Mexico: a $3 trillion trigger?

Regulators fear that a cessation of payments could detonate the "off-balance-sheet liabilities" bomb.

Reports just issued by the world's highest financial authorities admit, in effect, that the world banking system is insolvent, by the standard used by every bankruptcy-court judge in the United States. The Bank for International Settlements (representing the industrial nations' central banks) and the Group of 10 (representing their governments) issued identical reports recently, warning that the banking system might run "out of control," because the banks' liabilities exceed their assets by about 250%.

The Bank for International Settlements' *Annual Report,* issued June 9, warns, that "off-balance-sheet liabilities" represent "a continuing cause for concern," adding, "there is always the danger of things getting out of control."

Last month, a study issued by senior officials of the Group of 10, the committee formed by Treasury Secretary James Baker III and his colleagues from other industrial nations, warned that "financial innovations are making it harder for monetary authorities to effect policy."

The 270-page study, entitled, *Recent Innovations in International Banking,* singled out off-balance-sheet activities, such as note issuance facilities, forward rate agreements, currency and interest rate swaps, and foreign currency and interest rate options. Not only can the regulators no longer regulate: They cannot even find out how far the banks are in the hole, because the off-balance-sheet liabilities are not all reported.

The result is that "even bank statements are potentially misleading," the report complains. "Large off-balance-sheet movements could make the system less responsive to sudden liquidity needs, complicate debt-rescheduling problems by increasing the distance between debtor and creditor, and destroy the distinction between banks and other financial institutions," the Group of 10 study concludes.

What that means, in plain English, is that the whole shebang could go.

What worries British and Swiss central bankers is that the Mexico crisis could trigger an uncontrollable problem in the international banking system, given the system's overextension.

The Bank of England fears the combined outbreak of a new debt crisis, and a crisis in the expanding "off-balance sheet" high-risk bank liabilities. "It would be difficult to predict how severe an impact it could have. British banks have direct exposure to Mexico, but even more, indirectly they are tied into the major U.S. banks with exposure," according to a senior British central banker. The explosion of off-balance-sheet liabilities ties the major international banks even more closely together than did the system of interbank deposits, the subject of the 1982 crisis in the banking system.

Meanwhile, the British central bank is following the Mexican situation with growing alarm. The key indication they are watching is whether the Bank of Mexico head will leave in the wake of fired Finance Minister Jesus Silva Herzog. "If that happens, then we really have cause to worry."

America's top 15 banks have about $800 billion in assets, and over $2 trillion in liabilities. These 15 banks are insolvent by normal bankruptcy-court rules, but not "illiquid," for the simple reason that they are still able to increase their liabilities. They have reached this miserable condition by that device known as "off-balance-sheet liabilities," the subject of the panic reflected in the central bank and government reports.

International lending collapsed between 1982 and 1985, from over $100 billion per year to barely $10 billion last year. It collapsed because the banks' existing international loans, to Third World borrowers and others, became worthless. The banks could not earn sufficient income to pay interest on their existing deposits, much less show a profit, because a large proportion of their existing loan-portfolio died.

What they could not earn in interest from dead loans, the banks took in by issuing loan guarantees and similar commitments, in return for up-front fees. The volume of loan guarantees in the United States has grown from almost nothing, to $500 billion in 1985, as a result.

In effect, the banks expanded their liabilities in return for one-shot current income, which is the most dangerous and irresponsible thing banks can do. For a bank, a loan guarantee is no less a liability than a loan; if the borrower fails, the bank will have to pay off the loan.