# Two liquidity crises and two off-track solutions

by Richard Freeman

Corporate illiquidity in the United States, and general illiquidity worldwide, represent a tremendous pent-up demand for funds on the U.S. credit markets. The attempt to satisfy this demand will prevent U.S. interest rates from dipping much below the 12- to 14-percent range in the months ahead, short of a huge blowout of the U.S. economy.

The U.S. and world economies now demand ever-increasing volumes of funds just to keep functioning. The level of built-in indebtedness of the U.S. economy is such that debt service requirements are growing exponentially.

Precisely such a combination of forces was at work in the U.S. economy after the nadir of industrial activity in the second quarter of this year. By the end of 1979, the measure of liquid assets to short-term debt, the narrowest gauge of liquidity, had fallen to 0.28, less than one-fourth the level of U.S. non-financial corporate liquidity in 1945! Moreover, more costly short-term debt is overtaking the corporations' long-term debt. In 1976, long-term debt was 19 times greater than short-term debt. By 1970, the ratio was 12 times greater, and dropping fast. To get back to the 1976 level, a recent peak in an overall downward trend since World War II, long-term debt would have to grow at a $72 billion yearly rate compared with a $36.4 billion annual rate in 1975 and 1976—which were good years. For comparison, this U.S. corporate debt financing level would exceed the current account deficit of the Third World for 1979!

Our Aug. 26, 1980 issue carried a lead economics article entitled, " The Next Phase of Volcker's Austerity." *EIR* wrote that:

> Between now and November, we are headed for an interest-rate disaster. It is not merely that . . . pressure on securities markets will continue to push up rates during the next two months. The *external* side of the American fixed-income securities markets may push matters much further than domestic conditions, as such, would ever warrant.

The same general illiquidity in both the U.S. corporate sector and worldwide that led to this prediction is operative now. In August, *EIR* bucked the conventional wisdom of Wall Street, which almost to a man was saying that interest rates would stay in the July range of 10 to 11 percent and gradually ease lower. We were right and Wall Street was wrong. Now Wall Street is once again predicting a major easing-off of interest rates. This is a wrong conclusion in the short run.

## The international picture

The predicament of Brazil indicates the illiquidity of the world economy. Brazil, which had a long-term financing need of $14 billion for this year, according to best estimates had nailed down only $7 to $9 billion of that total after nine months, leave a huge amount for Brazil to finance in the final three months of this year. The likelihood is that Brazil, with a total of $55 billion in external indebtedness, will not get the full amount it is seeking within the prescribed time frame and will have to tide over its finances as part of an elaborate negotiating game, with short-term bridge loans from big banks, mostly of three-month duration.

The situation for many other Third World countries is similar—or worse. At the International Monetary Fund's recent annual meeting in Washington, D.C., the Fund's managing director, Jacques de Larosière, presented his solution: the advanced industrial nations of the West will have to undergo a five-year depression, supposedly for the general good, in which the West suffers large consumption cuts and disinvestment from basic industries. This will free up a huge volume of capital, which will then find its way onto the Third World accounts.

Such a strategy essentially envisages the looting of the U.S. credit market's internal resources by shifting funds out of domestic into international financing. This already occurred once during late spring and summer of 1980, when Volcker's policies pushed down U.S. internal credit demand, and big U.S. money center banks shifted a net $15 billion into the Euromarkets specifically for such projects as short-term loans to Brazil.

## Domestic illiquidity

As the above-cited figures indicate, the domestic liquidity picture in the U.S. is severely strained. This shows up both in such industries as auto and in the money market funds.

This week, the second largest money market fund catering to institutional investors, the Institutional Liquid Assets, had to be rescued by an operation that involved Salomon Brothers investment bank putting down $700,000 more for stocks it took off ILA's hands than the stocks were worth and by First National Bank of Chicago returning a $1 million fee to ILA to keep it liquid. The ILA had locked itself into long-term securities with low yields, and in the emergency operation Oct. 5 had to restructure its portfolio to higher yields on a brute-force basis.

Contrary to the stolid exterior the auto industry is wearing these days, the steady 30 percent sales and production drop year to date has led to the cooking of corporate books and resorting to financial gimmicks just to stay afloat.

Within this highly explosive context, where interest rates will settle becomes a subsumed predicate of what can be done—if anything—to rescue the U.S. credit system. There are two solutions in the foreground, and neither of them is workable.

## No-win solutions

On the one hand there are those extreme monetarists like Prof. Fritz Machlup, the Vienna-born monetarist who told one of *EIR*'s correspondents at the IMF meeting Oct. 1 that "it's already gone too far. Democracy has forfeited its right to survive. It's either a fascist or communist dictatorship that will take over." Machlup is of the school of thought, now dominant in Britain, that credit-contraction "shock therapy" has to be applied to the U.S. and world economies.

This variety of thought is already partly in practice at the Federal Reserve Board in the person and policies of Fed chairman Paul Volcker, and is heard increasingly in the camp of Republican Party hopeful Ronald Reagan. George Schultz, the chairman of the Reagan camp's Economic Policy Coordinating Committee, publicly supported Volcker's recent tightening of interest rates and has been quoted on the need for the U.S. economy to "bite the bullet."

The basic thrust of the Carter wing of the Democratic Party, in turn, is exemplified by the documents released in late September by the 25-member Senate Democratic Task Force on the Economy, which includes most of the high-powered and influential Democratic senators. The Task Force is chaired by Lloyd Bentsen of Texas. In 11 policy statements on subjects ranging from housing to taxes to trade, this group, which thinks of itself as setting policy for the 1980s, tilted heavily toward the side of monetarism, a remarkable departure for the Democrats. A document written by Sen. William Proxmire for the group on monetary policy calls for "gradual and firm reduction in money and credit expansion," and further advocates that "the Federal Reserve's new policy of controlling bank reserves, should not be abandoned in an effort to modify interest rates in order to influence short-term capital flows to the United States."

Proxmire is pursuing a proposal that his colleague Henry Reuss, chairman of the House Banking Committee, raised this summer: let the Fed supervise both credit allocation and industrial policy for five critical sectors of the economy—auto, steel, electronics, shipbuilding, and banking. The solution sought is to slowly gut these sectors, issuing just enough credit to keep them alive, but holding the private funds out of reach, because otherwise these sectors' demand for funds would be insatiable.

This would give the Fed virtual fingertip control over credit in an attempt to solve the huge illiquidity problems of the U.S. corporate sector. At the same time, however, the Senate Democratic Task Force on the Economy is proposing to prop up the housing market with more credit to keep it from blowing out.

To accommodate the needs of the housing market, superimposed on any attempt to meet the liquidity needs of corporations and international borrowers, will put a very severe strain on the U.S. credit markets. As long as these pressures are not totally suppressed, the forces pushing credit demand and hence interest rates upward will be omnipresent. And if these pressures *are* firmly suppressed, through interest-rate "shock therapy," the illiquidity problem will remain, but there may no longer be a U.S. economy.