Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

NEW YORK

Banks on the Brink

By Jack Egan

Flirting With a Global Collapse

REMEMBER THE NEW YORK CITY fiscal crisis of the mid-1970s? It took one cliff-hanger after another to keep the city from going bankrupt. Multiply the seriousness and complexity of that situation by at least ten, and you'll get some idea of what lies ahead in the coming year for the world's tightly interwoven international financial system.

It is no overstatement to say that the governments of dozens of debt-ridden nations, the International Monetary Fund, the Federal Reserve Board, and hundreds of American and foreign banks together face the severest and broadest financial crisis since the 1930s. Private banks here and abroad have lent over $300 billion to governments of developing or Eastern European countries and a growing number of those governments, led by Mexico, Argentina, and Poland, are unable to repay. An outright default by any of these countries could tip a number of major banks into insolvency.

Unlike in the 1930s, American depositors are protected by government insurance for up to $100,000 kept in any one bank account. But internationally there is no mechanism in place to ensure that events don't get out of control.

Former I.M.F. managing director Johannes Witteveen recently warned that "a crisis in confidence in the international banking system could turn this prolonged recession into a real depression." Unfortunately, last month's meeting of the fund, an international bank that keeps a monetary pool from which nations can borrow, failed to produce agreement on a global policy to stanch the widening crisis. Instead, each case is being dealt with on an ad hoc basis. The most troublesome case right now is Mexico, the world's most indebted nation, with over $60 billion in loans outstanding to private banks.

'WE'VE LEARNED FROM public policy that nothing gets done until there is a real crisis," says investment banker Felix Rohatyn, who was instrumental in working out a solution to the New York City mess. "But if you wait for crises to develop, you're going to have to be very lucky to get through all of them."

Big American banks are having problems with their loans not only to countries but also to corporations. Bankruptcies are running at a record rate, causing many banks to take large write-offs against earnings. And there have been some bad accidents. Chase Manhattan lost $285 million when Drysdale Government Securities went under in May. The Continental Illinois National Bank found itself holding $1.1 billion in questionable energy loans when the Penn Square Bank, of Oklahoma City, became insolvent in July.

Continental, the sixth-largest bank in the country, has a portfolio filled with loans to companies that either have filed for bankruptcy or are in very bad shape. As the main banker to International Harvester, which for all intents and purposes is technically insolvent, Continental has worked with a consortium of 200-plus banks to restructure the company while avoiding a formalbankruptcy proceeding. By keeping International Harvester from filing for bankruptcy, Continental is able to evade another large write-off.

The most promising development recently has been the rapid decline of interest rates in the United States, resulting from a decision by the Federal Reserve Board to stop fighting inflation by limiting the amount of money available for borrowing. The Fed is now trying to induce a national economic recovery and stem the mounting bankruptcies and defaults both here and abroad.

Fed Chairman Paul Volcker, in a recent speech to the Business Council, insisted that the sharp decline in rates "represents no change in the basic thrust of policy," but the explosive rises in stock and bond prices tell a different story. The market gains clearly reflect a belief that the Fed has given up on its previously restrictive monetary policy and will now do anything it can to bring interest rates down.

In fact, Volcker told Business Council members, the heads of the country's largest corporations, that the step to lower rates was "taken against a background of continued sluggishness in business activity, the exceptional recent strength of the dollar on the exchange markets and indications of strong demands for liquidity in some markets."

The question being asked by many is whether lowering interest rates at this point can do the trick—or whether the Fed stuck with its restrictive policy too long and is now acting in desperation to pump money into a domestic and international economy that is already too illiquid to respond. "It's very late in the day for the Fed to be easing up," says

Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

Volcker: *His effort to pump money into the system won't help if the banks refuse to lend.*

Rohatyn. He is especially concerned about the several hundred banks that operate in the Eurodollar market—banks that borrow and lend dollars outside the United States. They have no government to back them as a lender of last resort in case of failure. While the Fed has indicated that it will prevent any large U.S. bank or its direct subsidiary from going under, and other industrialized countries are expected similarly to prop up their own private banks, these Eurodollar banks could start tumbling like dominoes. "What we need right now is some coordinated thinking among the industrialized countries on how to prevent such a situation from occurring," Rohatyn says.

