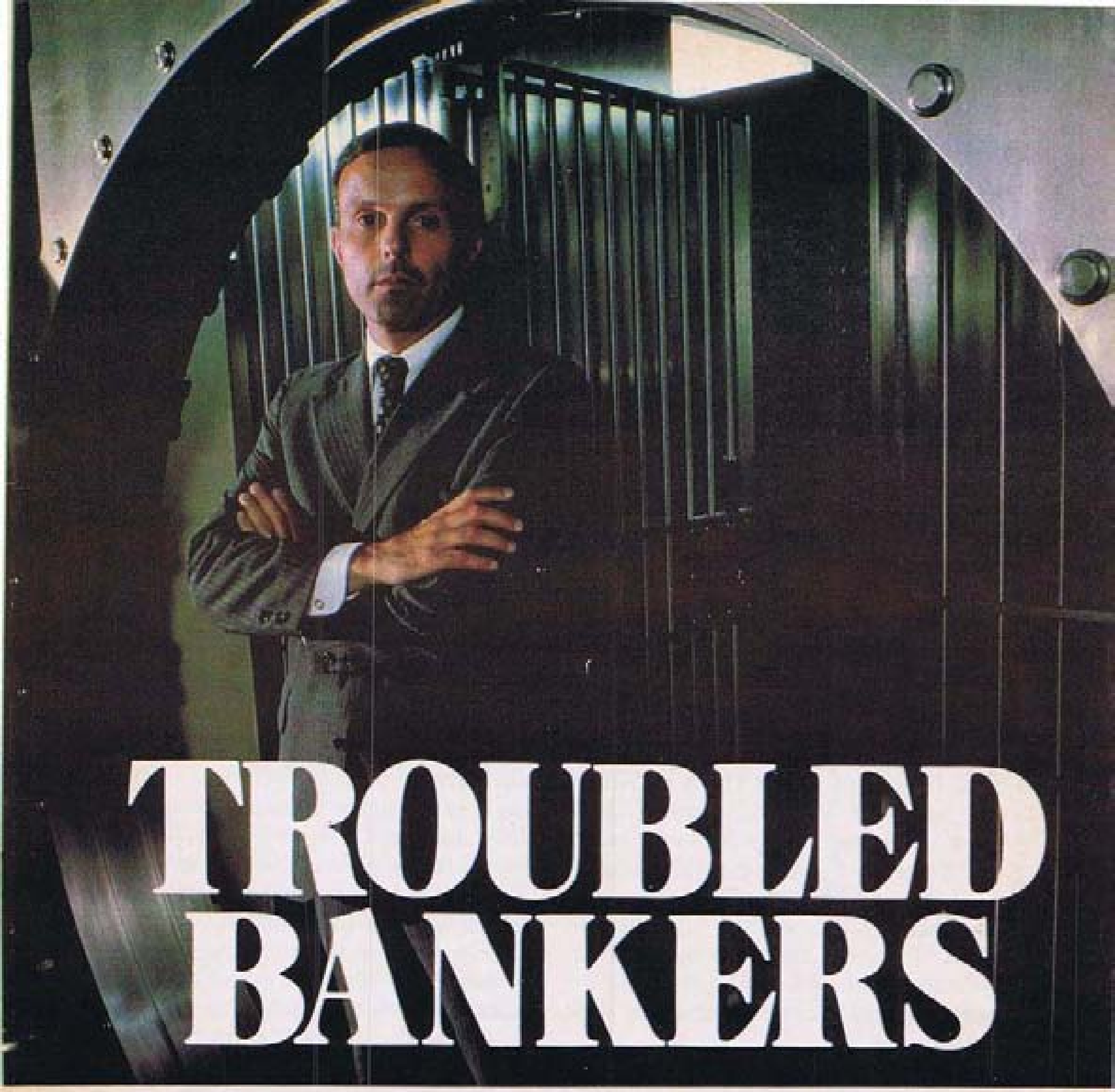

Four By Five

TROUBLED BANKERS

Gary Allen *is author of* None Dare Call It Conspiracy; The Rockefeller File; Kissinger; Jimmy Carter/Jimmy Carter; Tax Target: Washington; *and*, Ted Kennedy: In Over His Head. *He is an* AMERICAN OPINION *Contributing Editor.*

■ THIS YEAR, 1982, America has experienced the highest failure rate among its commercial banking institutions since 1942. Admitting that the bank failure rate averaged more than two per month in the first five months of this year, William Isaac, chairman of the Federal Deposit Insurance Corporation, attributes this upsurge in bank problems to a "combination of the recession and a prolonged period of high interest rates finally having an effect on the ability of borrowers to repay loans."

Earlier this year a computer analysis of the financial statements of more than eighteen thousand banks and Savings & Loans was completed by Veribanc, a firm in Woburn, Massachusetts. The study, initiated by

The megabanks have lent hundreds of billions to risky Third World borrowers and struggling corporations. A full 45 percent of the $300 billion in international bank loans will come due this year, and the bankers are now racing to cover up widening cracks in the debt pyramid to prevent a total financial collapse.

Personal Finance newsletter, revealed that of the country's fifty top commercial banks, thirty-one fail to meet the minimum equity capital requirements set up by the F.D.I.C.! The conclusion was based on the F.D.I.C.'s standard that requires a bank's equity to equal at least a "minimum acceptable level" of five percent of its total assets. Veribanc found that San Francisco-based Bank of America and New York's Chemical Bank have the worst equity-to-assets ratio: 3.4 percent. First National Bank of Chicago and Manufacturers Hanover are runners-up, with a 3.5 percent ratio. They are followed by First Interstate Bank of Los Angeles with 3.6 percent, and Chase Manhattan with 4.2 percent.

