Domestic Credit by David Goldman

The collapse of bank lending

A Salomon Brothers report shows how bad debts contract loans, and the oil sector was hardest hit.

Business loans outstanding from U.S. commercial banks fell by $2.5 billion during the first quarter of 1986, as *EIR* reported in April. We attributed the decline to disaster conditions in the nation's economy.

Indeed, loans by banks to business fell during only one year in the entire postwar period, namely 1974, and have not fallen on a quarterly basis since the second quarter of 1980, which registered the fastest rate of decline of industrial output in the history of the United States.

Salomon Brothers analyst James McKeon reported at some length on this phenomenon in a research report issued on June 9.

McKeon's piece does not add substantially to what has been obvious for some months, but it is still useful to re-state the point.

"Commercial banks were reluctant to supply credit as aggressively as they have recently," McKeon wrote, "because of the following factors:

"The increased incidence of nonperforming loans to farmers, foreigners, energy producers, and, in part of the country, real estate.

"The perception that, in many cases, capital ratios were inadequate.

"Uncertainties about the impact of tax reform on new investments."

As we reported earlier, the oil belt was hit worst. The Salomon report notes, "The decline appears to have a strongly regional character. About 60% was concentrated among the large weekly reporting banks in the Dallas Federal Reserve district, while the remainder was at smaller, non-reporting banks.

"If regional data were available for smaller banks, they might show that all of the decline was concentrated in oil-producing regions. The plunge in oil prices severely crimped demand in oil-producing regions, and a slide in bank earnings in that area also reduced the willingness and ability of banks to extend credit."

But the $1 billion decline in small banks' lending also provides an "acid test" of the bank regulators' program for dealing with problem institutions. Contrary to all the talk about stretch-outs to agricultural and energy borrowers, the Federal Deposit Insurance Corporation and the Treasury's Office of the Controller of the Currency are forcing the banks to liquidate borrowers.

In the 50-odd bank failures so far this year, the FDIC has followed its takeover of failed institutions by bankrupting the institutions' problem borrowers as well.

These data are sufficient to show that the collapse of the oil patch is, by itself, sufficient to turn the direction of the nation's economy downwards (*EIR* estimates a 7% decline of U.S. industrial output as a consequence of $12 a barrel oil).

However, it is not merely the oil patch that is in trouble, Salomon continues:

"Nevertheless, even if all of the first-quarter commercial and industrial loan retreat was the direct or indirect effect of energy price declines, loan demand would still be virtually nonexistent."

Part of the collapse in loan demand, of course, reflects large corporations' access to relatively cheap long-term money on the bond markets. But the major banks face the same problems that hit the oil patch, as Third World debt portfolios deteriorate.

"Loan sales at larger money center banks seem aimed at achieving the slower growth of assets and the substitution of higher-yielding loans for those being sold," writes McKeon.

But a large portion of those loans involve Ibero-American credits, now selling on the secondary market at between 40% and 70% of face value.

Conditions are likely to worsen for the major commercial banks, warns Salomon. "Declines in oil prices, interst rates and the U.S. dollar have not yet had the favorable impact that was expected. . . . These are the only potential improvements for the commercial banking system, however. And, they could be outweighed by the effects of the apparent recent deterioration in Mexico's external position if current international negotiations fail to resolve Mexico's difficulties."

Predictably, the banks have responded to the crunch in areas in which their previous speculations failed, by increasing their speculation in other areas, mimicking the gambling "system" proven to lead most rapidly to bankruptcy: doubling your bet.

Commercial banks are rapidly increasing their residential real-estate portfolios, financing the building of houses on speculation, among other things. Mortgages increased by $10 billion, which will add to the troubles of the banks, when the present mini-bubble in housing purchases deflates.

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