

# Welcome to Brazil?

## Fed Policies Are Debasing the Value of the Dollar

By CHRISTOPHER WHALEN

**WASHINGTON** — In the weeks of crises since the Iraqi invasion of Kuwait, markets have been exposed to an unfamiliar phenomenon: a weak dollar, rising Treasury-bond yields, and declining stock prices. Yield spreads between short-term money and 30-year Treasury bonds have widened dramatically, while the central bank struggles to keep the Federal funds rate south of 8 1/16%.

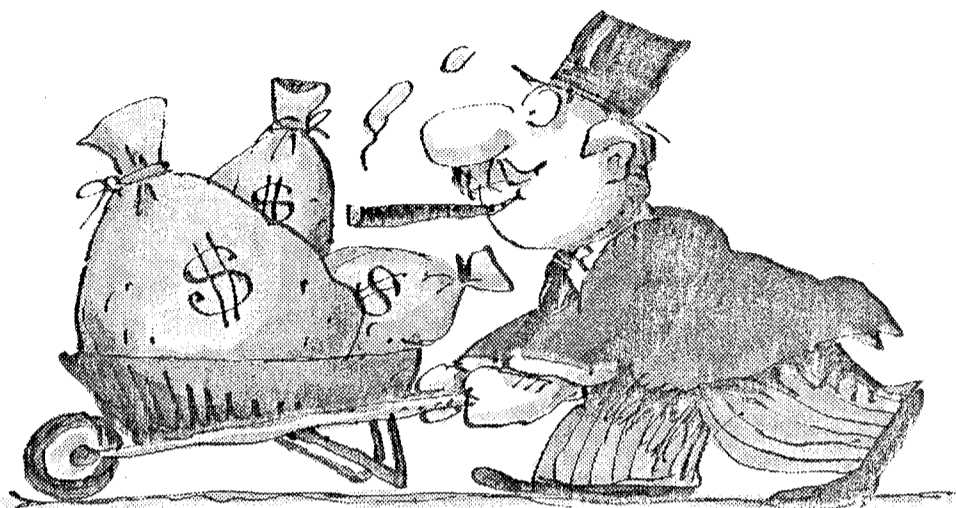
Rising long rates are not just evidence of burgeoning inflationary expectations, but reflect, as well, Wall Street's certain knowledge that a torrent of new government paper must soon come to market. The future growth of U.S. debt issuance is easily predicted since America's elected officials and bank regulators prefer to leverage the sweat of future generations rather than immediately resolve obvious price anomalies in loan portfolios of federally insured thrifts and banks. But as the mountain of assets from failed institutions and federal promissory instruments supporting them grows progressively higher, investors are turning recalcitrant toward new issues of government debt.

Recent commentary about Fed "intervention" in the market for U.S. government securities is a case in point. Investors and financial commentators innocently ask whether the Fed "is allowed" to manipulate market prices, implying that federal officials are somehow immune to the same political pressures that drive governments below the Tropic of Cancer to nationalize banks and print money to fund internal deficits. Grow up, kids: In the age of short-term crisis management, the answer to this hitherto unthinkable question is a resounding yes!

Fed support of prices for Treasury paper is a simple affair. Dealers were reportedly encouraged to bid "aggressively" for coming issues during the week of Aug. 10, with the implicit understanding that the Fed would accept greater than normal quantities of longer-maturity bonds as collateral on repurchase agreements without changing the rate. Several dealers also reported "unusual" Fed buying activity in longer Treasury maturities, though it is impossible to say whether purchases were made on behalf of customers or the Federal Reserve System's account.

This is not to imply that the

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Ed Renfro

Fed "bought" the 10-year auction. Perhaps a very grateful oil-producing nation offered to take down large amounts of paper, using its gold in the Fed's cavernous basement as security. But such musings aside, given a weak dollar, rising inflation, and attractive bond yields in Germany and Japan, 30-year Treasury yields below 9% should raise questions in the minds of reasonable men.

It is relatively easy to hide a few billion dollars worth of unsold Treasury paper on the books of the central bank, especially when monetary ease, or "a persisting seasonal, technical need to add reserves to the banking system," is both welcome and anticipated. Far more difficult is finding a place to conceal \$100 billion-\$150 billion of bonds to raise "working capital" for the Resolution Trust Corp., especially after the dismal failure of 40-year RTC zero-coupon bonds issued in the spring of this year. But never fear: Our heroic public servants at the Fed and Treasury are contemplating a truly Third World solution. Fed officials are preparing to finance some or all of the RTC's funding needs directly on the books of the central bank, despite whatever denials might be forthcoming.