More recently, another comprehensive study of America's commercial banks was conducted by the investment advisory firm of T.J. Holt and Company of Westport, Connecticut. The analysis used six key financial criteria in determining bank soundness. It is highly significant that the Big Six banks of New York — Citibank, Chase Manhattan, Manufacturers Hanover, Chemical, Bankers Trust, and Morgan Guaranty Trust — are among the twenty-five weakest banks listed in the Holt report. Bank of America, the nation's largest bank, is ranked as the ninth weakest bank in the country, while Continental Illinois, another biggy, came in as the fifteenth weakest. (For a list of the hundred weakest and hundred strongest banks listed in the study, send a 37-cent stamped, self-addressed, legal-size envelope to: T.J. Holt, 290 Post Road West, Westport, Connecticut 06880.)

Little wonder that investment advisor Harry Schultz believes a Banking Pearl Harbor is imminent. In the July fourteenth issue of the *International Harry Schultz Letter* he warns: "In the case of the monetary system, I fear a sudden big-bank failure (they are always kept secret 'til the situation is hopeless: then, it's suddenly announced), which results in a chain-reaction bank closure around the world within two hours."

Schultz maintains that the risk is greater now than in the Thirties. In part because the problem is worldwide today and partly because the extent of the debt crisis is greater than ever at all levels (city, state, national, corporate, and individual) while liquidity (cash) is much lower. He writes: "They won't call it 'The Wall Street Crash' this time. It'll probably be called the 'Great Bank Shutdown.' And in place of 'Black Friday, 1929,' will be 'The Day Money Dried Up, 1982.' "

Still, Harry Shultz believes that we

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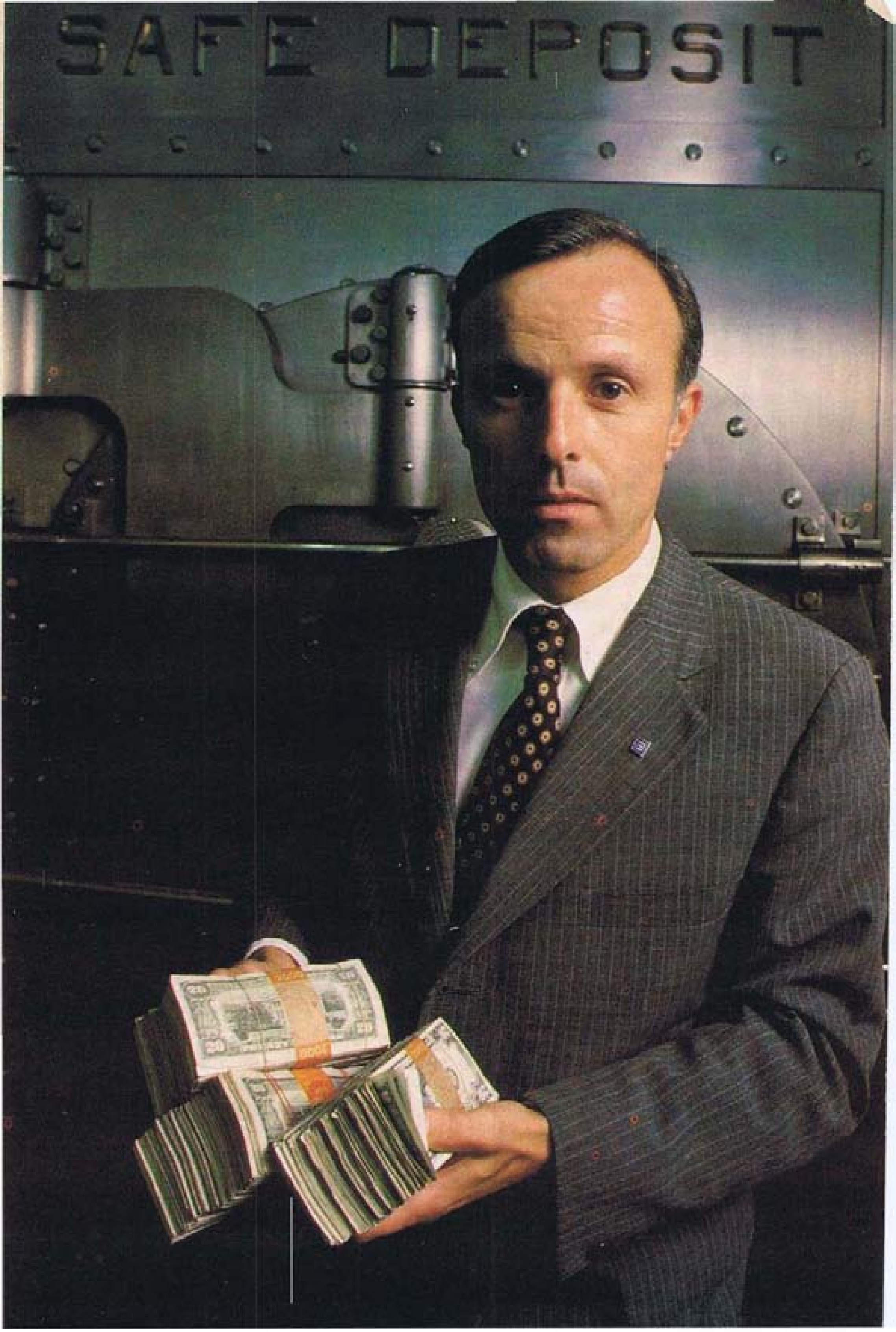
SAFE DEPOSIT

could limp along for another one or two years before the banking shutdown and consequent "Money Meltdown." He presents us with the following scenario: "Phase I began 10-15 years ago when banks increasingly made bad loans and lowered reserves. I warned them of the danger of such practices. Bankers scoffed. Phase II is now, with risk-awareness spreading. Phase III begins when worry turns to fear, and then to panic. Phase IV will see all banks shut. In 1933 it was for 11 days and the New York Stock Exchange closed too. This time it will probably be for five months. Last time, 3,600 U.S. banks *never* reopened. This time I'd guess 10,000 will *stay* shut, including branches, plus 5,000 more outside the U.S."

