

## **BANKS IN BONDAGE**

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For more than two years, most commercial banks have been unable or unwilling to lend significant amounts of capital vital to real recovery from recession. Stringent new federal banking rules rigorously enforced by regulators, have taken control of our bankers' business decision-making.

The result has been widespread cancellation of lines of credit, denial of term loans and forced sale or foreclosure of secured property. Real estate construction lending has all but ceased in most areas of the country.

Efforts to ease lending restrictions have been largely unheeded. Real estate values continue to decline, there are few signs that Southern California jobs growth will resume in the near future.

In stark contrast, interest rates continue to hover at their lowest levels in 20 years. Banks have reported record profits in the 1993 first quarter and prices for bank stock have increased dramatically during the 1992 fourth quarter and first quarter 1993.

So why is the banking industry a passive player in the recovery process? Is it really conceivable that the banking industry still in serious trouble given record earnings at many institutions?

This article addresses these questions and tries to shed some light on the root causes of the prolonged nature of the recession. A central focus of this inquiry will be an examination of why the banking system has been a virtual non-participant in this anemic recovery.

## BACKGROUND

On the premise that few economic problems are really new, I sought out some old textbooks on the structural relationship between the Treasury Department and the Federal Reserve System and the principal note holders of our national debt. These players and the ways that they interact play a powerful role in determining interest rates. Moreover, these fundamental relationships remain constant in their power to shape overall economic conditions in this country.

If we look closely at the factual record, we can see more clearly what in recent times has contributed to the lingering weakness in our economy, at a time when we should be experiencing the more robust conditions that traditionally accompany a recovery. The September 1992 issue of the U. S. Treasury Bulletin provides some of the evidence. It clearly documents a breakdown of ownership of public debt securities by private investors, including commercial banks.<sup>1</sup> The findings are quite telling

According to the Treasury Bulletin, commercial banks held approximately \$117.3 billion in U.S. Treasury debt securities in March 1982. By year-end 1990, holdings increased to \$171.6 billion. --

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1. U.S. Treasury Bulletin, September 1992, page 56, Table OFS-2, "Estimated Ownership of Public Debt Securities by Private Investors"

It is noted that a slightly larger holding (up to \$196 billion) occurred in 1986 and 1987 but total holdings had diminished to the \$171 billion level by year-end 1990. Starting in early 1991, the banks' holdings of U.S. public debt increased steadily and almost dramatically. By year-end 1991, the banks held \$231 billion of public debt rising in June 1992, to \$280 billion. These are in effect, loans to the federal government. Loans to private industry declined during this same period.

According to an article in the April 12, 1993 issue of National Review, bank lending to the U.S. government has increased significantly since 1990:

"By last June, investment in government securities (at \$610.7 billion) had surpassed loans to business, which stood at \$604.6 billion. As of this January, bank lending to business had slipped slightly, to \$601.3 billion while bank investment in U.S. Government securities had reached \$657.4 billion, according to the Federal Reserve.<sup>2</sup>

#### FORCED BANK INVESTMENT

Why has the banking system embarked upon this passive investment program given the relatively low rate of return available on these risk free investments? Why would banks wish to invest so heavily in U.S. Treasury notes during a recovery period? What is perhaps more puzzling is this question: how can banks be reporting record earnings when their loan portfolios are so heavily committed to low yielding Treasury debt?

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2. National Review, April 12, 1993, page 41, "Breaking the Banks" by Robert Stowe England.

Typically, recovery is characterized by an increase of loans to private industry. As confidence builds, employers seek working capital to make capital expenditures and increase employment to increase output in order to meet the anticipated greater demand for goods and services. Not so this time. Even President Clinton has had little impact on the Federal Reserve policy to date with his urging that banks to make more "character loans." It should be noted that the bulk of all U.S. private sector jobs are in small businesses and not large corporate employers, and it is these very same small businesses that cannot tap the commercial paper markets or, in many cases, raise equity capital to help offset the unavailability of bank loans.

