

Corporate sector liquidity squeeze

by Richard Freeman

U.S. corporate profits dropped 19.8 percent, adjusted for inflation, during the second quarter, the government reported Aug. 19. This drop is the largest in 25 years. Moreover, the monetary policy imposed by Federal Reserve chairman Volcker in many cases will only exacerbate the causes of decline.

The profit drop, the largest since 1954, occurred as the Federal Reserve's credit squeeze sent sales in basic U.S. industries—auto, steel, rubber, housing—down 25 to 40 percent. James McKeon, co-author of the Salomon Brothers investment bank study, "Restoring Corporate Balance Sheets: An Urgent Challenge," pointed out that "the balance sheets of non-petroleum manufacturing firms are parched."

The ratio indicators

The first indicator is the growing illiquidity of corporations.

In 1979, the liquid asset holdings of nonfinancial business corporations was \$170.8 billion, according to the Federal Reserve Board. According to the same source, in 1979, the short-term market debt of nonfinancial business corporations was \$266.4 billion, while their total short-term liabilities, including short-term market debt as well as trade, tax and other short-term payables, was \$616.8 billion. Thus the narrowest gauge of liquidity, liquid assets to short-term debt, shows a liquidity ratio of 0.64.

The broader and more accurate gauge of liquidity that takes liquid assets to total short-term liabilities is a strikingly low 0.28.

To appreciate these ratios, it is necessary to go back to 1945, when the economy was fairly liquid based on the expansion during the war. Then, the narrow gauge of liquidity had a ratio of 1.17, more than four times the current level.

The broader gauge of liquidity was 4.84, nearly 8

times the current level. As late as the mid-1960s, the liquidity ratios were substantially better. But then, corporations began borrowing short-term to finance the furious merger movement, while adding on mostly paper assets. Since the added-on assets were often in nonproductive ventures, they did not generate much new productive profit and thus add to liquid assets.

However, other key balance-sheet parameters have also been deteriorating. Short-term to long-term debt ratios for the U.S. economy as a whole have declined sharply.

From a high of 4.5 in 1949, the ratio of long-term to short-term credit market debt has fallen steadily, especially from 1962 onwards, to a level of 2.65 in 1979. This means that corporations are more and more committing themselves to the short side of the market, and a greater proportion of corporate funds has to be committed to rolling over short-term debt, at the expense of cash flow for development.

This also exposes corporations to the swings in short-term interest rates, which are more volatile than long-term rates.

Moreover, since the 1970s, and especially because of Fed chairman Volcker's monetary policy, which will produce an inflation rate of at least 10 percent next year, firms will have no opportunity to restore their balance sheet to long-side debt. To do that, they need low interest rates, which will occur only in a non-inflationary environment. This week interest rates blipped upward as Chase Manhattan raised its prime from 11 percent to 11.25. The Federal Reserve refused to intervene when Fed funds reached 9.75 percent, spurring marketwatchers to predict further hikes.

The other key corporate parameter in trouble is the debt-equity ratio.

Corporations are making fewer and fewer new stock issues as a percentage of total liabilities.

In 1979, equity was only 47 percent of liabilities. Since equity consists of new stock issued plus retained earnings, only the growth of retained earnings has kept the debt-equity ratio from going totally out of whack. The advantage of new stock issuance is that it doesn't require the corporation to retire the debt, as with a bond, and thus helps cash flow. The lack of stock issuance has cut back further on the capital spending needed to reverse the industrial collapse.

For example, in 1979 new stock issued was net only \$3.5 billion compared to annual net changes in total (long and short) liabilities of \$180.7, or barely 3 percent.

The sharp collapse of retained earnings in the second quarter of 1980, as registered by the 19.8 percent drop in second quarter profits, means that retained earnings cannot come to the rescue of the debt-equity ratio.

Volcker's policy has above all undermined the corporate sector by *intensifying* inflation. High interest rates have caused the collapse of key industries and massive unemployment. This has required a huge flow of unemployment insurance benefits and other automatic anti-recession expenses of the federal government. These outlays, along with the \$5 billion Social Security increase in July, sent the money supply soaring by \$8.9 billion for the week ending Aug. 6.

Second, Carter killed dams and water projects in 1977 that would have been necessary to counter the effects on farmers of severe drought, compounded by Volcker's restriction of credit.

The combination of these policies caused food prices to jump on a wholesale level by 3.8 percent in July, pushing up the overall producer price index by 1.7 percent.

Credit constriction

On top of inflation's damper on corporate bond possibilities, many corporations such as Chrysler and entire industries such as consumer goods are scheduled by Volcker to get scant funds.

Under these circumstances, not only will borrowing for corporations be hard and/or expensive, but there will be the additional factor that the U.S. government, with its huge deficit, will need to go to market for over \$100 billion (under the most optimistic scenario) between now and the end of 1981. For example, on Aug. 25-27, the Treasury will auction \$650 million in 90- and 180-day bills and \$3 billion in five-year-and-over notes.

The prospect of crowding out industrial firms is real. The retort to this is that insurance companies and pension funds are rich with cash. This overlooks two important developments.

First, half the volume of new publicly offered corporate bonds in May and June was medium term: investors are unwilling to invest long-term in corporate bonds during a period of high inflation, when the yield curve is out of whack (i.e., short-term bonds may fetch more than long-term bonds).

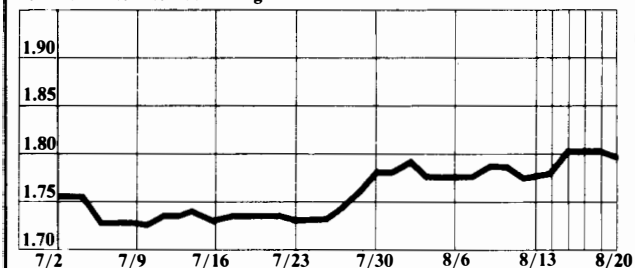
Second, the individual investor, who comprised a healthy segment of the purchasers of corporate long-term bonds, is now going into the glamor money market funds and money market savings certificates. Overall, the market for long-term corporate bonds is not as flush as it looks on the surface.

The solution to this problem of restoring corporate liquidity is not an easy one. But already there appears to be a faction that plans to solve it in the worst way possible. According to one of the most influential economists on Wall Street, "What this means is that balance sheets will be restored through forced liquidation if the adverse economic environment prevails."

Foreign Exchange

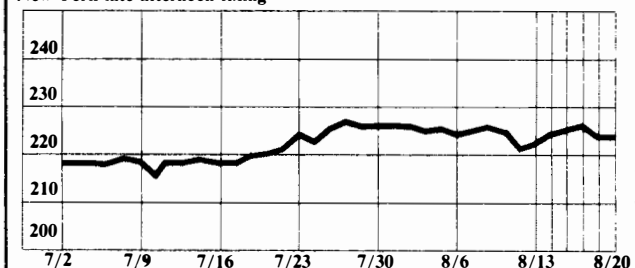
The dollar in deutschemarks

New York late afternoon fixing



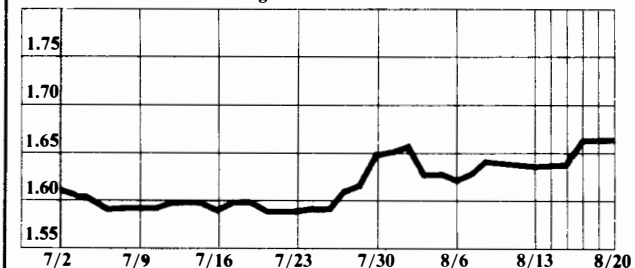
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing

