

# Liquidity picture is sheer disaster

by Richard Freeman

Heavily indebted, and plagued by confiscatory real interest rates, the U.S. economy is very near bankruptcy. The monetary system is simply papering over the crisis, but at the same time looting the industrial base of the economy, which brings it closer to collapse.

Consider how the monetary system is presently functioning. The U.S. economy is falling apart, yet a borrowing boom is now pushing interest rates back up again—after months of small, gradual declines—and strains the resources of the banking system to meet these needs. Never before in the post-World War II period has the demand for credit skyrocketed upward while the economy went plummeting downward.

During October and November, U.S. industrial production fell by 1.5 percent and 2.1 percent respectively, yet corporate borrowing did not decline. In November,

for the week ending Nov. 25, the combined rate of growth of business loans at large banks (domestic and foreign) plus non-financial commercial paper grew at a 24.3 percent annual rate, after increasing by 18.8 percent during the month of October.

What is happening?

The overbuilt level of U.S. corporate debt, hiked by the multiplier of Volcker's high interest rates, is intersecting a corporate sector whose profits, in real terms, are collapsing. Lacking enough funds even to maintain their reduced level of economic activity, and facing increasing debt payments, corporations go out and borrow. For the first nine months of 1981, more than 50 percent of all new corporate loans went to pay new interest on debt accrued.

In the U.S. economy, it has thus come to be the case that debt wags the economy, rather than the other way around, whereby the expansion of industrial growth determines temporary increases in the level of debt. The danger is that at the point that a number of corporations—such as Chrysler, International Harvester, Ford, or Pan Am—reach the point of inability to meet their debt payments, several financial institutions could be blown out and bring down the entire economy. Even in the period leading into the 1929-32 crash, the debt picture of the U.S. non-financial corporate sector was never so extreme as today.

This debt picture deteriorated over the course of the entire post-war period, especially in the 1970s. But it

Figure 1

## Liquidity ratios

(I-IV = billions of current dollars)

(V-VII = liquidity ratios)

Year	I Liquid assets	II Long-term debt	III Short-term debt	IV Total short-term liabilities	V Ratio I/IV	VI Ratio I/III	VII Ratio II/III
1945	\$ 38.7	\$ 35.5	\$ 8.0	\$ 33.1	1.17	4.48	4.44
1950	44.0	56.4	14.5	64.7	0.68	3.03	3.89
1960	51.4	122.1	31.9	109.6	0.47	1.62	3.84
1970	69.5	281.8	88.6	261.8	0.27	0.78	3.25
1971	78.8	318.3	91.2	278.5	0.28	0.86	3.49
1972	88.0	352.6	104.2	313.6	0.28	0.85	3.38
1973	101.0	393.9	127.9	378.6	0.27	0.79	3.08
1974	105.4	441.3	158.5	349.3	0.30	0.66	2.78
1975	125.2	477.2	152.2	347.0	0.36	0.82	3.14
1976	139.0	515.8	163.1	379.0	0.37	0.85	3.16
1977	141.0	566.2	190.0	426.2	0.33	0.74	2.98
1978	151.3	624.5	221.2	507.5	0.30	0.68	2.82
1979	170.2	693.7	264.6	617.3	0.28	0.64	2.62
1980	186.1	761.0	301.1	667.3	0.28	0.62	2.53
1981, 1Q	192.9	773.4	305.0	678.8	0.28	0.63	2.54
1981, 2Q	197.2	786.9	321.4	704.4	0.28	0.61	2.45
1981, 3Q	202.7	799.3	343.2	732.9	0.28	0.59	2.33

Figure 2

**Relationship of corporate debt to internal funds**

(in billions of current dollars)

Year	I Corporate interest debt service	II Gross corporate internal funds	Ratio of I/II
1946	\$ 1.19	\$ 7.83	15.2%
1950	1.73	17.82	9.7
1955	2.75	28.80	9.6
1960	5.28	34.69	15.2
1965	8.64	56.09	15.4
1970	23.36	58.85	39.7
1971	23.75	73.50	32.3
1972	26.91	85.00	31.7
1973	36.72	91.70	40.0
1974	49.66	85.60	58.0
1975	46.72	119.70	39.0
1976	49.44	134.20	36.8
1977	56.09	156.10	35.4
1978	70.62	171.90	41.1
1979	93.10	190.60	48.8
1980	119.49	197.00	60.7
1981, 1Q	139.57	220.00	63.4
1981, 2Q	148.45	226.00	65.5
1981, 3Q	167.75	233.00	69.4

was when Paul Adolph Volcker became Federal Reserve Board chairman in August 1979, that a monetary system already pushed near the limit began exhibiting the signs of utter pathology.