It is fair to raise the question here as to whether having U. S. banks soak up Treasury securities may be a deliberate move to avoid possible rate hikes from shrinking demand from international investors for the debt this country has become so adept at creating. Is our banking system the only source left for the Treasury to obtain financing of the national debt? Probably not, but it appears to be the easiest way to avert a major increase in interest rates. Further investigation reveals some answers.

## FOREIGN INVESTORS

Approximately one third of our national debt is owed to foreign investors. Foreign governments and investors were owed about \$150 billion in 1982. By mid-1992, their holdings had increased to over \$500 billion.<sup>1</sup> Most of this debt occurred during the nineteen eighties when Congress failed to pass budgets that seriously cut spending, thus leaving government spending at levels that far outpaced incoming tax revenues, each and every year.

These excesses were largely financed by foreign investors, including Japanese and German interests. Rates were high during the early 1980's making U.S. Treasury Notes an attractive alternative to domestic investment options available to these foreign investors. Such investments made political sense, too. After all, the United States was an attractive market for their exports and buying back U.S. debt helped keep the import tariff advocates slightly at bay.

Unification of Germany and the attendant major capital investment required to democratize East Germany at this time was still a few years away. Japan had tremendous surplus of investment funds, which held domestic interest rates to a fraction of those in the United States. Foreign investors flooded into this country, buying controlling interests of U.S. banks and industrial firms. They also made large direct investments in U.S. real estate. Then suddenly things changed.

The Savings and Loan debacle and the tremendous oversupply of most forms of commercial real estate caused both domestic and international investors to retreat. The breakup of the Soviet Union enabled the U.S. to slash defense spending, or at least start the process. Interest rates on U.S. Treasury securities dropped steadily in response to a succession of moves by the Federal Reserve to soften the effects of the recession.

Europe and Japan also moved into a recession. The Japanese stock market plummeted. The need for capital at home, on the part of our foreign allies, became more important than continued investment in U. S. Treasury Notes, many of which were maturing due to the high volume of short maturity borrowings by the Treasury in this period. So taken together, the need for cash at home

coupled with low U. S. interest rates prompted foreign investors to pull back from our U.S. Treasury security markets.

#### ALTERNATIVE SOURCES OF DEBT FINANCING

So where is the money coming from to pay off our foreign creditors? Traditionally, the Treasury sells more bonds to refund old ones. But with the retreat of foreign investors from U. S. Treasury investments, who is left to buy them? The Treasury could just print more money, like Third World countries do, but given the huge volume needed, the effect upon inflation and the devaluation of the U.S. dollar in world markets make that a poor choice. Nonetheless, it appears we have already done some of that. (On May 21, 1993, the value of the Japanese yen was 110.5 per U.S. dollar, a twenty-year historic low.)

During the 1980's, Japanese investors purchased U.S. investments at 125 to 135 yen to the dollar. Now we are giving them back their funds at \$.85 on the dollar. Thus we have made it costly for our foreign creditors to liquidate their U.S. holdings by adopting monetary policies that reduce the value of U.S. dollars. This has probably slowed their retreat, but not significantly. It has also helped restrict the competitive advantage of foreign exporters of cars, steel, etc., to the U.S. and improved U.S. exporters' competitive position in world trade.

Another alternative for our economic policy makers is to let interest rates rise, making Treasury Notes more attractive to potential investors. This is not an attractive option for several reasons, as it could stall the recovery. Nevertheless, the U.S. Treasury found itself still needing a way to raise

large sums of money to cover the government's continued deficit spending as well as the redemption of maturing issues.

The customary solution is to increase taxes. We are now doing just that, but it takes time to convince taxpayers and lawmakers who closely watch the polls that a tax increase is good news.

A skeptic might conclude that the Treasury Department financing planners turned their focus upon the Federal Reserve for a solution to their shortage of funds, resulting in a crowding out of private borrower demand. True or not, this writer has not researched this issue.

