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Bankruptcy 1995 (Not!)

A few years ago a best-selling book predicted that the Federal budget deficit would become unmanageable by 1995, bringing about an economic and financial meltdown. What went wrong with Harry Figgie and Gerald Swanson's forecast?

In their 1992 best-selling book *Bankruptcy 1995: The Coming Collapse of America and How To Stop It*, Harry E. Figgie, Jr. and Gerald J. Swanson predicted that the American economy would experience a complete breakdown in 1995 as a result of explosive growth in the Federal deficit and debt. The burden of debt, they said, would trigger a collapse in the financial system, hyperinflation, massive unemployment, and a total loss of confidence in the dollar. In short, chaos.

The book's forecasts were precise with respect to both the timing and the magnitude of the crisis. In 1995, it predicted, the Federal Government's budget deficit would be $850 billion and its accumulated debt would be $6.56 trillion. Interest payments on this debt would be $619 billion, which, according to the authors' projections, would eat up 85 percent of income tax revenues that year (up from 35 percent in 1992).

"The Week from Hell"

In a lengthy scenario, the authors gave a blow-by-blow description of how this fiscal doomsday would affect a typical American family. Their hypothetical aging couple would see their pension slashed by two-thirds. Unable to pay their property taxes, they would sell the family homestead. The buyers would be the Toyota company — according to the book, by 1995 the country would be "largely owned and controlled by politicians and corporations from cities such as Berlin, Riyadh, and Tokyo." The couple would move in with their grown children, who themselves would be struggling in an economy characterized by soaring prices, massive bank failures, rising unemployment, and a free-fall in the stock market.

All this and more would come to pass, Figgie and Swanson warned, "if present trends continue." Their projections for 1995 carried a "high degree of authenticity," they claimed, because their debt forecasts for the past 6 years had been "right on target."

What Happened?

It is now 1995. America has not collapsed. The economy is vigorous, price inflation and unemployment are relatively low. The foreign-exchange value of the dollar has weakened but hardly collapsed, the number of bank failures has decreased markedly since the early 1990s, and the banking industry posted record profits in 1994. The stock market has not collapsed, and Tokyo has not taken over control of American business. The prospects for a sweeping reversal of all these things in the next 12 months seem remote. Even if there is a sudden reversal in some areas — if, say, the financial markets take a dive — it will not be because Government debt has reached the levels predicted in *Bankruptcy 1995*.

The Government's finances are significantly better than Figgie and Swanson predicted. In June, the public debt stood at $4.7 trillion, and if it maintains its recent rate of increase it will reach roughly $5 trillion in 1995 — not good, but fully $1.5 trillion below what Figgie and Swanson expected. Interest payments on the debt are expected to be $299 billion in 1995 — about half what they predicted. Their forecast was widest of the mark with respect to the Federal deficit. In fiscal 1994 the deficit decreased to $203 billion, and the Office of Management and Budget projects that it will decrease to $167 billion this year. This is *$683 billion lower* than Figgie and Swanson predicted.

Why Didn't the Sky Fall?

One factor was the improved performance of the economy. The ballooning of the Federal deficit in 1990-91 was partly due to the recession, which slowed the growth of tax revenue and increased the rate of growth in expenditures. Such cyclically increased deficits usually are temporary. Figgie and Swanson appear to have overlooked this or assumed that the economy would remain in recession until 1995, even though there was ample evidence that a recovery was underway in 1992, when their book was published.

In addition, the authors based their dire projections on outdated figures. Their forecasts of the Federal deficit and debt came straight out of the report of the President's Private Sector Survey on Cost Control (popularly known as the Grace Commission), which was published in 1984, nearly a decade earlier. The Grace Commission's debt projections were premised on various assumptions about the economy, and by 1992 it was evident that most of them were wrong

For example, the Grace Commission assumed that price inflation would average 6.0 percent annually during the period 1985-90 and 8.2 percent from 1990-95. Reported price inflation, as measured by the Consumer Price Index, averaged much lower than this — 4.1 percent and 3.6 percent, respectively. The Grace Commission forecast of interest rates also was too high — corporate bonds were predicted to pay an average annual return of 12.38 percent in 1990-95, and 3-month Treasury bills were expected to pay 10.77 percent. The Commission's assumptions about the rate of economic growth, the level of unemployment, and other economic variables also were wrong. As forecasts go, the Grace Commission's predictions were reasonable for their time, but their inaccuracy is not surprising. There is no scientific basis for making precise long-term forecasts of the economy.

What *is* surprising is that Figgie and Swanson recycled the Grace Commission forecasts nearly a decade after they were issued. By 1992, when their book was published, the gap between the Commission's predictions and the economic record was clear. Apparently, the authors decided to sacrifice accuracy for shock value. Telling people that the world as we know it will end 3 years from now grabs people's attention (and sells books); admitting that the prediction is based on stale, inaccurate data would dilute the message, to put it mildly.

Misleading forecasts were not the only

problem with *Bankruptcy 1995*. The authors presented their data in graphic form in ways that seriously misrepresented their effect, *e.g.*, using arithmetic rather than logarithmic scales (see "Bankruptcy 1995," *Research Reports*, January 4, 1993). This deceptive presentation exaggerated the trends in Government spending and borrowing. For example, the book's chart of the Federal debt depicted it reaching unprecedented heights in the 1980s and running almost vertically off the chart by 1995. In relation to the rest of the economy, however, the debt was smaller in the 1980s than it was in the 1950s, and its recent rate of increase has been much more moderate than the book's charts suggest. The charts made historical trends appear worse than they were — another reason why the authors' prediction of monetary and economic collapse by 1995 was so far off the mark.

Presumably few people are disappointed that *Bankruptcy 1995*'s prophecies have turned out to be false. Even Harry Figgie may be relieved, having troubles enough as it is. (Figgie, the founder, chairman, and CEO of Figgie International, a large industrial company, recently retired and resigned from the board of directors after auditors said the company's recent losses and declining net worth raised doubts about its future.) In another sense, however, it is unfortunate that the best-selling book's forecasts were so wrong. Despite its serious flaws, the book did present some useful observations. The level of Government debt *has* been increasing in relation to the economy, and if it continues to increase the burden of debt could become so large that policymakers will have little choice but to inflate it away. There is ample reason to worry about this despite the recent decrease in the deficit, because rising Government obligations threaten to put unprecedented strains on the budget early in the next century. These strains *could* destroy the dollar, wreck the financial system, and ruin the economy. In addition to calling attention to this issue, Figgie and Swanson also recommended a number of useful steps to shrink Government and reduce the deficit that, if adopted, could head off a crisis.

More Harm Than Good

Ironically, by misrepresenting the data the authors may have done more harm than good to their effort to stir up public debate over the possible consequences of Government borrowing. Readers who were fooled by the book's forecasts will be tempted to dismiss the issue altogether, which would be a mistake. If current trends persist, the burden of Government financing eventually will become a problem that cannot be ignored. That no one, including the authors of *Bankruptcy 1995*, can say with certainty when this might happen is all the more reason for concern, both from the standpoint of what policymakers can do to avoid a crisis and what individuals might do to protect themselves against it. ❑

They Just Don't Get It

The Democrats' responses to the Republicans' tax reform proposals show that the President and the Congressional minority remain wedded to the notion that the tax code should serve to micro-manage private spending decisions. This is clearest with respect to the question of providing tax relief for taxpayers with dependents.

The Federal income tax code allows taxpayers to take an additional personal exemption for each dependent. Presumably, this is designed to further "horizontal equity" — the principle that taxpayers in equal circumstances should pay equal taxes. Taxpayers with dependents clearly have less discretionary income than taxpayers with the same income and no dependents. However well intended, there are two reason why this procedure is grotesque.

First, allowing an income tax exemption for each dependent provides a larger tax break for those with higher incomes, except for those with the very highest incomes, because each exemption is "worth" the amount of the exemption, $2,450 in 1994, times the taxpayer's marginal tax rate. For 1994, taxpayers in the 15 percent bracket will pay $367.50 less per child. Those in the top bracket of 36 percent could receive up to $857.50 per dependent child, but at income levels subject to the 36 percent rate, this "tax break" is reduced or eliminated.*

Second, these amounts ($367.50 to $837.50) are almost insultingly inadequate to support one's dependents.