"We have a race between the Fed's attempt to re-liquefy the financial system and the continuing deterioration of the economy," says Raymond Dalio, president of Bridgewater Associates, an economic-consulting firm. "And it's a race that will go right down to the wire." Dalio is doubtful that the Fed will succeed. If it does, he believes, it could, by making borrowing easier and less expensive, set off a new round of serious inflation by 1983 or 1984.

Optimists are hoping that a financial crisis can be avoided if the U.S. economy starts to turn around. A rebound here could begin to pull the world out of its economic doldrums, providing the growth that would permit the developing countries to repay their debts. However, current projections suggest that the U.S. economy won't snap back vigorously when a recovery finally begins, and that recovery may still be many months away. The global economy, meanwhile, is expected to grow a tepid 1 percent in 1983, far from enough to generate the cash for developing countries to repay their debts.

The bankers can only hope that the mutual interest of all the parties involved will keep the system from breaking apart. "There are going to be some major strains for some time to come, but I don't think the bubble is going to burst," says Norman Klath, a Morgan Guaranty Bank vice-president who specializes in international economic analysis. "Everyone has too much at stake, from the borrowers to the lenders to the governments. The biggest problem right now is working through one or two troubled countries, demonstrating that all the parties involved realize the consequences of failure."

THE BIGGEST PROBLEM RIGHT now to work through is Mexico. Although a rescue package has been put together for that country, the terms of a final agreement are still unclear, and difficult negotiations lie ahead. As a condition for more than $4 billion in new loans, the I.M.F. is trying to impose severe austerity measures on Mexico. But if Mexico is forced to slow down its economy, it is hard to see how it can begin to pay back its debts. Only a resumption of strong economic growth can reverse the situation, and the I.M.F.'s conditions for a bailout will probably put Mexico deeper into the red. Even if an agreement is reached, growing internal unrest and political turmoil may make any promise to deflate the Mexican economy impossible to carry out for very long.

Argentina is in even worse shape. Hyperinflation has turned it into a basket case. With more than $25 billion in outstanding bank loans, Argentina is making minimal interest payments on these debts and has stopped repaying any principal. It is not even making any effort to reschedule its debts. There has recently been talk that Argentina may repudiate its loans, a thought that sends shudders through the banking community. However, the banks have looked the other way, fearing to take write-offs that could wipe out their capital. An approach to the I.M.F. for assistance has been made by Argentina, but no announcement of any bailout package has been made.