#### THE PRESENT SOLUTION

By January 1991, re-regulation of the banking system was already under way. During the period from 1985 to 1990, U. S. banks made concerted efforts to expand their role in international banking. U. S. Bankers discovered they were destined to be minor players in international banking transactions unless their capital ratios and real estate portfolios were adjusted to meet the standards set forth by the International Bank of Settlement. The I.B. of S. was established by the large central bankers of Europe to stabilize international exchange and trade settlements referred to as the Basle Accord. By its standards, most if not all major U. S. banks' capital ratios were less than half those required to meet European Common Market Bankers criteria for membership, and their ratio of real estate investments was almost twice the "acceptable level" for membership. Although 60% of world trade is transacted in U. S. dollars, only 7% is transacted by U. S. banks. Clearly, significant strengthening of the U. S. banking system was necessary for them to expand significantly into global trade. The recovery plan that has evolved appears to have offered a

solution to the U. S. Treasury's need for a substantial new investor segment to soak up debt securities. Strengthening U. S. banks was critically important on its own merits to avoid a bailout expense that would be almost indigestible. These circumstances conveniently dovetailed with the need to find a replacement for foreign investors who no longer had the same appetite for extensive holdings in U. S. Treasury offerings.

The Treasury Department is one of the Federal Reserve's underlying sources of funds (and vice versa.) Fed Funds (reserves) are available through the Federal Reserve to member banks at very low rates. During 1992 and thus far in 1993, member banks have invested very profitably in U.S. Treasury securities. The favorable spread between the cost of these funds and the yield on U.S. Treasury investments has attracted major bank purchases in U.S. debt obligations. This has permitted banks' balance sheets to improve substantially. No reserve requirements are placed on debt backed by the full faith and credit of the U.S. government. The zero risk and profitable yield is very compelling. Why make loans to private industry if additional bank funds must be placed in reserve with the Fed and real estate loan reserve requirements are punitive? (Incidentally, a characteristic of Third World country banks is to hold more loans to the government than to private enterprise.)

Unfortunately there are negative consequences to such investment decisions. The first is that this process crowds out loans to private industry. It is ironic that private depositors are the primary source of bank lending, but private industry bank clients, of late, are denied access to their own money in the form of commercial loans.

Graph I illustrates Federal Reserve member banks' annual volume of real estate loans, currently at a twenty-year low.<sup>3</sup>

## GRAPH I

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3. Federal Reserve Board, "Flow of Funds", Merrill Lynch & Co., "Investment Strategy", May 11, 1993.

Given the oversupply of most types of commercial properties in principal trade areas, this is not surprising. Given the high level of liquidity among savers and would-be depositors, one might assume that banks have merely shifted their emphasis to commercial and industrial loans. Not so. Graph II illustrates the banks' decline in lending to industry as well.<sup>3</sup>

## GRAPH II

It appears the banks' abdication of their role to serve private industry is creating increased demand for commercial paper financing through investment bankers. However, moving the role of banking outside the Federal Reserve System also removes depositor savings from the built in protective regulations of the banking system.

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3. Weekly Observations, May 11, 1993, page 5, "Non-financial Commercial Paper vs. Commercial & Industrial Loans", Merrill Lynch & Co.

Secondly, money loaned to the government returns directly to the Treasury with no multiplier effect upon the economy. Graph III depicts the annual Growth in M3, national money supply <sup>5</sup> and clearly shows the negative impact of Treasury debt purchases by our banking system on the nation's capital base.

### **GRAPH III**

Money growth has actually been NEGATIVE for the past two quarters! Is it any wonder that the recovery has been so slow in coming and has been absent a noticeable increase in jobs? Growth in money supply, after adjustment for inflation, has been extremely predictive of future economic performance. Monetarists hold that "... when M3 falls significantly below the Consumer Price Index, recessionary economic performance is the result." <sup>6</sup>

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5 Federal Reserve Board, Weekly Observations, May 11, 1993, page 1, Merrill Lynch & Co.

6. Quarterly Strategic Outlook, Second Quarter 1993, page 3, Houlihan Lokey Howard & Zukin Investment Management.

## CONCLUSION

We have won the cold war, but it is of little value if we lose the economic war. Dependency upon foreign creditors has proven to be almost as threatening. Government overspending eventually transfers the power of self-determination to our creditors. This is not surprising; it works the same way in our family finances. Financial independence is just as important as political independence. Ask any family that overspent their earnings during the 1980's and are now out of work. It is our creditors that hold economic control over the quality of our lives. We must hold our borrowings in balance with our ability to pay it back over the loan term.