We sit on the brink of the worst economic debacle in U.S. history. As the cracks in the huge debt pyramid quietly but quickly widen into giant fissures and crevices, the financial community is becoming as jittery as a bowl of Jello in an earthquake.

While banking has become more centralized, it has become more vulnerable to a chain reaction in which one or two major bank failures could set off the rest of the financial institutions. As market watcher Howard Ruff puts it: "The United States banking system is dominated by no more than fifteen banking groups, most of them controlled by giant holding companies. They are the First National City Bank of New York, Chase Manhattan, Chemical, Manufacturers Hanover, Marine Midland, Morgan Guaranty, Bank of America, Wachovia, Continental Bank of Chicago, the Mellon Bank, Security Pacific and Western Bank Corporation. These are the banks where nearly all of the thousands of smaller banks in the country do their banking. This is where all the money and credit in the United States come together. They are the key log in the jam. If you pull it out, the entire system crumbles."

If a large enough bank goes down, it will likely take many others with it. No one knows when the dominoes would stop falling. Even if a financial institution is not one of the biggies, its collapse can adversely affect the whole system, producing in its wake many losses and repercussions. Such was the case this summer with the Penn Square Bank in Oklahoma.

Penn Square, a relatively small bank in Oklahoma City, was the twentieth U.S. bank to fail this year. Its collapse was especially significant because of the widespread and startling repercussions in the financial community — impacting at least five major banking corporations and several Savings & Loans. Due to the aggressive and flamboyant selling techniques of its top executives, Penn Square had become involved in a euphoria of incredibly risky loans to wildcat oil and gas drillers. It became increasingly obvious that many of these energy firms would not be able to repay. On July fifth of this year, federal regulators closed Penn Square when heavy loan losses became just too glaring to hide. The F.D.I.C. (Federal Deposit Insurance Corporation), which guarantees deposits of federally insured banks up to $100,000, is now running the bank under receivership.

The big problem was that Penn Square had not only made many risky loans itself, but had also acted as a broker selling loans to the big banks. When the "nonperforming loans" went sour, Penn Square's lending spree wiped it out and also caused losses "for the five big banks that bought about $2 billion in loans from Penn Square. But while the losses are still being sorted out, many bankers are now asking how such a tiny bank could have sold so much bad business

Chart by Don Eckelkamp — American Opinion

TROUBLED BANKS

to some of the nation's biggest and most elite banks." (*Wall Street Journal*, July 19, 1982.)

Who are these five big banks?

The major holders of the $2 billion in bad Penn Square bank loans are: Continental Illinois National Bank & Trust Company ($1 billion), Chase Manhattan ($212 million), Seafirst Corporation ($400 million), Michigan National Corporation ($200 million), and Northern Trust Corporation ($125 million).

Continental Illinois, the nation's sixth largest banking group, has itself been one of the foremost lenders to risky small- and medium-sized firms in the energy industry and the real-estate market — sectors of the economy which have been increasingly hard-hit by the deepening recession. It has also been a generous lender to such troubled businesses as International Harvester and the now-bankrupt Braniff International Corporation. Continental's shaky loan portfolio came under public scrutiny when Penn Square and its bad loans collapsed. The Illinois-based bank had purchased a whopping $1 *billion* in loans from Penn Square and had made a direct loan of $30 million to the failed bank. This, at least in part, was responsible for Continental's reported loss of over $61 million in the second quarter of this year — the biggest loss in the field of banking in recent years. Subsequent to the Penn Square failure, analysts revealed that Continental's problem loans had catapulted from $519 million in mid-1981 to a stunning $1.3 billion by the second quarter of 1982.

Chase Manhattan Bank, flagship of the Rockefeller financial empire, was suckered into buying over $212 million in loans from Penn Square. When the Oklahoma bank went under this summer, Chase reported a $16.1 million operating loss for the second quarter of this year. It had turned an operating profit of $100.6 million in the second quarter one year earlier. As with Continental Illinois, Chase's incautious purchase of the risky loans involved poor loan-review procedures or none at all. The *Wall Street Journal* reported that "the Penn Square loans were not reviewed by energy lenders or engineers. Instead, they were accepted by the correspondent banking division. Chase's loan officer for Penn Square was a 27-year-old second vice president, Margaret C. Sipperly. . . . 'At Chase, it was being handled by nonprofessionals who didn't know any better,' says a Chicago banker."

In addition to Continental Illinois and Chase Manhattan, three other big banking corporations were also sucked into Penn Square's quagmire of bad loans. Seafirst Corporation, a large Seattle-based bank, got stuck with $400 million in bad loans. In its efforts to diversify out of the depressed Northern home markets and into energy projects in the Southwest, Michigan National Corporation, of Bloomfield Hills, Michigan, had bought $200 million of loans from Penn Square. Northern Trust Corporation, Chicago, had been involved in Penn Square's energy-lending euphoria also — and was left holding the bag on $125 million of the worthless loans.

