America's big banks look into the abyss

by Richard Freeman

The latest sharp tightening in U.S. credit terms has produced only one virtual certainty—sections of the U.S. banking system will go belly side up. U.S. banks which borrowed heavily short-term, to lend in great volume long term, now find themselves technically insolvent, refunding their short-term obligations at higher and higher interest rates. They are, in the words of a Wall street bank analyst, "slowly bleeding to death."

This of course produced immediate rumors concerning perhaps the first bank that would go in the credit crunch: First Pennsylvania, with $9 billion in assets, and stock selling in the $3.50 to $5.00 per share range, less than one third of its 1978 level. Last year, First Penn's earnings dropped 50 percent and its total assets fell a remarkable $0.7 billion, or almost one eleventh during 1979. First Penn's equity cannot cover its bad paper. But more important, its losing holdings are beginning to outweigh its earning assets, the true tip-off that it is on its way down and out.

But, bank analysts are ticking off other insolvency targets, putting at the top of the list: First Chicago, First Wisconsin and Equibank of Pittsburgh.

This problem in the commercial banking sphere is matched among the thrift institutions. The *Wall Street Journal* of March 26 pinpointed the precise nature of the problem: nearly one third of the savings and loans are losing money this year, and the industry as a whole will on the year lose $1 billion if interest rates don't go higher. Reports the *Journal*, "The spread is shrinking to the vanishing point. Industry costs have been rising by as much per week as they previously did per year. The prospect is that a few failing home lenders will quietly be merged into stronger institutions."

The overall problem is that the shake-out in the banking industry will lead to an acceleration of the liquidity problem in the already unsteady corporate industrial sector, producing one or several large sized Penn Central-style bankruptcies.

How Volcker is moving

That the banking sector should meet this fate is mostly its own doing. Following the meeting of 65 banking leaders with the Federal Reserve chairman on March 17 in Washington, D.C., Volcker laid out the ground rules of how he would run a credit crunch using the extraordinary, martial-law-like powers granted him under the 1969 Credit Control Act. That Act gives Volcker control over any and all types of credit extension, either by banking or corporate, agricultural, or consumer credit institutions and firms. Under the guise of examining these institutions financial transactions, Volcker can impose the most far-reaching changes on the economy. At the March 17 meeting, Volcker told the banks that he would allow the banks to lend new credit only at the rate of 6 to 9 percent per year: less than one half the rate of inflation. The banks agreed to this, aware of its obvious deleterious influence on production.

One economist for a large New York City bank explained the rationale behind this move in an interview with *EIR* March 26. "Look, I'd be drummed out of my bank for telling you this," reported the economist, "but the commercial banks welcomed Volcker's crunch as a god-send. The commercial banks wanted to retrench. They wanted for a while to stop giving out new credit to their customers, but they were afraid that if they stopped first, their customers would pick up and go to another bank. The policy is 'we'll all retrench together.' "

On the grounds that they could let the burden of the ensuing banking industry shake-out occur at the expense of the "smaller banks," the large money center banks were more than willing to play ball with Volcker. Moreover, reasoned the large banks, if there is such a shake-out, smaller banks can be picked up at distress sale prices.

One bank analyst noted, "several British banks are ready to step in and pick up U.S. banks as dollar assets before the value of the dollar goes kaput."

Where the shake-out will lead

On the basis of strategic miscalculation of the above sort the large banks may become the victims of the very process they agreed to unleash.

The London *Economist* magazine of March 22-28 in its cover story, sums up the obvious. Entitled "The Userer's Recession," the lead story states that "inflation has climbed to a rate that Americans used to associate with banana republics." The attempt to kill off this inflation, via the Carter-Volcker package of energy conservation, selective credit controls and deep budget cuts brings with it the danger of global recession and a deep collapse in the United States. At the point this occurs, asks the *Economist*, will Fed chairman Volcker have the "nerve" to continue pushing downward?

An analogous situation obtained in the early years of the Nixon administration; Milton Friedman prescribed keeping money supply between the range of 3 to 5 percent, promising that this formula would eliminate inflation and push up GNP output to the 3 to 5 percent level. As Leonard Silk relates in his book *Nixonomics*, from December 1968 to June 1969, the money supply grew by 4.4 percent, just within the range laid down by Friedman, but during the first half of 1969, the consumer price index rose at an annual rate of 5.8 percent.

William McChesney Martin, chairman of the Federal Reserve Board had followed Friedman's advice "to the T." Between June and December 1969, he held the money supply to a 0.6 percent rate of growth. In the next six months, inflation not only rose to 6.0 percent, but the economy fell apart, as GNP fell in the first quarter of 1970 at a 3 percent annual rate. President Nixon rushed in Arthur Burns as head of the Fed to replace Martin, but the damage was done by June 1970. Penn Central filed for bankruptcy and the stock market went into its worst decline since 1929. In panicked reaction, Burns did what he and Nixon thought was necessary to salvage the economy and the upcoming congressional elections: pump money like crazy into the economy to prop things up. The inflation rate took off like a shot, and on Aug. 15, 1971, as the crisis played itself out, Nixon and his Treasury Secretary John Connally made the dollar inconvertible, burying the gold-based Bretton Woods system.

What now confronts Carter and the dollar is what one investment banker asked out loud this week: "what if the economy begins to fall like a stone," just as in the first half of 1970, with one or several Penn Central-style bankruptcies.

The London *Times*, in its lead editorial March 27, "The Fed Looks at the Future," predicted that in an election year Volcker and Carter's "follow through cannot be taken for granted," but that certainly once the elections are completed, the consumer credit sector, among others, must be annihilated. Yet, the *Times* is not calculating on the true dimensions of what is in store.

If the U.S. attempts to artificially keep U.S. interest rates up, but blows out the economy, the dollar will not remain strong, and capital flight will ensue for the simple reason that investors will know that the U.S. lacks the means to pay off on its paper. On the other hand, if Volcker decides to let interest rates fall, the current dollar bubble will not be able to hold up under massive capital flight. In either case, money will flee the dollar, and $1 trillion Eurodollars will be presented for repayment.

If that happens, the U.S. banking system is shot: Citibank, Bank of America and all the other top banks playing footsy with Volcker's credit crunch will be in the situation of First Pennsylvania. The sole measure the U.S. could take to stem the dollar flight—exchange controls—will not solve, but only intensify the problems. As the countries of the European Monetary System see that they cannot trade in dollars, they will probably do what Volcker's measures have been partly designed to prevent, resort to gold-based European Currency Units.