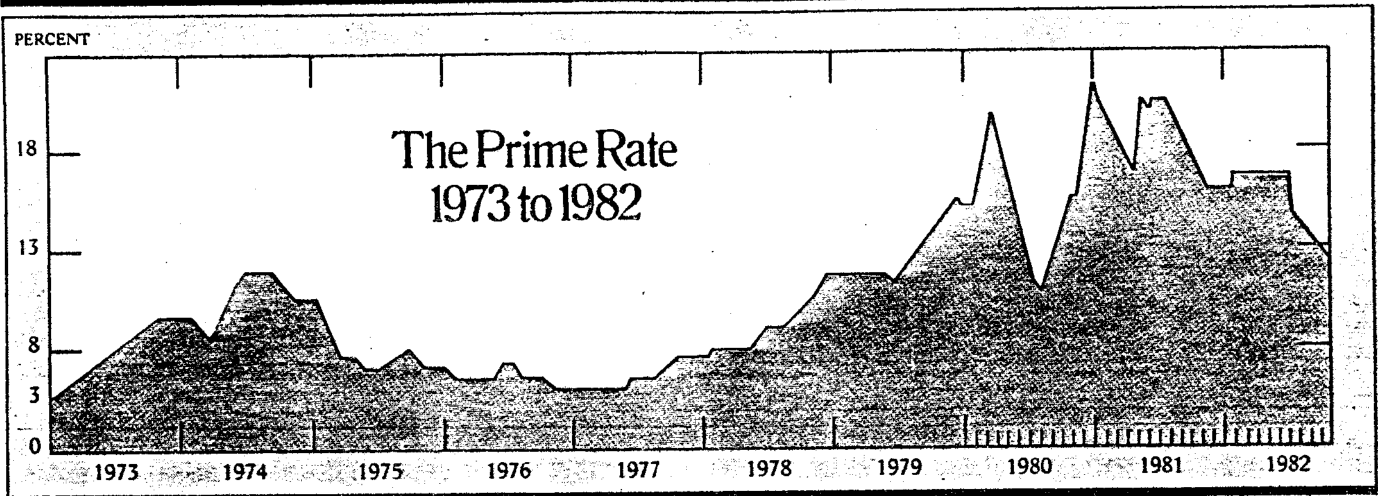
The repayment difficulties of Mexico and Argentina, which together account for one-quarter of the loans to all developing countries, have caused the banks virtually to freeze lending to all countries in Latin America. U.S. banks hold about a third of this total

Photograph by Terry Arthur/Camera 5.

Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

"...The bankers can only hope that the mutual interest



debt. Eastern-bloc countries have also been cut off from new loans, as a result of Poland's financial problems.

The growing reluctance of banks to extend new loans, reversing the lending binge of the last ten years, has created problems for all countries. Brazil, for example, which owes $53 billion to the banks, is finding it more and more difficult to get new financing. As a result, it may soon find itself in the same position as Mexico. Brazilian officials have been meeting with lenders in New York, London, and Tokyo to try to convince them that Brazil's economy is in much better shape than Mexico's. So far, Brazil has raised about three-fourths of the $18-billion in total borrowing it needs this year to remain solvent. But if it fails to get *all* it needs, a crisis of major dimensions could follow.

THERE'S AN ESSENTIAL CONtradiction in the policy the I.M.F. is pursuing to deal with the problems of the growing list of debtor nations that are in jeopardy. While one country after another finds that it can't repay its debts, the I.M.F.'s conditions for fresh aid include cutting back on imports and clamping down on economic growth as a way to subdue inflation. But while such measures may be effective for a specific country, they serve to depress overall world economic activity even more. One nation's imports are another's exports. The effort by any one country to reduce its inflation by curbing imports only drives the global economy into a deeper recession. And the pressure for protection against imports also increases as domestic unemployment rises.

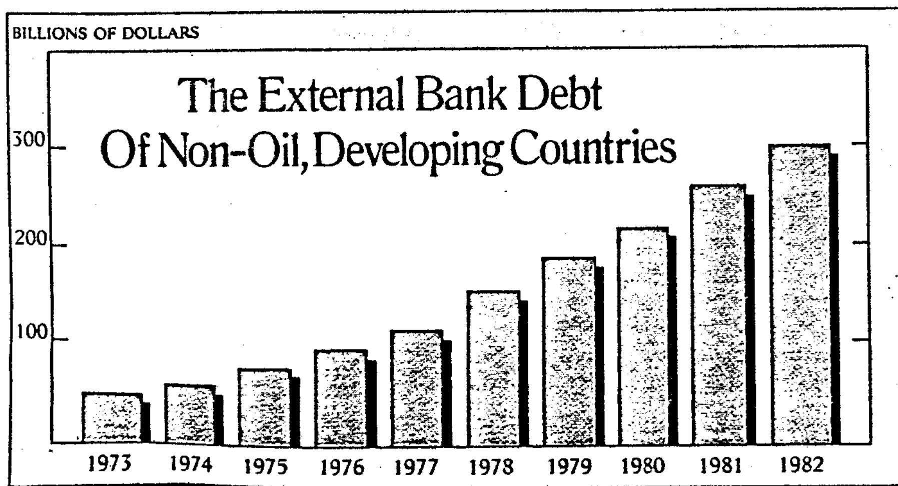
Deflation was the economic disease of the Great Depression. But memories seem to be short. As John Kenneth Galbraith points out in *Money*, "the fear of inflation which inflation leaves in its wake can be as damaging as the inflation itself."