To appreciate fully the viciousness of Volcker's policy, consider this: in the 1940s, the average prime lending rate was 1.60 percent; during the 1950s, it was 3.33 percent. As of November 1981, during the 28 months Volcker has been in office the prime rate averaged 16.6 percent, a thousandfold increase over the decade of the 1940s (despite the heavy wartime demand for credit) and a five-hundredfold increase over the decade of the 1950s.

Of course, Volcker has claimed that his high interest rates were needed to fight inflation. That is a sham. During Volcker's reign, inflation has been at its highest rate since the end of World War II: 11.85 for the period between August 1979 and October 1981. High interest rates, which add an extra charge to the costs of production, have been passed through in the form of higher prices, and often in the form of reduced production as well.

Thus, Volcker's policy is maintaining a floor under the inflation rate, and keeping interest rates high at the same time.

How this intersects the monetary system is indicated by the debt maturity and corporate liquidity ratios shown in Figure 1.

In 1945—even though, as noted, the war had meant tremendous corporate borrowing needs—corporations were still flush with cash. Thus the ratio of their liquid assets (cash and readily liquefiable assets) to short-term debt (mostly bank borrowing) was 4.84. This means that for every \$1.00 in short-term debt, corporations had \$4.84 in cash and liquefiable securities, or nearly \$5 in their corporate treasury for every \$1 owed to the banks. But through the 1950s and 1960s, this ratio declined.

By 1970, corporations had only 78 cents in liquid assets for every dollar of debt, because short-term debt rose spectacularly, while assets built only slowly. This meant that by 1970, corporations could no longer cover all their debts in an emergency.

By the end of the third quarter of 1981, this ratio had fallen to the point that for each dollar of short-term debt, corporations had only 59 cents to cover it. Of course, this is an average for all corporations, large and small; most small and medium-sized corporations have only 20 to 30 cents for each dollar in short-term debt. In the event of a call-in of debt, these corporations will go belly-side up.

If one measures liquid assets against total short-term liabilities, which include commercial paper, finance-company loans to corporations, bankers' acceptances, etc., then the situation is even more dangerous. By the end of the third quarter of 1981, all corporations together only had 28 cents in cash and liquid assets in their treasury for each dollar of short-term liability. Again, the condition of small and medium-sized firms is worse.

At the same time, the maturity of debt has shortened. One of the reasons for this development is that Volcker's high interest rates have kept corporations from going to long-term bond markets, and forced them to loan up on short-term debt. The debt maturity ratio is represented in column VII of Figure 1. From a ratio of 4.44 in 1945—meaning that corporations had \$4.44 in long-term debt for each dollar in short-term debt—the ratio fell to 2.62 by 1980. However, this ratio utterly collapsed during the course of 1981, falling from 2.62 to 2.33, a drop of 11 percent in just nine months.

**From the 1950s to the 1980s**

The difficulty here is twofold. After each succeeding recession in the post-war period, corporations have found it more and more difficult to fund out into long-term debt, thus precluding essential capital formation. Second, the growth of short-term debt relative to long-term debt means that corporations are ever more dependent on credit which is volatile, requires more frequent rollover, and is more expensive. This can be seen in Figure 2.

For most of the 1950s and into the middle of the 1960s, corporate interest payments consumed between

Figure 3

**Relationship of interest to corporate debt, 1978-81**

(in billions of current dollars)

Year	I Corporate credit	II Annual growth in corporate credit	III Annual growth in interest debt service paid	IV Ratio III/II
	(\$)	(\$)	(\$)	(%)
1978	819.2	85.5	14.53	17.0
1979	915.6	96.4	22.47	23.3
1980	1030.2	114.6	26.39	23.0
1981				
1Q	1045.9	15.7	20.8	127.9
2Q	1082.6	36.7	8.9	24.2
3Q	1112.0	29.4	19.3	65.6

10 and 15 percent of the equivalent of gross corporate internal funds (which are essentially profits, adjusted for inventory valuation). By the middle to late part of the 1960s, the ratio rose to between 20 to 45 percent. But starting in 1980, the ratio has gotten higher and higher, to the point that in the third quarter of 1981, interest payments were a shade under 70 percent of gross internal funds.

The amount interest payments are taking out of corporate treasuries directly reflects the growth of corporate indebtedness. Figure 3 compares two amounts: the *increase* or *increment* in corporate total indebtedness from one year to the next, and the *increase* of corporate

interest debt service paid from one year to the next. The ratio between these two amounts can be expressed as the answer to the question, "How much new debt contracted for in one year must go to pay for new interest accrued in that year?" As can be seen, for 1980, this ratio reached 23.0 percent, meaning that 23 cents out of each dollar in new corporate debt was going to pay for new interest costs.