The House Republicans have proposed a $500 tax *credit* for each dependent as part of their "Contract with America." The Republicans stated that only families with incomes of less than $200,000 would receive this credit, yet the proposal was vigorously attacked by Rep. Richard Gephardt, the leader of the House Democrats, because families with high incomes would get it too. President Clinton then weighed in with his (hitherto unrevealed) plan, which called for the same $500 credit for families with less than $75,000 income, as well as new flexibility for IRAs and deductions for college tuition, both severely limited by complex rules and to be phased in over 5 years — more work for the accountants and less money for people to spend as they see fit.

It is not clear whether either form of the $500 tax credit is to be a supplement to, or a substitute for, the existing exemption. We suspect that the credit is to be in addition to the exemption because Gephardt's attack was not dismissed out of hand — only the lowest income (15 percent bracket) taxpayers stand to benefit from substitution because the $500 is less than each exemption is now worth to anyone in a bracket above 15 percent. Instead, the result was a sterile debate about what constitutes "middle class" income.

Substituting a credit for the exemption would be preferable in our view. Because it is likely that more taxes would be paid by those for whom the exemption is now worth over $500 than would be saved by those for whom it is worth less, a "revenue neutral" substitution of a credit for the dependent exemption could be made with a credit of more than $500. This would foster greater "horizontal equity," and the money would be redirected to the families most in need of it to support dependents.

Both sides of what seems to be shaping up as a "bidding war" for middle class tax relief seem to have lost sight of the essence of any useful tax reform — keeping the rates to a minimum. Our politicians continue to prefer "targeted" tax cuts that do not cut rates.

* On adjusted gross incomes over $167,700 for married couples and $111,800 for single persons, all exemptions and credits begin to be "phased out." Under current law, those subject to the 10 percent surcharge on taxable incomes in excess of $250,000 (for whom the effective marginal rate is 39.6 percent), receive no benefit from any exemptions.

IF THE BANKS ARE CURED, WHY DO THEY FEEL SICK?

Judged by their financial statements, the profitability of U.S. commercial banks has soared during the past 3 years. During the past 12 months, however, Wall Street has rendered a largely negative verdict on bank stocks, which now rank among the "dogs" of the market. What's going on? Among other things, deceptive accounting procedures that overstate the banks' market worths and interest rate volatility that promises to continue to whipsaw all financial institutions so long as our fiat currency regime persists.

According to the official data released by the Federal Reserve, 1992 and 1993 were record years for commercial banking profitability, and the recently released third quarter 1994 data suggest that this year will show further performance gains. By most traditional measures, the "banking crisis" of the past decade or so appears to have abated. Compared with the third quarter 1992, net income of commercial banks for the quarter ended September 30 is up over 30 percent; equity and loan loss reserves have increased by $57 billion; problem loans have dropped from $87.5 billion to $42.9 billion and foreclosures have been halved; the number of banks reporting losses dropped from 823 to 496; and the number of banks with nonperforming loans in excess of loan loss reserves plus equity (*i.e.*, insolvencies) plummeted from 117 to 31.

There are a number of obvious reasons for these improvements. A key factor was that lower interest rates increased bank margins and enabled a number of troubled banks to return to profitability. Loan workout deals that permitted borrowers to refinance their commitments at lower rates, together with improved business conditions, lifted many borrowers off the bad loan lists. Moreover, a wave of bank mergers over the past several years accelerated the "disappearance rate" of the weakest banks. Many of the banks that the regulatory agencies deemed most troubled have been absorbed by larger banks that reorganized the operations of their acquisitions. Some credit may be due the Resolution Trust Corporation (RTC), which helped to enable such mergers (and, generally has sold failed bank assets for far more than originally estimated — in FY 1994, the RTC returned money to the Treasury).

Wall Street's Contrary Reaction

In light of these developments, it might seem curious that Wall Street recently has been so bearish on bank stocks, some of which have dropped 30 to 40 percent in value over the past 12 months. Bank stocks are among the new "dogs" of the market. Plainly, the financial markets saw something that is not reflected in the traditional balance sheet data.

In large part, Wall Street's current negative appraisal of commercial bank prospects no doubt reflects concerns about the effects of rising interest rates on bank profitability. Whenever interest rates increase sharply, as they have over the past 12 months, banks run the risk of an interest rate "squeeze": *i.e.*, interest expenses increase as payments to deposit accounts rise to meet market rates at the same time that revenue is locked in at the lower rates on prior loans. The severity of the resulting squeeze depends primarily on the extent to which a bank has "lent long" at the lower rates (*i.e.*, the proportion of its asset portfolio that is below the current market) and the magnitude of the differential between rates applied to assets and liabilities.