The accelerating inflation of the 1970s, aggravated by two oil shocks, is probably the main reason for the current banking and liquidity crisis. As inflation advanced faster than interest rates, borrowing became more desirable, since loans could be repaid in cheaper dollars. This fueled more inflation and more borrowing. The banks were only too glad to go along. The best way to keep earnings growing as inflation heated up was to increase loan volume. The big surpluses that built up in the petroleum-producing countries were deposited in the multinational banks, which in turn recycled the money to the developing countries to help them pay their mounting energy bills. The booming international loan market meanwhile encouraged many new banks to enter the business, and competition for market share became fierce.

The propensity to borrow was not limited to developing countries. The U.S. government also ran a perpetual deficit, and corporations and consumers took on mountains of debt. The rationale was the same: With prices going up faster than interest rates, it was best to buy something today that would only cost more tomorrow, when repayment could be made in a depreciated currency. As a result, an enormous debt bubble was created. Money was socked into real estate, gold, collectibles, and other "hard" assets. Corporate and government bonds, representing the claims of creditors, took a dive.

The rules of the game suddenly changed in October 1979, when the Federal Reserve Board, under Chairman Volcker, announced that it would no longer try to control interest rates but would stick to a predetermined level of growth in the country's money supply. This drastic shift in policy was in direct response to monetarist economic theory, which contends that the rate of inflation is determined by how fast the central bank ladles out money. By the spring of 1980, the bank prime rate had hit 20 percent as a result of the change in emphasis.

In March 1980, under prodding from President Carter, the Fed imposed regulations limiting borrowing. The result was an unexpectedly sharp contraction in the economy. The Fed let interest rates plunge, and the prime dropped to



Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6

# of all the parties will keep the system together..."

10 percent only two months later. When the controls were lifted, interest rates surged again, and in December 1980 the prime rate hit 21.5 percent.

Inflation was slow to respond to the new policy. But in the last twelve months, it has dropped drastically, from an annual rate of about 13 percent to less than 6 percent. Interest rates, however, have come down more slowly. As recently as January, the prime rate stood at 18 percent. Rates began falling in August, and their descent has accelerated in the last month. Last week, a number of major banks cut the prime to 12 percent, the lowest level in more than two years. A 12 percent rate, however, is far higher than the average bank lending rate over the last hundred years.

Just as borrowing worked to the advantage of consumers when prices were climbing faster than inflation, the persistence of double-digit interest rates when inflation is declining rapidly has strained borrowers. Leverage, after all, works both ways. The current recession, the most serious since the 1930s, has reduced corporate cash flow and made it extremely difficult for businesses to repay their high levels of accumulated debt.

The Fed's latest policy shift, despite disclaimers from Volcker, is clearly an attempt to ameliorate the situation by abandoning the pure monetarist approach. However, the belated effort to re-liquefy corporations and stimulate the economy may not work if the banks don't cooperate. Having gone overboard in extending credit during the last ten years, the banks have become reluctant to make new loans. And no matter how much money the Fed pumps into the financial system, it won't help if the banks refuse to lend.

In Canada, the government has been forced to bail out Dome Petroleum in order to prevent a bankruptcy that would have annihilated a number of the country's largest banks. Germany is helping to save AEG-Telefunken, the electronics giant. The reluctance of the banks to extend more money to foreign governments is equally understandable but is only hastening the crisis.