For 1981, the figures have gone wild. During the first quarter of 1981, new interest charges were 127.9 percent of debt, as corporations took \$15.7 billion in new loans but had to pay \$20.8 billion in new interest debt charges. The total amount of new corporate bor-

Figure 4

**Growth in household debt and interest, 1960-1981**

(in billions of current dollars)

Year	I Annual increase in household debt	II Annual increase in interest on debt	III Ratio II/I
	(\$)	(\$)	(%)
1960	15.306	1.842	12.0
1965	25.281	1.538	6.1
1970	19.498	1.964	10.1
1975	45.900	-0.103	-0.2
1976	83.200	6.194	7.4
1977	130.200	12.194	9.4
1978	149.000	20.789	14.0
1979	144.500	28.159	19.5
1980	84.600	21.003	24.8
1981			
1Q	35.700	16.886	47.3
2Q	24.800	5.447	22.0
3Q	24.480	10.986	44.9

rowing in the first quarter of 1981 had to go to pay for new interest charges; on top of that, \$5.1 billion had to be taken out of corporate treasuries to make up the difference in what is owed.

During the second quarter, the ratio fell to a more manageable 24.2 percent ratio; by the third quarter, the ratio was back up to 65.6 percent.

Thus, for the first nine months of 1981, corporations borrowed \$81.8 billion, a very large amount. But of that amount, \$49.3 billion went to pay new interest charges, or a staggering 60 percent of total borrowing. When it is considered that 25 percent of all corporate loans went to pay for corporate mergers, like the DuPont-Conoco deal, and another 15 percent financed inventory build-up, a largely involuntary buildup caused by lack of sales, it can be seen that the amount borrowed for productive purposes, such as expanding plant and equipment, was *negative*. Corporations borrowed heavily and still had to pick their own pockets.

### Household illiquidity

The same problem is also wreaking havoc with the U.S. household balance sheet. As Figure 4 shows, the average household was paying at least 22 percent (and

as high as 47 percent) of its new consumer and mortgage debt this year, just to cover new interest charges. Consumers' purchasing power is not being enhanced; rather, the consumer is relaying much of that new borrowing in payments just to stay out of bankruptcy court.

Figure 5 shows that, even taken against total household income, the interest burden is becoming a serious problem. From less than 1 percent in 1945, and less than 3 percent up until 1960, the total amount of interest debt service outstanding has risen to 8.5 percent of U.S. households' total disposable income.

If we divide the sum of consumer debt and mortgage debt by the population for that year, we get the result:

1971 .....	\$2,541 per person
1976 .....	\$4,008 per person
1981 .....	\$6,914 per person

The real after-tax disposable income of the average non-agricultural worker with three dependents fell by 11 percent since 1979. Households are paying more and more debt, while the income they have to pay it out of is shrinking. The same is true of the corporate sector. This is the magnitude of the U.S. debt crisis.

Figure 5

### Relationship of household debt\* to disposable income, 1945-1981

(I, II and IV in billions of current dollars)

Year	I Sum of household debt	II Disposable income	III Ratio I/II	IV Interest debt Service on I	V Ratio IV/II
	(\$)	(\$)	(%)	(\$)	(%)
1945	20.462	1491.1	13.8	0.974	0.07
1950	56.701	206.6	27.4	2.623	1.3
1955	112.391	275.0	40.9	5.553	2.0
1960	180.408	352.0	51.3	9.893	2.8
1965	285.634	475.8	60.0	16.190	3.4
1970	393.158	695.3	56.5	27.952	4.1
1971	435.400	751.8	57.9	29.172	3.9
1972	491.800	810.3	60.6	33.051	4.1
1973	560.800	914.5	61.3	42.937	4.7
1974	605.500	998.3	60.7	52.088	5.2
1975	651.400	1096.1	59.4	51.985	4.7
1976	734.600	1194.4	61.5	58.129	4.9
1977	864.800	1311.5	65.9	70.373	5.4
1978	1013.800	1462.9	69.3	91.162	6.2
1979	1158.300	1641.7	70.6	119.321	7.3
1980	1242.900	1821.7	68.2	140.324	7.7
1981					
1Q	1278.600	1947.8	65.6	157.210	8.1
2Q	1303.400	1985.6	65.6	162.657	8.2
3Q	1327.400	2041.8	65.0	173.643	8.5

\* Household debt equals the sum of consumer installment credit plus household mortgage debt.