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Domestic Credit by Richard Freeman

The Salomon report

An understated estimate of credit needs—along with a mistaken view of the recession.

In its latest publication, "1981 Prospects for Financial Markets," Salomon Brothers investment bank predicts, "Typically, at the start of economic recoveries, nonfinancial business corporations gain a respite from heavy external financing needs. But if the economy behaves, even a brief respite is unlikely in 1981. *We expect that total external financing requirements will rise from this past year's estimated $106.3 billion to $125.5 billion in the coming year*—an 18.1 percent increase versus the precipitous fall" in external financing requirements during the 1975-76 recovery from the 1974 recession (emphasis in original).

The Salomon Brothers report, written under the supervision of economist Henry Kaufman, emphasizes that this external financing requirement will put a large strain on the financial markets next year.

What is remarkable about the report is that it accurately reflects the pent-up credit demand of nonfinancial corporations, even if, because of the interest-rate escalation, this corporate need for funds is once again denied access to the credit markets.

The Salomon scenario for the economy foresees increased plant and equipment spending producing an economic recovery of sorts in 1981: 1.5 percent real GNP growth. It predicts that the recovery "is most unlikely to deteriorate into a so-called 'double-dip' recession." On an economy-wide basis, Salomon places the requirement for *new* funds at $412 billion in 1981, compared with $311 billion this year.

As I have emphasized in this column, the credit needs of the U.S. economy are built in very deeply. Corporations have been increasingly loading themselves up with short-term debt and wiping out their assets as a result of the credit crunch. To restore their corporate balance sheets would require the most enormous credit infusion the U.S. economy has experienced. For example, the liquidity ratio for corporations, which measures liquid assets to short-term market debt, has been plummeting since 1945. In 1945, liquid assets outweighed short-term market debt 5:1. By 1960, the ratio was 1.5:1, and it stabilized at that level for a while until falling below the 1:1 level in 1969. Today, there are only 75 cents of liquid assets for every dollar in short-term market debt. Ironically, under the current interest-rate situation, the deterioration of assets requires further reliance on outside financing, which includes short-term debt in sizable quantity.

The other key parameter showing the balance sheets of corporations is the ratio of long-term (mostly bonded) market debt to short-term market debt. This level has fallen from a 3.2:1 ratio as late as 1976 to a 2.7:1 ratio in 1980, reflecting the overall inability of corporations to float long-term debt.

What would have to be done to restore the second ratio (i.e., a paydown of short-term debt) is a massive flotation of long-term bonds and a generation of internal sources of funds (liquid assets), which would require every penny of the $125.5 billion level of external financing that Salomon Brothers is projecting for 1981, without allowance for a healthy level of capital spending.

But ironically, Salomon Brothers does not believe that corporations will raise as much long-term debt next year as this year ($40.7 billion). This is Salomon Brothers only concession to reality on how the economy will perform: Salomon predicts that "long-term rates are likely to show on balance an irregular upward direction." In other words, the report expects that Volcker's policy will continue, and high rates will frighten corporate borrowers away from the bond markets.

In fact, Volcker's interest-rate binge will produce next year the "double-dip recession" Salomon Brothers so derides, which *EIR* first predicted in August. At that time we anticipated that the illiquidity in the economy would translate into borrowings in the latter part of the year, swell the money supply, and invite Volcker's attempt to contain demand by crunching the economy. If Volcker crunches the economy fully in the first quarter, *the same credit-demand spiral will take off again next year.*

The answer to this credit demand is not to chop it off as Volcker, Salomon Brothers and others are currently demanding—it can't be chopped off without chopping up the economy. The solution is, in brief, a two-tier credit system, directing low-cost, long-term funds into useful production.

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