Led by New York Fed President E. Gerald Corrigan, senior central-bank officials have circulated legal memoranda justifying the acceptance of RTC paper as de facto Treasury obligations, thereby allowing the Fed to ultimately underwrite the RTC bonds should both parties agree to proceed. This massive corruption of the Fed's balance sheet with low-quality collateral is thought justified under the rationale of being necessary to take pressure off the Treasury's cost of funds.

Since the military confrontation with Iraq will probably increase monthly federal outlays by as much as \$1 billion or

more, Corrigan and his peers in Washington reason that offering substantial amounts of new debt of the RTC would push Treasury's borrowing costs, and the federal budget deficit, up dramatically.

Monetizing tens of billions in RTC debt is seen as a small price to pay in future inflation for maintaining the superficial stability of the credit markets. But to understand how officials of the institution charged with defending the soundness of the dollar could willingly debase the asset quality of the U.S. bank of issue, it is useful to explore why RTC needs "working capital" at all.

As of April, over 30,000 residential mortgages—"whole loans," in the parlance of the mortgage-backed securities trade—were on the books of the RTC. Yet this enormous and growing stock of mortgages is dwarfed by a \$100 billion-plus mountain of paper—junk bonds, mortgage pass-throughs, and other securities of various types—taken from the books of more than 350 failed thrifts.

The RTC is seeking to finance its enormous stock of whole loans and securities because selling them immediately would entail realizing a substantial loss—the difference between what the government has paid to creditors of insolvent depository institutions (individuals and institutional investors) and what these assets are actually worth. Estimates of the net asset value of these financial cats and dogs run in the 30%-40% range, but no one will know for sure until the RTC offers them to the marketplace.

Both mom and dad, and many institutional investors,

have been made "whole"—100 cents on the dollar—for deposits and even debt liabilities of insured thrifts. The alternative, namely a payout based on the true asset value, was considered too dangerous for the soundness of the U.S. banking and payment system, except in the case of very small institutions. This illustrates why the "too big to fail" doctrine is really a subsidy for holders of bank debt and institutional investors who deliberately place funds in \$100,000 increments with insolvent

thrifts and commercial banks.

Congress has already appropriated \$100 billion for the RTC, but the RTC will require a minimum of \$140 billion (present value) in additional "assistance" to cover the difference between what it has already paid to liquify thrift liabilities and the market value of its assets.

To finance the multibillion-dollar RTC shortfall on the Fed's books represents inflation, pure and simple. Yet this is only the first installment on billions in additional funds necessary to achieve an orderly liquidation of insolvent savings and loans. Estimates of the assets of the roughly 1,000 insolvent thrifts in the U.S. that must eventually be closed run between \$400 billion and \$600 billion. If the past is any guide, the RTC will be lucky to recover half the actual figure.

The real problem is that federal officials in Washington and New York have not learned anything from their experience with failing thrifts in the 1980s. Contrary to statements made at the time, thrifts did not "grow out" of their bad assets; losses simply got larger. The decision to fund RTC assets, rather than immediately sell them, will only compound losses already locked in by thrift closures made to date, and increase the cost to the taxpayer.

Indeed, the example of the Treasury and Fed's handling of the price deflation that now threatens the nation's commercial banks suggests that past mistakes are being repeated on a grand scale. Just last week, FDIC Chairman William Seidman suggested that leaving insolvent thrifts open might "reduce the cost of this debacle."

Since federal regulators lack the financial experience and political backing to quickly resolve bank insolvencies, regulatory forbearance—that is, keeping open bankrupt depository institutions that by any reasonable financial measure should be closed—is now spreading to the largest banks in the country.

The rationale for bending legal and accounting rules is that the FDIC is itself flat broke. Dan Brumbaugh of Stanford University, for example, who worked at the Federal Home Loan Bank Board in 1984 and is now a consultant to the House Banking Committee, has repeatedly pronounced the Federal Deposit Insurance Corp. insolvent.

With only \$13 billion in "visible" reserves, the FDIC does not have sufficient funds to close down all or even most of the insolvent banks in the country. Moreover, the immediate political and financial costs of actually resolving bank failures on standard commercial terms—namely, holding depositors safe up to \$100,000 while allowing stock and bond holders to bear losses—is considered too high. Thus, scores of dead banks, far above the 200 FDIC Chairman Seidman estimates will be closed this year, are being kept alive by the federal government in a creeping nationalization of the banking system.

Wall Street is unaware of this massive covert federal support program because the source of funds is not only the 12 regional Federal Reserve Banks, but the Treasury itself. Billions in Treasury, Tax & Loan—or TT&L—balances are being used to support insolvent institutions. These operations do not show up in weekly Federal Reserve loan figures because the Treasury does not disclose its aid to "deserving banks." In fact, this secret liquidity mechanism dates back to the massive government support effort for First Republic Bank of Texas in 1988.

