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Debt burden and investment collapse: the fraud of the consumer-led recovery

by David Goldman

During the first quarter of 1982, U.S. business credit expanded at an $80 billion annual rate (commercial paper and bank loans outstanding). This is the highest annual rate ever recorded, and exceeded only once on a quarterly basis, during the third quarter of 1981. Including bond-market issuances, corporate credit rose at a $126 billion annual rate. If trade credits were included, the rate would be considerably higher; the TRW Company credit analysis reports indicate that the volume of overdue receivables—involuntary trade credits—is at its highest recorded rate. However, data on trade credits, available from the Federal Trade Commission survey, will not be available for some weeks yet. What may be concluded, and will be documented in the analysis below, is that the tendency for debt service to siphon funds away from productive activity has intensified during the first two quarters of this year.

The corporate drain

An ironical twist in the credit picture for the first half of 1982 is the so-called consumer recovery, which translates into a modest improvement in the auto industry (from 30 percent below the 1981 average to "only" 17 percent below the 1981 average as of the beginning of June).

The transfer of funds from corporate balance sheets to consumer incomes is mirrored in the picture of corporate dividends. Although corporate profits in the first quarter of 1982 were a full 30 percent below the previous year's levels, corporate dividends dropped only marginally. Corporations maintained dividends by raising the proportion of retained earnings paid out as dividends from the historical levels of 40 to 45 percent to a full 60 percent.

Debt service has risen from only 1 percent of GNP in 1945 to 10 percent of GNP in 1981; a considerable portion of that debt service is paid to individual investors, who benefit in the short run from high interest rates. The growth of money-market funds to over $200 billion in assets, heavily invested in unsecured, high-interest commercial paper, has played a major role, in the context of the "financial deregulation process" of the past two years.

Since the total volume of interest payments in Gross National Product is a net $300 billion, or 10 percent of GNP, the circulation of interest costs is of far greater importance for economic activity than the $30 billion tax cut coming on line July 1, and the net result for the economy has been negative. That has, in fact, been the case for the economic results reported to date. May 1982 industrial production declined by 0.2 percent (according to the Federal Reserve Index, an early but unreliable indicator). A modest improvement in consumer durables was overbalanced by a rapid decline of capital-goods output. That has characterized the economy all year.

It may well be the case that we have already been through the consumer recovery's peak, and face a new series of declines; but even if consumer spending manages to stabilize the Federal Reserve's industrial production index during, say, the July-September period, it is evident that the breakdown of the capital-goods sector will leave the economy in a sharply negative direction by the fourth quarter. Year on year, *EIR*'s estimate of a 7 percent production decline over 1981-82 still holds.

Through the year, capital-goods output (including raw material such as steel) has fallen at a 20 percent annual rate, while consumer durables have risen at more than a 9 percent annual rate; the overall rate of production decline has been 6 percent since last December. In May, business equipment fell 1.6 percent and consumer durables rose 2.3 percent (although consumer non-durables continued to fall), and the overall index fell 0.2 percent. The relatively small drop in the index has aroused the predictable cry of "recovery." But the fact that the bulk of the consumer-durables rise was due to a one month 10 percent increase in auto sales, linked to non-recurring (and immensely costly) auto rebates, does not augur well for the third quarter.

What is evident from the available data on the financial position of non-financial corporations, however, is that the *rapid decline of capital investment has only begun.* Under prevailing circumstances capital investment stands to decline by over $35 billion, or about 15 percent, from 1981 levels. That assumes no destabil-

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ization of the lending markets, no inroads against the current investment tax incentives, no financial panic—all of which are in fact to be expected within the next year. Therefore, while it is theoretically possible that the rising curve of consumer spending could temporarily cross the falling curve of capital spending for two or three months during the third quarter, showing a temporary rise in the industrial production index, no recovery whatsoever is in the works.

The collapse of the capital-goods sector represents not so much a continuation of the falling phase of a business cycle, but a change in America's industrial base, in which major industries will face reduction to roughly half their former output levels. Let us examine the financial mechanism through which this is brought about.

Cash flows and investment

According to the Federal Reserve's numbers for sources and uses of funds during the first quarter, American corporations' internal cash generation (in annualized values) fell from $208 billion in the last year's fourth quarter to only $169 billion in the first quarter. Sixteen billion dollars of the decline was due to a rise in tax payments (lagged versus accruals one quarter), but most was due to a fall in profits from $166 billion to $127 billion.

In all, their cash needs rose by some $60 billion, as capital spending rose to $254 from $247 billion (all annual rates). Corporations met these needs by increasing their rate of borrowing from all sources by $34 billion (from $92 billion to $126 billion), and by liquidating $35 billion worth of inventories.

The rapid runoff of inventories, which reached a record 0.9 percent in May, has been viewed as a factor promoting recovery; more importantly, it has been a means by which corporations raised needed cash flow during the first quarter. It is no coincidence that the big bankruptcy wave started in April after the inventory cycle had run its course.

To achieve the same sales rates, corporations would have to sharply increase expenditures and therefore their rate of borrowing. Although the rate of corporate borrowing has remained high, there is no indication of such a burst; Chase Manhattan recently publicly characterized the present 23 percent annual rate of rise of bank lending and commercial paper writing as "distress borrowing."

Capital-investment plans are relatively slow to respond (reaction time of more than one quarter) to a collapse in corporate income, and the collapse of first-quarter profits will only begin to show up fully in the third and fourth quarters of this year—and perhaps through the beginning of 1983, according to some investment bank analysts. The rate of capital-goods production has already dropped; but the order cancellations that became apparent in the Commerce Department estimate that factory orders fell by 2.3 percent in April, and the National Association of Purchasing Manager's reports that capital-goods orders were the lowest since 1955, indicate much worse to come.

Judging from the first-quarter balance-sheet numbers, non-financial corporations will have to fill a $35 to $40 billion hole in their balance sheets by other means than access to the credit markets. Certainly with the Treasury in the market for $90 billion in the next six months and long-term interest rates on the rise again, the drying up of the corporate bond markets can be taken for granted. This hole will have to be filled somehow, and the only area untouched by corporate managers in the first quarter was capital expenditure.

The 'lease-back' loophole

If Sen. Robert Dole's (R-Kan.) Senate Finance Committee responds to the budget crisis by eliminating, as seems likely, tax-related leasing arrangements which cost the Treasury upwards of $12 billion a year, matters could become much worse. Currently corporations may lease capital equipment from a profitable corporation that buys capital equipment for them, and as nominal owner, takes the value of the tax credit in return for a partial cash payment of the tax credit's value. This reintroduction of tax-farming, outrageous as it is, nonetheless enables troubled industries like the airlines and auto companies to maintain certain capital purchases. Now United Airlines has officially threatened to cancel all its $1.8 billion of orders for new Boeing 767 jets should the lease-back provision be canceled. All in all, Morgan Guaranty Trust estimated this year, some $50 to $60 billion of capital investment, or about a quarter of the total, will involve some form of lease-back tax arrangements. A significant portion would be endangered by a move against this prominent "loophole."

As bad as all this may sound, it is really a numbers game, useful to the extent that it demonstrates that the current trend cannot possibly make both ends meet, but wholly inadequate for picturing the next several months. The three great crises in the financial system, the U.S. federal budget, the American corporate problem, and the developing sector debt situation, will not sit and wait.

No such direction as may now be discerned from the corporate liquidity figures ever follows itself out to logical conclusions. A political crisis intervenes en route, and decides matters, appearing as an "exogenous variable." The basic truth of the present situation is that as long as the Volcker monetary policy remains in force, America will continue to descend into depression.