% are grade BB, while 17.7% are CCC or below.

The crisis is nearing a *denouement*. Campeau Corp.,

TABLE 8  
New housing starts, new home prices, and off-budget U.S. government housing-related credit

Year	New housing starts (millions)	Median new home price (\$)	Off-budget housing agency and mortgage pool housing-related credit (billions \$)
1980	1.31	65,000	226.6
1981	1.10	69,000	262.9
1982	1.07	69,000	323.6
1983	1.71	75,000	392.3
1984	1.76	80,000	464.5
1985	1.75	84,000	572.4
1986	1.81	92,000	785.8
1987	1.64	105,000	966.2
1988	1.48	113,000	1,085.8
1989*	1.51	119,000	1,126.0

\* First quarter.



*First Texas, one of the hundreds of Texas savings and loan banks to go under this year, was sold and converted into a commercial bank.*

Bob Trout

which made a multibillion-dollar bid to buy Federated Department stores a few years back, still can't come up with interest payments, nor sell off its divisions. Or take the RJ Reynolds buy-out of Nabisco, worth \$25 billion, the largest in history. The interest charges on the buy-out are \$2.5 to \$2.8 billion, which is larger than Nabisco's entire revenue flow. But the asset stripping which is part and parcel of a takeover, in order to have cash to pay down one's debt, has not worked out as well for RJR Nabisco. There have been many food company takeovers in recent years, including last year's takeover of Kraft. Many companies are desperately trying to sell food units into the market in order to raise cash, but they aren't finding buyers at the price they need.

### **Trigger-point #3: off-budget U.S. agencies and mortgage pools**

A fundamental shift in housing policy was carried out under the Reagan administration. The United States shifted from funding, through private and public sources, approximately 2 million new housing unit starts per year in the 1970s, at a price per home that bore at least some connection to reality, to instead funding only 1.3 to 1.5 million unit starts per year, but at a much higher price. Thus, the same or even a higher total volume of mortgages now supports far fewer units, but at much higher prices. The Department of Housing and Urban Development has virtually dropped out of the new home-building business. Whereas HUD helped construct about 150,000 units per year, mostly of multi-dwelling housing in inner cities, last year it helped finance only 25,000 units.

But as the savings and loan banks increasingly got into trouble on old loans, HUD and Wall Street didn't want to think about \$250,000-and-up starting price homes that it was bringing

onto the market. So, it decided to funnel money at the problem.

These agencies are now experiencing difficulties. Table 8 shows the number of new housing units, the median price of a home, and the explosive growth of off-budget U.S. government agency (Ginnie Mae) or quasi-agency (Fannie Mae) paper. This off-budget financing is not all housing related; some of it is connected to agriculture and rural electrification programs and student loans. But the lion's share of it is housing related. Only that portion of off-budget debt which is housing related appears in Table 8. Remember, these agencies compete directly with the U.S. Treasury, and are issuing almost the same amount of instruments of indebtedness as the Treasury does each year.

Now, at the point when the Japanese and other nations refuse to buy any more U.S. Treasury paper, they certainly won't be buying new, or rolling over old Ginnie Maes and Fannie Maes, either. What happens then to the housing structure? But the problem is also transmitted from the other end: If the prices of homes soften significantly—as they have been doing and will continue to do—then that will rock Ginnie Mae and Fannie Mae and attack the government from a quarter that it is least prepared to handle.

Any short-term liquidity squeeze, which puts pressure on over-leveraged corporate treasuries, or which causes even a 7-10% default on bank off-balance sheet liabilities, or which causes off-budget government-backed housing-related paper to not be able to go to market or to experience a shakeout; any further chain reaction collapse of LBOs, any sharp price drop in the dollar, and the Crash of 1989 thunders upon the shores of the United States and the world—the dollar is still the world's reserve currency. Such is the emerging profile of the crash that could erupt this October, as a result of the accumulated debt of the financial system.