Bogus Accounting

In this respect, the haste with which many banks refinanced their mortgage loan portfolios when interest rates were decreasing, which boosted their profits *via* refinancing point fees, probably has exacerbated the effect of the recent rate hikes. Of course, not all banks have been affected similarly. The smart banks refinanced their mortgage portfolios, took the related fee income, and then unloaded the new paper on the secondary market. It is not surprising that the "hot market" news in recent months has focused especially on concerns about banks and brokerages that subsequently invested heavily in mortgage securities and derivatives. However, demonizing derivatives misses the point. Derivatives trading is a zero-sum game with a winner and a loser — much the same as a commodities trade. It is a sideshow to the main event, which is what happens when the values of the underlying securities plummet in response to rising interest rates.

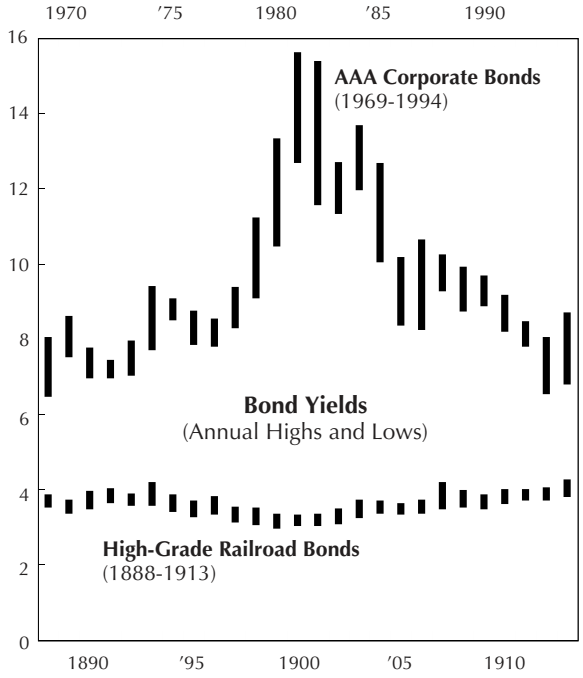
The dirty secret is that, in relation to current market values, the official balance sheets of commercial banks are bogus. As a result of regulatory accounting provisions that permit them to hide their losses on certain classes of assets, many banks have accrued far greater losses in their securities portfolios than have been reported. According to current accounting rules, and unlike bond funds and other financial entities, banks are not required to write down losses on debt securities that they intend to hold to maturity.

The result has been that, through the third quarter of 1994, some $12 billion in accrued losses on such hold-to-maturity securities have gone unreported (roughly equivalent to the total of third quarter 1994 bank earnings). Inasmuch as the $480 billion total of such securities held by commercial banks exceeded their reported $388 billion total of equity and loan loss reserves at the end of the third quarter, such accounting sleight-of-hand would seem to be of no small consequence, especially to shareholders.

Will They Ever Learn?

It would be impossible in this discussion to review at length the historical effects of interest rate volatility on commercial banking practices. Nevertheless, some understanding of the events surrounding the 1990-91 recessionary "credit crunch" and its aftermath may be helpful. Although the causes of that episode may never be fully understood, the combined incentive effects on commercial banks of a sharp drop-off in both the volume of market loans and interest rates was pronounced: in the aggregate, they loaded their asset portfolios with "riskless" Treasury securities rather than take on shaky market loans that might bring them under even greater regulatory scrutiny. As rates continued to drop during 1992 and 1993, some banks sold their higher-yielding securities to realize gains and then re-lent long at lower rates — while others borrowed short-term funds to purchase (slightly) higher-yielding longer-term debt. Whichever strategy was used to boost short-term profitability, the result was the same: the accumulation of relatively low-yielding long-term assets and short-term liabilities subject to change at the whim of the market — *i.e.*, the classic prescription for an interest-rate squeeze.

At this time, it is difficult to estimate the likely effects of the predicament the worst offenders now find themselves in. In the "best case" scenario, banks that hold low-yielding hold-to-maturity securities will see reduced income until those issues mature. But this will put pressure on the remaining portion of the portfolio to generate the earnings required by higher interest rates to retain deposits — which could encourage even greater risk-taking. In the "worst case" scenario, to meet their



obligations some banks may be required to liquidate issues at a loss, reducing equity markedly or precipitating insolvency. Much depends on the "exogenous" behavior of the financial markets and the whim of depositors —neither of which is reliably predictable. Some market analysts think that bank stocks actually have been overdiscounted and may be a "good buy." Others think that the worst is yet to come.