And the Penn Square Bank's bad loans are not isolated cases. Chase Manhattan reported that its total of "non-performing loans" — loans that won't be repaid — as of June thirteenth had surged upward a full forty-seven percent since last year. The unsound debt pyramid is beginning to crumble, and try as they might, the big banks can no longer cover up the widening cracks in the huge, top-heavy edifice.

Chase Manhattan had suffered greater losses, however, in May when Drysdale Government Securities de-

(*Continued on page ninety-seven.*)

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faulted. A tiny investment company, Drysdale had defaulted on an incredible $160 million of interest payments owed to thirty of this country's top brokerage firms. Chase had acted as an intermediary between Drysdale and these creditors — but insisted that it had no obligation to make good Drysdale's bad debts. This put the government securities market in a tizzy. The brokerage houses involved stood to lose millions — many facing collapse if Chase continued to refuse to bail them out. As panic grew in the shaky financial markets, some banks began seriously considering whether to call in loans from such debt-ridden companies as International Harvester. If that had happened, it could have triggered the feared chain reaction and collapsed the whole banking network.

Realizing this, the banking *Insiders* quickly acted to head off a full-scale financial panic. Chase Chairman Willard C. Butcher (C.F.R.) telephoned Federal Reserve officials in New York to get their help with the Drysdale default. By this time — the middle of May — brokerage house executives were furious at Chase's weaseling. They considered the Rockefeller bank to be responsible for their losses because it had promoted Drysdale to them as a financially sound firm . . . when it assuredly was not. As *Newsweek* put it on May thirty-first:

"While one major New York bank limits its business with such blue-chip borrowers as Salomon Brothers and Merrill Lynch to no more than $100 million, Chase had helped Drysdale — capitalized at no more than $30 million — to build up positions in government securities worth several billions of dollars. According to other bankers, Chase should have known immediately that something was amiss."

Pressure mounted on Wall Street for Chase to take responsibility for the Drysdale defaults. William C. Melton, vice president of Irving Trust Company, sided with the brokers: "I can hardly think of another case where a bank has refused to pay up. Carried to its logical conclusion, [*Chase Chairman*] Butcher should lose his Visa card."

Meanwhile, the New York Federal Reserve had called a meeting with twelve major New York banks to discuss the implications of the Drysdale default. The Fed officials offered easy credit to bail out the situation if it began to get out of hand. In a statement issued to bankers and bond dealers alike at the conclusion of that meeting the Fed announced its willingness "to provide funds to assist commercial banks in meeting unusual credit demands related to market problems."

At the same time, the powerful Manufacturers Hanover bank revealed that it too had acted as a conduit for Drysdale securities dealings and that Drysdale had defaulted on those obligations also. *Newsweek* reported: "Unlike Chase, Manny Hanny declared that it would pay the $29.3 million in interest due to the brokerage firms with which it had dealt. That was too much for Chase. One hour later Chase capitulated: it agreed to pay the $160 million in interest and to liquidate Drysdale's accounts on its own. According to one Chase insider, the initial loss to the bank might amount to more than $300 million, although the bank itself will not predict its total loss.

"The reasons for Chase's sudden about-face were abundant. The bank said it realized that a failure to make good on the Drysdale debt could cause 'a financial gridlock' that 'might have brought the bond market to a standstill' — injuring major bond traders and those who do business with them, including the Chase. The bank also feared protracted lawsuits that would inevitably anger the brokers with which it must do business daily."

A Federal Reserve official in Washington reportedly remarked, "What the hell could Chase do? They wouldn't have had ten customers left anywhere in the world if they left the brokers holding the bag, and they must have quickly realized it."

Bankers have long portrayed themselves as careful, conservative, and sound in their financial practices. But the revelations of some of their wheelings and dealings which have come out in the wake of the Drysdale defaults and the Penn Square fiasco have greatly tarnished that image. Despite their public veneer of staid respectability, it is now clear that some of the biggest bankers in the country are also among the biggest crapshooters in town.

Newspapers in Taiwan regularly report on the arrest and punishment of bank officials who make bad loans of their depositors' money. In Arabia they would probably cut off a hand or two. Just consider what such a sensible policy here would do to the management officials of Chase Manhattan and company. The general practice in this country, however, is for the government to help the banks keep their business dealings secret from their depositors and to try to cover up problems as they develop.*

But trouble in the banking establishment has now become too big and too widespread to be kept from the public. A recent survey by Burke Marketing Research of Cincinnati showed that almost ninety percent of Americans polled now have some concern about the stability of U.S. financial institutions. Only about ten percent have any real trust in the present banking environment.

And rightly so.

Banks, as they operate today, are not Free Enterprise institutions. They are *politically privileged* entities which create money out of thin air through a fractional-reserve system sanctioned by law. Government has not only handed banks a monopoly in certain services, but has cartelized them through regulations which prevent certain forms of competition in the field of money and banking. In its role as protector of the bankers' privilege of creating new money (inflating) by lending out demand deposits, government has institutionalized dishonest practices and underwrites and encourages mismanagement.

John Pugsley comments in the January issue of his *Common Sense Viewpoint*:

"Prior to the existence of the Federal Reserve System, individual banks stood all the risks of their lending policies. If a bank made risky loans, or did not keep enough money on hand to meet possible withdrawals, it would collapse. Bank failures were not uncommon, and because of this the public had a healthy distrust of banks. Most individuals kept their money in gold, and used banks very sparingly. Bankers had to keep a far higher ratio of solid investments than they do today, and were thereby unable to expand their deposits to the extent now possible.

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*In August the government released the F.D.I.C. "Problem Bank List," which cited 277 banks in trouble as of the end of July. This was up from 217 in July of 1980. The U.S. Comptroller of the Currency admitted that the number of problem banks could jump sharply by year's end. The interesting thing about this list is that Penn Square was not on it! Yet, government regulatory officials reportedly knew about the Oklahoma bank's runaway loan operations as far back as two years ago.