"THE SITUation right now is quite unpredictable," says a World Bank official. "There is certainly every possibility of a major financial crisis. What will happen depends largely on the uncoordinated decisions of a large number of commercial banks. There is currently no existing international coordinating mechanism. The tragedy of the recent I.M.F. meeting was that the representatives of the industrialized countries failed to reach any agreement on what to do." Another I.M.F. meeting has been scheduled for next April. But that's too far off to deal with a crisis that could erupt at any moment.

What, in fact, should be done? Felix Rohatyn, in an article in *The New York Review of Books* titled "The State of the Banks," makes several suggestions. Current accounting practices require a U.S. bank to write off loan losses against its capital, which includes both retained earnings and shareholder equity, not against its deposits. While the Federal Reserve can pour money into a bank that is experiencing a run on its deposits, there is no mechanism to keep a bank solvent if a large creditor, such as Mexico, or a bankrupt corporation defaults on its loans. Rohatyn suggests that either the government form a new Reconstruction Finance Corporation, which could buy preferred stock in a bank, thereby providing capital, or the Federal Reserve Board make such investments directly.

He also suggests strengthening international financial institutions like the International Monetary Fund. "Sizable new credits from the banking system, extensions of existing debts, temporary moratoriums—all these measures will be required. To carry some of them out may require government guarantees as well as the involvement of both national and international institutions. The private banks, alone, cannot carry the burden."

ONE NEED NOT AGREE WITH all of Rohatyn's suggestions to realize that some immediate and coordinated action by the world's major governments is required to prevent a financial collapse that could lead to a full-fledged international depression. As Charles P. Kindleberger wrote in *The World in Depression, 1929–1939,* "the world economic system was unstable unless some country stabilized it, as Britain had done in the nineteenth century and up to 1913. In 1929, the British couldn't and the United States wouldn't. When every country turned to protect its national private interest, the world public interest went down the drain, and with it the private interest of all."

It can be argued that the policies of the Federal Reserve Board and the Republican and Democratic administrations of the last fifteen years have ignored "the world public interest" and pursued narrow national goals, helping to produce the current situation. The governments of other industrialized countries cannot be absolved, either. Nor can the overburdened debtor nations, nor the multinational banks, which have contributed generously to the current crisis.

But it's useless to spend time assigning blame now. The need is to prevent a bad situation from becoming a global disaster. ■

How Much They Owe

Banks' claims on selected countries, as reported to the Bank for International Settlements.

COUNTRIES	1981 TOTAL (BILLIONS OF DOLLARS)	U.S. BANKS' SHARE	
		ALL BANKS	NINE LARGEST
DEVELOPING	331.3	35%	23%
Non-OPEC Countries	258.5	36	23
Mexico	56.9	38	20
Brazil	52.7	32	20
Argentina	24.8	34	21
Korea	19.9	45	28
Chile	10.5	55	31
Philippines	10.2	53	36
Taiwan	6.6	75	47
Colombia	5.4	51	36
Thailand	5.1	32	21
Malaysia	4.4	22	19
Egypt	4.4	27	20
Peru	4.4	45	24
Turkey	4.2	34	21
OPEC Countries	72.8	32	22
Venezuela	26.2	40	27
Algeria	8.4	16	11
Indonesia	7.2	33	27
Nigeria	6.0	19	15
Ecuador	4.5	47	27
EASTERN EUROPE	71.5	11	7
Soviet Union	16.3	3	2
Poland	15.3	13	8
East Germany	10.7	9	6
Yugoslavia	10.7	25	15
Hungary	7.7	15	9
Romania	5.1	7	5

Source: Bank for International Settlements (BIS), The Maturity Distribution of International Bank Lending; *and Federal Financial Institutions Examination Council,* Country Exposure Lending Survey.

Approved For Release 2007/02/20 : CIA-RDP83M00914R001000030024-6