The deadly second quarter

High interest rates create loan demand in an unhealthy cycle; big bankruptcies could come very soon.

In the second quarter, there will be no U.S. industrial upturn—in fact, there will be more downturn because of inventory liquidation and depressed demand—and second, interest rates, which have been murdering the economy, will remain high.

In this context, the statement of Commerce Secretary Malcolm Baldrige to a breakfast meeting with reporters April 5 that "My gut instinct tells me there will be one or two" large industrial failures may qualify as the understatement of the year. However, Baldrige's reiteration of the Reagan administration's line that there will be no federal bailout may be the ingredient that turns a couple of major bankruptcies into 20 or 40.

The problem is that unless Fed Chairman Paul Volcker is forced to resign or lower interest rates, by the course of "market events," interest rates will stay up and may even rise.

"The prime rate could go as high as 18 percent in the second quarter," Gert von der Linde, chief economist for the Wall Street firm of Donaldson, Lufkin, Jenrette, reported April 7. "You have a steady level of high corporate borrowing, even though that shouldn't be happening in a recession. Corporations are borrowing," von der Linde confirmed, not for industrial expansion, "but to pay off old interest on old debt and even in many cases to meet current payrolls."

This unwholesome phenomenon, in which high interest rates produce artificial borrowing needs to finance debt, is reflected in the fact that corporate borrowing at banks continued at a 20.5 percent per annum rate over the last three months for the latest reporting week ending March 17, the St. Louis Federal Reserve Bank reported. Corporate issuance of commercial paper—IOUs—is equally high.

Normally, in the second quarter the Treasury Department, because of incoming tax receipts, would actually pay down debt, thus injecting liquidity into the markets. But falling tax receipts and increased expenditures caused by the Volcker depression make it likely that the Treasury will have to borrow in the second quarter, keeping the financial markets tight. It will need to finance a record $50 billion in the third quarter to meet the needs of the fiscal 1982 federal budget deficit.

Money supply will bulge in the middle of April by as much, perhaps, as $8 to $9 billion, because large beginning-of-the-quarter Social Security payments and tax refunds will be mailed out and find their way into M-1. Volcker's reaction will be to tighten.

In this environment, corporations in trouble may be cut off from funds by banks who had previously carried them in the belief that an upturn would make their debt more viable.

"It is very likely that there will be bankruptcies," stated von der Linde; "there may be some that are unexpected."

However, it is the bankruptcy that is most expected which will pose the greatest dangers to the economy: International Harvester, the 25th largest U.S. corporation. "The chances of avoiding a Harvester bankruptcy are pretty slim. It just depends on what the threshold of pain is for the banks," stated Larry Hollis, an analyst with Robert Baird & Company, on April 6.

In its restructuring agreement on $4.2 billion of outstanding debt last December with a consortium of 350 banks, Harvester had agreed that its net worth would not fall below $1 billion. But Harvester announced April 2 that its net worth will fall below that level, and by May the company will technically be in default of its agreement. The banks could choose to roll Harvester over nonetheless. But Harvester lost $300 million in its first financial quarter, and if it continues to operate at 35 percent of capacity—as is most likely—it will have only $300 to $400 million in net worth by December. How many banks will wait that long before they foreclose?

If Harvester is put into bankruptcy court, it will probably be parceled out to various buyers. This would break up its integrated capacity to produce farm, earth-moving, and irrigation equipment vitally needed in the United States and Third World.

And, if Harvester goes, 200 to 250 small banks in the Midwest, which don't have access to the Eurodollar market to tide them over, will either go bankrupt or call in their loans to other companies.