"The creation of the Federal Reserve changed all that. By usurping the right of individual banks to issue banknotes, and by standing ready to step in and protect the depositors in the event of bank failure, the Fed and the FDIC have created a totally different public attitude toward banks. Of course, the Fed would not have been able to step in and save every imprudent banker from the consequences of his own poor judgment if the requirement for a gold backing to the currency had not been abolished. The monopoly over the issuance of currency coupled with the removal of gold as backing is what really permitted the banks to expand credit as they have. Now there is no limit to their excesses, and no reason to think that they will not postpone the day of reckoning by continuing to inflate the money supply."

In their TV and radio commercials banks advertise the fact that deposits "are insured up to $100,000 by the Federal Deposit Insurance Corporation (F.D.I.C.), an agency of the U.S. Government." This is supposed to assure customers that their money is safe. In fact, it is like putting a penny in the fuse box. According to best-selling author Douglas Casey, assets owned by the F.D.I.C. only amount to about one-quarter of one percent of the nation's "insured" bank deposits. This would be sufficient to bail out perhaps one or two large banks, but in today's shaky economy the F.D.I.C. itself would not be able to cope with a number of large failures or any large-scale panic out of bank deposits.* Casey observes:

"The FDIC is authorized to borrow directly from the U.S. Treasury should its assets be depleted, but this would mean that depositors' accounts would be redeemed literally by the printing of more paper currency. Everyone would get their dollars, but the dollars would be worth only a nominal sum. On the other hand, if the FDIC became overextended and the Treasury declined to bail it out, the result would be a complete collapse of confidence in the financial system of the country. Unfortunately, the whole system today is based on nothing more substantial than confidence, and the main purpose of the FDIC, in effect, is to assure the people that the only thing they have to fear is fear itself. That, however, is the least they have to fear.

"The FDIC is a bad thing insofar as it not only encourages a false sense of confidence on the part of the public, but on the part of bankers who feel they will be defended against their mistakes by the U.S. government. The knowledge that the FDIC, or the Federal Reserve, or the Treasury will always be there to bail them out has doubtless encouraged profligacy among them."

With the above background in mind, let us now consider the general stability and soundness of our financial institutions. To do this we must first recognize that banks can get into trouble by having problems on either side of their balance sheets. Today, they have problems on both sides.

A bank is insolvent when its assets (loans, investments, and operating capital) fall in market value below the total of its liabilities (money left with it by depositors). Almost all of the liabilities (the deposits) of the banks are very short-term — payable on demand, in fact. John Pugsley reports: "The average commercial bank in this country has only about 1.5 percent of the total deposits of its cus-

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*In 1975 the F.D.I.C. used over forty percent of its total fund to rescue the depositors of the failed Franklin National Bank. If one or two of the nation's top dozen banks got into real trouble, the F.D.I.C. could not by itself save them.

tomers in ready cash, and only another 14 percent in reserves available to meet withdrawals. If depositors attempted to withdraw even 5 percent of their total deposits from any bank, it would create a severe problem, and a withdrawal of 15 percent of deposits would shut the bank down completely."

Thus any financial crisis, ripple, or trauma which causes people to withdraw money from banks in significant quantities is a threat to the whole banking system because of the prospect of chain-reaction bank runs. With today's uncertain times, this makes for a colossal accident just waiting to happen.

Perhaps the most important group of depositors are the oil-rich Arabs. They have recycled their oil profits into huge Certificates of Deposit at the big New York banks. If the O.P.E.C.ers began losing confidence in the purchasing power of the dollar, and refused to renew their C.D.s — moving out of the dollar and into gold — such action would likely topple our precariously balanced banking system. Some financial writers even go so far as to maintain that this makes the big banks captives of the Arab nations.

Maybe — but look again. Other writers point out that the Arabs cannot hurt the banks without suffering terrific losses themselves. Sure, they could pull out their money. That is, if the banks had enough cash on hand to cover the withdrawals — which they don't. But these giant depositors would have to act very carefully or they would quickly provoke a banking panic and financial tailspin which would destroy the dollar before they could get all of their money out safely. Their losses would be immense.

But we cannot view the Arabs as a single body and mind. The oil-money deposits are made up of money belonging to a goodly number of wealthy individuals and governments. If they fear a run on the banks, they won't want to be last in line. Under those conditions, they might elect to grab what they can as fast as they can on the assumption that the U.S. Government would not dare freeze all O.P.E.C. deposits simultaneously since that would be followed by a full-scale oil embargo and the international collapse of the dollar.

Meanwhile, the Middle East is as unstable as nitroglycerin. Most nations there are threatened by revolution (from both Islamic religious fanatics and Communist extremists) and by war. A revolutionary takeover or military *coup* in, say, Saudi Arabia could easily trigger a chain reaction that would produce a run on Western banks. So, it might very well be that the banks are every bit as vulnerable to a big money pullout by the grand pooh-bahs of the camel kingdoms as it appears on the surface.

Banks are in trouble on the asset side of their ledgers, too. Loans make up the large majority of bank assets, the rest being operating capital and investments (mostly in government bonds). The problem is, as previously mentioned, the big banks have been increasingly lax in the number and shakiness of the loans they make. After all, bankers profit from making loans. But we do not have a free market, so bankers no longer really lend money at their own risk. If the government, F.D.I.C., or Federal Reserve acts as a safety net — bailing out the big bankers whenever they get into trouble — then it stands to reason that banks will lend more aggressively and lend to less credit-worthy borrowers. This is exactly what has happened.