It is this writer's view that the Federal Government should not be exempt from the same fundamental rule of having to live within its means. Continued excess government spending over revenues together with refunding old Treasury debt will continue to add to the total volume of national debt unless spending is offset by additional revenue, i.e. more taxes. Without significant increases in bond interest rates, the Treasury will be hard pressed to attract additional foreign investors. Yet, both higher rates and higher taxes stifle economic recovery.

Our study concludes that the commercial banking system has been a major purchaser of Treasury borrowings since January 1991. The banking industry is centrally controlled and supervised and must follow the regulatory requirements of the Fed to stay in business. A primary tool of the Federal Reserve to improve the financial health of the commercial banks is to increase reserve requirements. Reserves can be in cash or securities backed by the full faith and credit of the U. S. Treasury. Treasury Bonds are the obvious choice for banks as they earn interest, as opposed to cash. By increasing reserve requirements the Fed can render member bank investment in certain

types of private industry loans less attractive. For example, a real estate construction loan may require up to 100% reserve requirement, which would encumber twice as much lending capital and thereby reduce the effective yield to a level below which the “high risk” investment is no longer attractive. Being obliged to purchase U. S. Treasury Bonds through regulatory reserve requirements has worked to the advantage of the U. S. Treasury and has the additional benefit of strengthening banks’ financial condition.

Holding our banks in bondage through the regulatory reserve requirements is a short-term solution, as it discourages banks from investing in private industry loans.

It is an accepted fact that America’s commercial banks have lost a considerable market share of depositors to money market funds, marketable securities and credit unions during the past ten years. Perhaps these new bank functionaries will also be regulated into having mandatory reserves at some point in the future. Is the role of banks changing to serve government financings over the needs of private industry? What are the long-term consequences? After the banking industry regains financial health, who then will be large buyers of the ever-increasing amount of Treasury Bonds? Does government plan to regulate pension funds and life insurance company investments in a similar manner, making them mandatory buyers of Treasury Bonds to meet the Treasury’s insatiable appetite for more funds?

Holding our banks in bondage through stringent reserve management policies has reduced them to minor player status in the economic recover process. An increase in taxes with limited bank

participation makes meaningful economic recovery uncertain. Consequently, in my view, interest rates are unlikely to move significantly higher in the foreseeable future.

What are some plausible solutions? There really are some and they are being voiced. So far, neither the Clinton Administration nor Congress has shown signs of taking what in my view could be considered appropriate action. Simply stated some of the solutions include:

1) CUTTING SPENDING to balance the budget, with particular emphasis on welfare benefits, entitlement spending on Medicare, Medicaid, government and military pensions and Social Security spending.

2) REDUCE TAXES to stimulate more investment in capital and jobs, particularly capital gains taxes

3) Require PUBLIC PENSION FUNDS to hold at least a 20% reserve in DIRECT U.S. Treasury Debt (excluding Agency debt)

4) Return control of the banks to the bankers

5) RECONSIDER the importance of meeting European Central Bank criteria for membership.  
Do we really want to go the way of Europe?

The social ills of our country cannot be met by a "tax and spend" policy. It will merely add to the problem by creating more dependency on government debt. Almost half of our federal budget is now comprised of social and welfare spending. As the average age of Americans increases,

proportionately fewer and fewer taxpayers must carry the financial burden of those who are not.

It's only a matter of time. Must we wait to cut back spending until all our financial institutions are regulated into substantial holdings of our national debt in the form of Treasury Bonds?

We all have compassion for the poor and those whose retirement incomes have dwindled, but how can we hope to improve their lives if we continue to take away the incentives from those who must take the risks to earn profits to pay for it?

In California, 1992 marked the first year that the population was comprised of more tax dollar recipients than taxpayers.

Americans voted for change in 1992, not another dose of deficits and tax increases. How can we get this message to our legislators?

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