

## Domestic Credit by Richard Freeman

### High rates and a cold economy

*Despite the claims of some Wall Street analysts, the economy is not really 'heated up.'*

The announcement that six-month Treasury bill rates had risen to 13.269 percent on Nov. 3 confirmed in most market analysts' minds that interest rates will continue to rise. A week before, the same six-month Treasuries, dated for maturity Nov. 6, 1980, were selling at 12.28 percent. By Nov. 3 their price was marked down  $6\frac{3}{4}$  points from par.

The affirmation of an interest-rate run-up continued when former Treasury Secretary William Simon, now adviser to President-elect Reagan, stated Nov. 3 that "I wouldn't be surprised to see a prime of 15 or 16 percent soon." It is an open secret that Federal Reserve Board chairman Paul Volcker will soon raise the discount rate from its current level of 11 percent to 12 or 13 percent.

But the common interpretation given to the interest-rate increase is misleading. Most market analysts are saying that the economy is "heating up" again, and such indicators as the surge in commercial bank commerce and industry loans to corporations, punctuated by the \$359 million increase for the latest reporting week, are said to be pressing rates upward.

Other evidence for the "heating up" includes the 4.8 percent increase in new factory orders for September, fed by a large increase in military procurements, and the fact that auto sales for the Big Three carmakers dropped by only 7

percent during October.

Yet the economy is not "heating up." On the contrary, corporations are just exercising their need for a 10 to 15 percent credit expansion to cover debt refinancing and the rate of inflation. When the credit for inventory financing is added in, corporations are treading water, making no growth headway.

Moreover, before production levels can be significantly increased, corporations must first dispose of backed-up inventory. During the third quarter, inventories were drawn down by the annualized amount of \$17.9 billion, following an \$11 billion annualized buildup in the second quarter. However, when compared to sales in real terms, inventories are still heavy on the shelves.

The manufacturing inventory-to-sales ratio for the third quarter was estimated to be 1.67 in real terms, compared with 1.71 in the second quarter, and 1.60 in the fourth quarter of last year. Thus, the real ratio stands 4.5 percent higher than in the fourth quarter of 1979.

Not only are there inventories to liquidate, but the U.S. economy faces another obstacle to regaining production levels: sagging export sales (see Foreign Exchange for a trade analysis).

Indeed, far from exhibiting "heating up" or incipient recovery, GNP figures show the U.S. economy to be going nowhere in a hurry.

GNP, because it measures speculative hot-air economic activities along with productive economic activity, has a tendency to shoot up if there is even a hint of economic activity. But as a recent Manufacturer's Hanover newsletter notes, whereas GNP fell by \$36 billion in the second quarter, it only recovered one-tenth that amount, or \$3.5 billion, in the third quarter.

Indeed, if interest rates do head into the 15 or 16 percent range, the wobbly U.S. economy will find itself in no shape to confront such a situation. No economic recovery takes place at such interest rates, nor has one ever occurred. Consumer credit makes up two-fifths of total consumer expenditures, while consumer expenditures account for two-thirds of GNP. Consumer credit will dry up entirely at such interest rates.

On the private manufacturing side, the outlook is equally grim. According to Commerce Department official figures, new plant and equipment expenditures for manufacturing were \$87.25 billion in the third quarter of this year, unchanged since the first-quarter level of \$87.32 billion. When inflation, inventory, and capital adjustment allowances are taken into account, the level of plant and equipment expenditures can be seen to have fallen.

With no head of steam under capital expenditures, it is impossible for corporations to rush to purchase each other's capital goods when they will have to pay 15 to 16 percent bond rates to finance such purchases. A new hike in interest rates will push the economy toward a steeper level of collapse than the second-quarter production drops of this year.