Over the past decade bank loans and investments have mushroomed dramatically. Many of these — as with Drysdale Securities and Penn

Square Bank — were ill-considered loans which never should have been made. Others were made on the assumption that there would be an uninterrupted boom. Too many loans were made to business enterprises that could stay afloat only as long as the economy kept growing strongly. When the slump came, the loans often turned out to be uncollectible as an increasing number of hard-pressed firms turned belly-up.

Never before has so much money been lent out to so many unworthy debtors. Loans to foreign governments head the list.

Probably the greatest source of potential danger facing the financial community, however, is the teetering debt pyramid of the Less Developed Countries. The megabankers have taken the O.P.E.C. money deposited with them and lent it long-term to such economic basket cases as Brazil, Mexico, Zaïre, and Chad. By so doing, they have evidently committed the classic investment mistake of "borrowing short and lending long."

The total debts of the underdeveloped nations have risen from about \$87 billion in 1970 to over \$525 billion today. Of this overall debt, about \$274 billion is owed to Western bankers. At least one-quarter of that represents loans from U.S. banks. According to Bankers Trust, the nine largest U.S.-based banks have lent \$46 billion — almost twice their capital and reserves — to just six of the largest of the L.D.C.s: Brazil, Mexico, Korea, Argentina, Taiwan, and the Philippines. These top nine banks have *total* L.D.C. exposure of \$65 billion — three times their total capital reserves!

Total interest payments due (but not necessarily paid) to service this vast debt of Third World countries amounted in 1981 to \$175 billion — about half of their current account balance of payments receipts. Many of these poor countries — dominated as they are in most cases by socialistic regimes — are on the brink of bankruptcy and consequently have no real prospect of ever paying their debt obligations. In fact, an increasing number of them are borrowing simply to finance immediate consumption, just to survive. They need the money to eat and pay their oil bills to O.P.E.C. When it runs out, the people in those countries could starve to death as the price they'll pay for their governments' borrowing sprees.

Default on this much debt would bust the banks, which would bust the American economy, which would bust the world. Bankers and government debt-watchers are frankly "nervous" about the situation. The *Wall Street Journal* for July first quotes one unnamed official as admitting: "There's an increasing level of concern just about getting through the next year or so. Some 45 percent of the \$300 billion in international bank loans now outstanding is scheduled to come due this year. If there's a panic reaction anywhere, it could lead to an implosion of the system." *Time* magazine for August 2, 1982, quotes one top Chase Manhattan banker as warning: "If Latin America goes into default, it will bring down all the major banks in this country."

Moody's Investment Service published a report in March pointing out that every dollar of equity at the largest U.S. banks now supports twenty-eight dollars of bank assets. A major portion of these "assets" carried on the books by the banks are actually those virtually worthless "non-performing" (uncollectible) loans to foreign governments which are about to default. The table on page five, compiled by Money Forecasts of West Palm Beach, Florida, lists total capital and reserves *versus* the estimated paper losses from bad loans for eight major banks and two insurance companies. The figures are in billions.

These institutions would appear to be insolvent. For, as financial writer William J. Quirk quips: "It seems fairly unlikely that these loans [*to the L.D.C.s*] will be repaid. The loans are not legally enforceable since the debtor is a sovereign state. No court has any jurisdiction over Zaïre. Can an American bank, under its state law, take depositors' funds and make a loan that is not legally enforceable?" With billions of dollars at stake, that may be a good question. The big bankers, however, may not be too worried about the ability of Zaïre to repay its debt — if they can get American taxpayers to pick up the tab.

Readers of this magazine know that we have recounted details of several occasions on which the megabankers have resorted to political intervention to rescue their unsound loans. For example, when it became clear that the little nation of Panama was having trouble repaying its loans to the bankers, the *Insiders* and their C.F.R.-Trilateralist agents in the U.S. State Department engineered the payaway of our Panama Canal to the Leftist regime there.

Panama owed many millions of dollars to the New York bankers, including Marine Midland which was one of the largest creditors. Panama had no way of paying these debts unless it could gain control of the Canal and its revenues. Sol Linowitz, a member of the Trilateral Commission and a director of Marine Midland bank, was appointed by President Carter to be "our" chief negotiator for the new Canal treaty. The treaty was soon completed, ballyhooed by the C.F.R. bankers' club, and approved by the Senate. The result was that the New York bankers had their loans to Panama saved so that they wouldn't have to write them off as a loss.

In the bad old days the bankers would simply get some Western government to take over a defaulting country as the British and French foreclosed on Egypt in the 1860s during the reign of Ismail Pasha. The lenders would then arrange to take over the tax collection system and pay themselves. Things are a bit more complicated today. Such obvious strongarm tactics are not always the most effective means of collection. Without a World Government to enforce international loans, the bankers have to use Uncle Sam's muscle to extract the money from the beleaguered taxpayers — or socialize their losses through the device of inflation. Either way, the megabankers continue to get away with making other people pay for their bad loans.

What the bankers are now nervous about is that they are juggling many loans which could default at any time and result in an *uncontrolled* collapse. Once triggered by any of the L.D.C. defaults, the resulting chain reaction could proceed so quickly that the Money Manipulators wouldn't have time to do what is necessary to save their assets. So, even though the debt crisis will ultimately be dealt with through runaway inflation, they must deal with the debt in the meantime and try to keep each impending default from turning into the feared international disaster.