Under federal regulations, Treasury is supposed to make advances based upon full collateral, generally its own obligations. The size of the current support effort, however, has forced Treasury to bend the rules, meaning that banks are pledging such things as student loans and short-term commercial debt, along with other low-quality assets of less than two years' maturity. Further, this inferior collateral is taken at "book value," with no haircut or discount to market value assessed to protect the taxpayer against potential loss.

Funding support from the Fed and Treasury is maintained until a suitable merger partner can be found, but foreign banks need not apply. Fed officials reportedly resist sales to offshore institutions, feeling that a foreign acquisition of a major bank, especially members of the New York Clearing House, would be a "blow to national security." Meanwhile, large insolvent institutions remain open as wards of the government while losses mount, increasing the eventual cost of closure or sale.

The most recent example of such an operation involved the merger of the \$1 billion-asset National Bank of Washington with Riggs National Corp., with consolidated assets of more than \$7 billion, Washington's largest bank holding company. When the deal closed, the FDIC assumed the Fed's \$400 million advance to NBW, but since the deposit insurance agency did not have sufficient cash to actually repay the central bank, this loan to the FDIC is now carried as "other assets" on the books of the Richmond Fed (below premises, furniture, etc.).

There is considerable question as to what, exactly, Riggs bought for \$33 million in addition to \$1 billion in deposits, branches across the street from its own or in bad parts of town, and some dubious intangibles. But a more interesting question is why Riggs was allowed to make the purchase in the first place.

As of June 30, 1990, a month before the merger, Riggs's lead bank had equity equal to only 4.5% of its \$6.4 billion in total assets, while total capital (including subordinated debt) was only 5.9%, well below minimum federal guidelines. Over one-third of its assets are invested in real-estate loans, an area into which the traditionally conservative institution has rapidly expanded in the past three years. In addition, Moody's cut its rating on the subordinated debt of Riggs's parent to Ba2, well below investment grade, before the merger with NBW.

As in most federally arranged marriages of failing banks, Riggs received cash "assistance" of \$404.2 million to liquify the NBW deposits and has since exercised the right to put back to the FDIC additional bad assets. But the fact remains that the consolidated Riggs group of banks grew overnight by \$1 billion on a capital base that was already inadequate under established capital guidelines.

The problem with making exceptions to the rules regarding bank capital is that in the deflationary environment currently facing U.S. real-estate markets, even healthy banks are likely to suffer considerable pain before asset values revive. As in the early 1980s with many now dead S&Ls, regulators ar-

gue that insolvent commercial banks should be assisted so that they can "grow out" of problem loans. But with most experts predicting lower real-estate prices in the Northeast for the next several years, the only growth likely to occur is in non-performing assets, bank failures and federal support for the U.S. banking system.

Setting a precedent by using Treasury balances to keep dead banks open is both dangerous and ill-advised. It assumes that the Treasury has the legal authority to employ taxpayer funds in such a manner, and also takes for granted that Treasury will always have access to the funds necessary to keep insolvent banks afloat. Once the government extends funding support to dead banks, it then takes on ultimate responsibility for keeping the institution open, regardless of the cost. Ask the Israelis.

Of course, the crisis control junkies at the Fed and Treasury will protest that liquidating failed thrifts and banks, or selling the RTC's vast pool of assets, will depress market prices and raise the cost of funds for the Treasury. But the same voices of expediency who today argue in favor of Fed manipulation of credit markets, Treasury support for insolvent commercial banks or the inflationary flotation of RTC debt on the books of the Fed will tomorrow support limits on foreign currency holdings and capital flight by U.S. citizens in the name of supporting the dollar. They have, in fact, done so before in the 1960s and 1970s.

If the U.S. is to avoid the inflationary road to perdition that has robbed our cousins in Latin America of their wealth over the past 20 years, the debt-driven erosion of the dollar's soundness must be resisted. Congress must put a halt to the regulatory accommodation for dead commercial banks and the RTC currently in progress at the Fed and Treasury.

Moreover, Congress should demand that the RTC immediately price and sell those assets that can be offered in secondary markets before further taxpayer funds are appropriated. Only by keeping the process in the open market—and off the books of the Fed and Treasury—can the true cost of the crisis confronting the American financial system be properly monitored and resolved.

But in all likelihood Congress will not act, covert Treasury support for dead banks will continue and Mr. Corrigan will float the RTC bonds on the books of the New York Fed, abetted by those regional Federal Reserve Banks willing to countenance this immense public deception. On that day, this writer and several other Fed alumni will emerge from Jim Brady's pub and stretch a banner across the front of the wonderful hamburger stand at the corner of Maiden Lane and Nassau Street. It will read: "Welcome to Brazil." ■