The more interesting question is how this situation came about in the first place. Even though they may be exempt from the full disclosure of their actual financial statuses, the banks that have borrowed short and lent long have in no way gained protection against a potential interest rate squeeze such as the one that devastated thrifts in the 1970s. Bookkeeping sleight-of-hand will be of little comfort in the event that depositors actually decide to withdraw their funds ("disintermediation"). In that circumstance, the classification of securities according to a bank's intent has no practical meaning whatever, and the affected banks would have no alternative but to sell their securities at the market in order to cover their liabilities.

A Regulatory Double Standard

What is troubling about this situation is that these possibilities should be well understood by both the banks and the regulators. Unlike, say, life insurance or annuity companies that can stagger the maturities of their securities to meet contractually fixed liabilities, the vast majority of a bank's liabilities are not fixed, and could come due at any time. There is no reason, other than wishful thinking and the confidence borne of custom, for a bank to believe that it will be able to retain any asset for any period of time.

In fact, if they were adopted throughout the financial industry, the accounting practices currently sanctioned by bank regulators almost surely would result in charges of fraud — and prison terms for the "greedy" perpetrators. It seems highly unlikely that the regulators would condone the current accounting policies unless they somehow were seen to serve some other "public purpose."

In this respect, the mounting fiscal concerns of the Federal Government may loom largest. To the extent that these bizarre accounting rules encouraged banks to purchase medium- to long-term public debt in great quantities when rates were dropping —and so boost demand for the Government's paper and drive rates lower still — it might be said to have served a "public purpose." In recent years the budget outlays required to service the national debt have accounted for about 14 percent of all Federal spending. At current debt levels, every percentage point decrease in interest rates "saves" roughly $45 billion in annual outlays. In short, the banks and the Federal Government have had a mutual interest in perpetrating the deception.

A final irony is that the very assets classified as "riskless" by the regulatory agencies are anything but. Whenever liquidity is a consideration, even Treasury securities are exposed to interest rate risk. This is something that every money manager knows, or ought to know, and can be called to account for failure to disclose such. The flagrancy with which commercial banks have been exempted from the accounting rules that others must obey is simply one more indication of the extent to which regulators are willing to apply a double standard when it may serve Government, but not the public, interest.

It Wasn't Always Like This

There may be another reason why banks are allowed to carry "riskless" securities on their books at par, without "marking to market" or establishing reserves for losses (which amounts to the same thing) — once upon a time it made some sense. When long-term loans with excellent prospects of repayment did not fluctuate much in price, and when beekeeping was done by hand, there was little point in constantly updating balance sheets to reflect market fluctuations.

The accompanying chart shows the annual range of yields on AAA Corporate Bonds for the past 26 years and similar data for high-grade railroad bonds during the 26 years ended in 1913. As the chart clearly shows, the yields, and therefore the prices, of "riskless" loans fluctuated in a very small range during the earlier period.

They remained a useful source of funds (*i.e.*, one that did not destroy earnings or wipe out equity) at banks that needed to sell them, even during the "panics" of 1893 and 1907. In contrast, in addition to the rates being much higher nowadays, the fluctuations are markedly larger even over relatively short spans (the bars in the chart are much taller).

The difference between the two periods was, of course, not only that there was no central bank prior to 1913 (the Federal Reserve was established in that year), but also that the dollar and all other major currencies of the world were freely convertible into gold on demand. Bond investors could largely ignore whatever was going on in the economy or "in the street," when they expected to be paid in dollars "as good as gold."

During the later period, currencies lost all links to gold or anything else, and investors could only guess what their eventual repayment might be worth. With the Fed pumping reserves "out of thin air" (a process with no real limits — in contrast to finding gold and digging it out of the ground) at highly variable rates, investors have had to outguess the Fed in the light of constantly changing conditions. No wonder even the highest-rated bonds have become speculations. ❑

PRICE OF GOLD

	1992	*1993*	*—— 1994 ——*	
	Dec. 31	*Dec. 30*	*Dec. 22*	*Dec. 29*
Final fixing in London	$332.90	$391.75	$381.55	$384.40

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