Among all national governments of the Third World, Mexico holds the largest amount of foreign indebtedness — over $80 billion. It has borrowed liberally from the international bankers in recent years in anticipation of being able to repay the loans with revenues from its still-developing oil production. As long as the big oil revenues kept coming in, the government south of the border could make at least some payments on that debt. Now, however, Mexico is experiencing a $10 billion shortfall in oil revenues — partly due to the world oil glut. In addition, the Mexican economy is in a shambles. As with so many Socialist countries, Mexico has become a heavy food importer despite an abundance of arable land and a large pool of willing workers. The government there has simply followed policies which discourage efficient agricultural production.

Even when petroleum prices were at their peak, Mexico could hardly afford its expensive system of subsidizing food, housing, and transportation — and at the same time pay the interest on its foreign debts. Result: an inflation rate over sixty percent. Mexico's economy has meanwhile been burdened by an incredibly corrupt government, excessive regulation, inefficient government-owned enterprises (such as PEMEX, Mexico's petroleum company), and assorted ill-starred Welfare State programs. Its cash flow has dwindled to a trickle. Under these conditions, is lending money to Mexico any less crazy than Penn Square, Continental Illinois, and Chase lending money to wildcat drillers? The difference is that Mexico's default would make the bad Penn Square loans look like a tiny drop in a bucket of red ink.

And so it was that on the heels of the Drysdale and Penn Square scandals which had already shaken the banking industry, Mexico faced the prospect of bankruptcy by August of this year. As *Newsweek* for August 30, 1982 put it: "With its currency burned by unprecedented devaluations, its oil revenues in sharp decline, its economy battered, and its options exhausted, Mexico took the only step left: in effect, it declared bankruptcy and desperately appealed to its international creditors for help."

With some $22 billion of loans from one hundred U.S. banks at stake, a formal default by Mexico would have toppled the now-reeling global banking establishment.* Facing that grim prospect, the big bankers and the Reagan Administration quickly mounted an international emergency rescue operation of the ailing Mexican economy. This mammoth bailout includes $2 billion in advanced funds and "federal credit guarantees" against future deliveries of American agricultural products to Mexico and of Mexican oil to the United States. Another $1.5 billion in emergency funds came from the Federal Reserve and its sister central banks in Europe, coordinated by the Bank for International Settlements in Basel, Switzerland. The International Monetary Fund will come through with more than $4 billion over the next three years. Meanwhile, a conference of one hundred fifteen U.S. banks was held at the Federal Reserve Bank of New York on August twentieth and agreed to Mexico's pleas to postpone for ninety days its payment of $10 billion due this year. That's until late November!

In addition to all this huge L.D.C.

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*Patrick J. Buchanan observed in his syndicated column for August twenty-fifth: "The specific reason for the Wall Street jitters is that American banks are heavily, heavily exposed. Between $18 billion and $34 billion of all the Mexican paper is held by some 1,000 U.S. banks, ten times their exposure in the Polish loans. Some banks have lent 90 percent of their equity south of the border. Should Mexico default, the long-predicted bank crisis would be instantly at hand." *Time* magazine for August thirtieth boldly reported that Manufacturers Hanover Trust and Chase Manhattan "had extended so many loans to Mexico that a default would leave them insolvent." And: "Three of the world's largest banks — Bank of America, Citibank, and Lloyds Bank of Britain — were reported to have the greatest 'exposure,' in banking terminology, to Mexican borrowers."

debt overhang, there is also the growing debt crisis of the needy Communists. Western governments and bankers now have on their books between $80 billion and $100 billion in outstanding loans to the Soviet Union and the East bloc nations. Over $20 billion of this is owed by Romania and Hungary, and they are unable to pay even the interest. Poland owes a whopping $28 billion to the West, $16 billion of which is owed to American and European banks. It cannot pay. Presidential advisor Ed Meese has admitted that the Reagan Administration decided to bail out the situation for fear of a snowballing series of bank collapses beginning in West Germany, instead of requiring Poland to default. Realizing the West's vulnerability, Poland's dictator Jaruzelski is threatening a formal default if more credit is not forthcoming!

The West has been lending money to the Communists and the Third World countries just to help them pay the interest owed on previous debts which they will never pay. Now, many cannot even pay the service charges! The banks and Western governments have two choices according to William J. Quirk: "They can loan more money if they can get it. Or they can stop and watch the LDCs go off like a string of Chinese firecrackers — with the banks as the cherry bomb at the end."

It is in the interest of the Communists, the Latin dictators, the African tyrants, and the international bankers to maintain the pretense that all these loans are sound. If the bankers were forced to write them down to their real book value, it would mean writing off billions now on their books as paper assets, thus taking huge losses which would mean insolvency for most major banks. This whole pernicious operation means that it has been arranged for us to have a vested interest in preventing the collapse of Communism since a Red default could bring down the whole banking system and crush our economy.

Bluff and public confidence seem to be the only glue holding everything together. Paul McCracken, former head of President Nixon's Council of Economic Advisors, admits: "The world is balanced on a knife-edge and could easily plunge into another era of international economic disintegration." It is global balance of terror!

Citibank epitomizes the situation of most major commercial banks. With a claimed $119 billion in assets and fifty-eight thousand employees, Citibank is America's second-largest bank. In a timely article entitled "Busted Flat On Wall Street" which appeared in the *New Republic* magazine in August, Professor William Quirk examines Citibank's assets and concludes: "The reality is that Citibank is bust. The true value of what it owns is less than what it owes. It has made a lot of stupid loans that are not going to be repaid."

Pointing out that neither the Federal Reserve nor Citibank will disclose Citibank's proportion of the unsound loans to the L.D.C. and Communist governments, Quirk estimates such loans total between $8 billion and $10 billion — "which is about 200 percent of the bank's reserves, or enough to wipe out the shareholders twice over. Citibank's stated capital is $4.9 billion."

