

Domestic Credit by Richard Freeman

Paying Peter to pay Paul

The U.S. government is leading the 'recovery' by means of deficit financing, which can't go on too long.

For the sixth month in a row, the U.S. industrial production index rose in May. With the 1.1 percent increase in that month, it has risen by 7 percent since last November. At the same time, the factory utilization rate rose in May to 72 percent. Though this represents an increase from the low 66 percent of last November, it means that factories are still operating at below three-quarters of capacity.

The U.S. economy's industrial-agricultural infrastructure is still obsolete. Capital goods production, as indicated by pitifully depressed machine tool orders, is still in a state of collapse. But, as the increase in the capacity and production numbers indicates, something is occurring: basically a U.S. government deficit financing-led boomlet in selected categories of (especially) consumer goods, and a limited return to liquidity in the corporate sector.

The means by which this is being achieved is a classic Mutt-and-Jeff routine, run by Treasury Secretary Donald Regan and Federal Reserve Board chairman Paul Volcker. When the poor President gets up and says the U.S. recovery will finance the deficit and close the budget gap, what he doesn't know is that the budget deficit is what is financing the recovery, and causing money supply to billow.

Donald Regan is using the bountiful resources of the U.S. budget to "give away" various types of income, meant to be a boost to various branches of the U.S. economy. Meanwhile,

Paul Volcker is working with the banks to pump tremendous amounts of reserves into the banking system to allow the banks to purchase U.S. Treasury securities in record numbers, and thus finance the deficit that Regan has helped create.

The role of Volcker and the banks can be seen in the reports from the Federal Reserve's own flow of funds statements. In any given year for the last decade, the U.S. banks usually have bought between \$5 and \$20 billion annually of U.S. Treasury securities, in a few years going as high as \$30 billion. But in the fourth quarter of 1982, the banks bought \$62 billion worth, on an annualized basis, and in the first quarter this figure hit a staggering annualized \$93.8 billion. This means the banks were picking up half the \$189.1 billion worth of Treasury issues, annualized, that the U.S. government was offering during the first quarter.

In turn, Volcker was feeding these banks the reserves they were using to buy the Treasury securities. Thus, instead of monetizing the Treasury debt directly, the Fed used the banks as an intermediary.

At the same time, U.S. state and local governments were playing their own financial intermediation game. On an annualized basis, they issued \$52 billion of state and city government bond issues, but turned around and invested the receipts from the bond sales—which, because the municipal bonds are tax-free, are issued at a low-

er interest rate—in higher-yield Treasury issues. In the first quarter, the state and local governments bought \$67.7 billion worth of U.S. Treasuries. Together, state and local governments and the U.S. banks purchased a staggering 85 percent of all Treasury debt in the first quarter.

This explains how the deficit got financed.

The government's ability to dispose of its debt permitted the use of the U.S. budget for the following rather exceptional purposes:

- As a result of the crazy Payment In Kind (PIK) agricultural program, the U.S. government will pay out to farmers an extra \$10 to \$15 billion for PIK above farm price-support program levels.

- The U.S. government continues to give out large amounts of funds for transfer payments for the unemployed and other victims of the industrial depression.

- It should also be noted that largely as a result of the high interest rates and declines in profits, but also because of tax law changes, the amount of net receipts that the U.S. government took in from corporations for the first five months of fiscal year 1983 plunged to \$17.1 billion from a level of \$30.2 billion in the comparable period of fiscal year 1982, a fall of 43.5 percent.

These reduced tax outlays, plus a large volume of corporate bond flotations and a sharp reduction in corporate capital spending, made the corporate sector as a whole slightly more liquid in the first quarter, temporarily helping them stabilize their finances.

Thus depression-level U.S. government deficit financing constitutes a major cause for the so-called upswing, but by its nature, this kind of "recovery" can only have a short lifespan.