In addition to loans to foreign governments, the assets of the major banks also include a large proportion of bonds. In fact, the banks are loaded with bonds. But the market value of bonds has been anemic in recent years because of persistently high interest rates. Earlier this year, when interest rates stayed stubbornly high, the bonds held by the banks were worth far less than when purchased. If the banks had been required to mark down their bond portfolios to their market values, they would all have been technically and legally insolvent and forced to shut down. But the government — aiding the banks in the pretense of soundness — allows the bankers to carry the bonds on their books at the purchase price. Even so, the banks were getting desperate. How long could such a fiction be kept up in the face of an increasingly wary and aware public? Something had to be done and quickly.

By the middle of August, when financial crises resulting from trouble at Drysdale and Penn Square and in Mexico were rattling the financial community, the banking *Insiders* dispatched Henry Kaufman to the rescue.

Mr. Kaufman, a resident member of the Council on Foreign Relations, is the chief economist for Salomon Brothers, a major Establishment merchant banking firm and one of the largest bond dealers in the world. Kaufman had been played up in the financial press as *the* guru of interest rates. For months he had been predicting that interest rates would remain high! All of a sudden, Henry Kaufman staged a dramatic about-face by announcing that long-term interest rates were on their way down. The markets went crazy. This was the signal for which they had desperately hoped. As *Newsweek* of August thirtieth reported: "The day Kaufman spoke, the Dow Jones industrial average surged a record 39 points, and on the stock exchanges, a record-shattering trading frenzy continued throughout the week. The bond market catapulted to new highs, sending long-term rates plunging 115 basis points in a single morning."

This was just what the financial doctor had ordered for the ailing big bankers! And why not? Was Citibank chairman Walter B. Wriston not now also chairman of the President's board of economic advisors? Just call him Dr. Wriston.

The Fed had already begun to drop its discount rate — the interest it charges banks for borrowed reserves — no fewer than three times in less than a month, the third time it did so being on August fifteenth. But it was Henry Kaufman's authoritative call that triggered the "Kaufman Rally." Again quoting *Newsweek*: "Almost from the moment Kaufman's memo hit the wires on Tuesday [*August seventeenth*], the market went wild. Insurance companies, banks, endowment and pension funds and other large institutional investors snapped up blocks of stock of more than 10,000 shares."

When you hear someone like Kaufman saying what he did — and when you see the aftermath triggered by it — you have to ask yourself: *cui bono*? Who benefits from this? Clearly, the people for whom this rally was engineered were its biggest beneficiaries: the big banks — the major holders of bonds.

We interviewed investment advisor Larry Abraham concerning August's spectacular market activity and Henry Kaufman's role in saving the banks' assets. He told us:

"Everybody has had their eyes glued on the stock market, but even more important — and performing even more dramatically on a broader base — has been the bond market. Much, much larger than the stock market, the bond market is the core of banking liquidity. The points that have been put on the bond market over the last week have been incredible. What that has done to the bond portfolios of the major banks has been to add literally billions of dollars to their assets."

Of course, what was a "surprise" to almost everybody else was anticipated by the Big Boys. We may never know exactly how much money Salomon Brothers raked in by positioning itself on the long side of the stock and bond markets just prior to Henry's sudden "change of heart"! Mr. Abraham observes: "About an hour after Kaufman made his comment, it came out on the broad tape that Salomon Brothers had bought a thousand futures contracts on Treasury bonds. This was widely acknowledged. What was not widely acknowledged was that about an hour or so *before* Kaufman had made his statement, they went long on 3,000 contracts on Treasury bonds. This information has come to me from very authoritative sources."

Abraham calculates that Salomon Brothers made approximately $21 million on those three thousand contracts in less than a week after the Kaufman Rally. They have made much more since then, as interest rates have continued to fall in response to lowered discount rates from the Fed.

The whole scam reminds Abraham of the time, in 1815, when Nathan Rothschild walked onto the floor of the London exchange and started selling British bonds. "Everybody interpreted that as a victory for Napoleon at Waterloo," comments Abraham: "Panic selling started and the bottom fell out of the British bond market. Nathan and his syndicate then walked back in and bought the bonds all back up at a tremendous discount. When the news finally came in that Wellington had defeated Napoleon at Waterloo, British bonds shot up and Rothschild was sitting pretty.

"Since that time, there have always been highly acclaimed gurus who, at various times, could stampede markets. How long has the name Henry Kaufman been known as an interest-rate authority? It has only been the last eight or nine months that his name has meant anything to anybody. Kaufman was publicized by the financial establishment and was made into the interest-rate guru for a purpose." Conspiracy anyone?

Unfortunately, the dip in interest rates will be only temporary. The weight of the gargantuan federal deficit is too great to float in the credit-market pool. Long-term, rates must go up. We are headed into more economic body blows in the months ahead. Will the banks collapse? Probably not. They will more likely close down for a while as Harry Schultz has suggested. Market analyst Howard Ruff has written: "As a practical matter, the government is not going to let the banking system 'fail' anyway, in the classic meaning of the word. If we have runs on the banks due to a collapsing dollar, a liquidity squeeze with lots of bankruptcies, the Arabs withdrawing their short-term deposits, *etc.*, the government will be loading up C-141s with mountains of paper money and flying off to cover the banks until the run has run out of steam. This explosion of paper money could convert us quickly from a credit economy into a printing-press economy."

And that, my friends, is how the world is now run. ■ ■

CRACKER BARREL

■ The Black Plague destroyed half the population of Europe in the Fourteenth Century.

■ Lightning puts ten million tons of nitrogen into the earth each year.