Behind The U.S. Economic Collapse

The various proposals that have been advanced in recent days by Federal Reserve Chairman G. William Miller, the Joint Economic Committee of Congress, and other City of London allies as measures for combatting inflation and defending the dollar amount to one thing: formulas for collapsing the U.S. economy.

The proposals that are being touted — alternately the "fiscal conservative" solution of cutting money supply growth, or the British-modeled incomes policy approach of the New York Federal Reserve Bank, the JEC, and company — are intended to salvage the U.S. economy's rotten financial structure and put the real economy out of business for good. As the following survey will detail, the key dynamic at work in the U.S. economy is the simultaneous stagnation of all the indices of real economic growth and the unprecedented expansion of debt associated with nonproductive investment. Under these conditions, an indiscriminate clamping down on monetary growth or government controls on wages and prices will simply cripple the productive sectors of the economy.

The U.S. economy is essentially in the same condition as many bankrupt corporations. It has been badly managed and its financial structure is untenable. However, its assets — its productive plant and equipment and its labor force — are fundamentally sound. The job is to salvage these assets and redirect all credit flows to this productive sector and away from speculative investments.

In 1977, the U.S. economy took two directions: stagnation of industrial production, capital spending, real spendable earnings, and other indices of real economic growth; and an explosion of practically all categories of domestic debt.

Total funds raised in the credit markets last year amounted to a record $398.6 billion (Flow of Funds Accounts, Fourth Quarter 1977), compared with $296.5 billion in 1976 — a 34 percent increase — and $219.5 billion in the official recession year of 1975. The increased demand for credit came from households (auto and mortgage loans), nonfinancial corporations, the financial sector (including federal agencies), and state and local governments. The only areas of decline were foreign borrowing, largely as a result of Canada and other customary borrowers seeking more favorable rates in the Eurobond market, and U.S. Treasury borrowing.

This year the most conservative estimates show total government borrowing (by the Treasury and off-budget and federally sponsored agencies) easily approaching $100 billion and possibly running as high as $140-150 billion if projected revenues and other assumptions fall short of the government's optimistic expectations. All projections show credit demand from other sectors at least holding firm at 1977 levels, pushing total for credit easily to $406 billion (estimate of Manufacturers Hanover Trust, see Chart 1). These projections may be left far behind, however. Through mid-March, total short-term borrowing by U.S. business (commercial and industrial loans, finance company loans, and commercial paper) was running well ahead of the level of the last three years. Nationally banks have had to issue more CDs (certificates of deposit) over this period than at any time since 1973 to meet the loan demand.

There is nothing inherently unsound about an increase in credit extensions of this order of magnitude — despite what most fiscal conservatives might think — provided that the new debt created is backed up by expanded hard commodity production. In 1977, however, this was clearly not the case. The record $398.6 billion in new credit flowed into such nonproductive areas as the refinancing of mortgages based on speculatively inflated property values, financing of corporate takeovers, and short-term investments — better characterized as gambling — in currency arbitrage and the like by nonfinancial corporations. The continuing flow of credit into either pure debt refinancing or other speculative investments, while productivity-boosting investment in new plant and equipment and research and development is languishing, is the real source of the elusive "underlying" inflation everyone is talking about.

There is another alarming trend in the economy which became more evident over the course of 1977: since 1975

Chart 1

Funds Raised in U.S. Credit Markets

	1974	1975	1976	1977 (e)	1978 (p)
Nonfinancial Sectors	189.7	205.7	268.2	331.5	354.0
U.S. Treasury	11.8	85.4	69.0	55.0	73.0
State & Local Governments	16.2	11.2	14.6	27.0	23.0
Foreigners	15.4	13.2	20.3	10.5	11.0
Households	49.2	48.6	89.8	133.0	135.0
Business	97.1	47.3	74.5	106.0	112.0
Nonfinancial Corporations	81.8	36.6	58.3	81.0	94.0
Farm	7.9	8.7	11.2	16.0	10.0
Noncorp. Nonfarm	7.4	2.0	5.2	9.0	8.0
Financial Sectors	39.4	14.0	28.6	58.0	52.0
Federal Agencies	23.1	13.5	18.6	26.0	29.0
Commercial Banks	- 1.1	1.7	7.4	14.0	12.5
Finance Companies	4.5	0.5	6.4	12.0	10.0
All Other	8.4	- 1.7	- 3.8	6.0	0.5
Total Funds Raised	229.1	219.7	296.8	389.5	406.0
Memo:					
Gross National Product	1412.0	1528.8	1706.5	1889.0	2083.2
Funds Raised as % of GNP	16.2	14.3	17.4	20.6	19.5

Source: Manufacturers Trust

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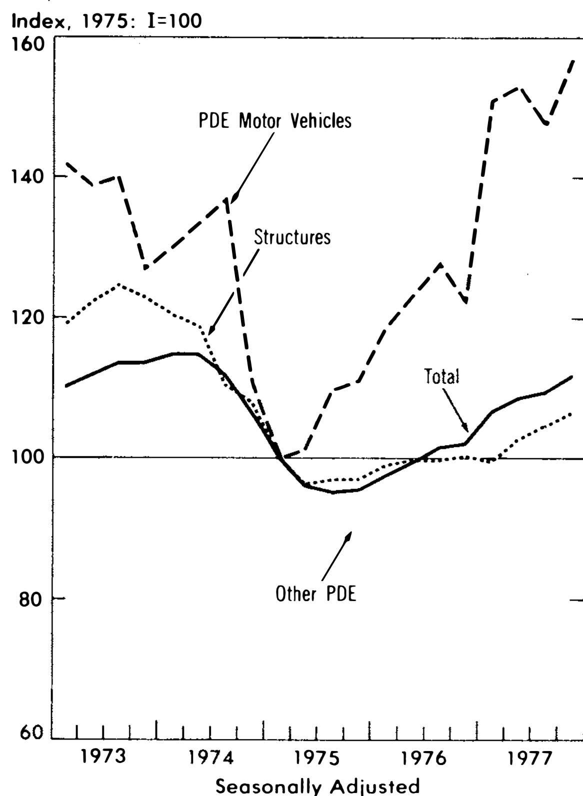
and the start of the "recovery," the level of real corporate profits (profits adjusted for inflation) has improved at the expense of total employee compensation. This trend entered a new phase in 1977 with developments in the steel industry. Analysts are looking for an eventual improvement in the profitability of the industry as a result of the write-off of high-cost, underutilized capacity, and a significant drop in "unit labor costs." Since the summer of 1977, levels of steel production have remained more or less constant despite the fact that thousands — more than 20,000 — of steelworkers were laid off over the same period. This is the kind of "efficiency" that will lead to the irreversable destruction of the U.S. workforce.

The Debt Explosion

Nonfinancial corporations.

The most noteworthy point about the $85 billion raised by nonfinancial corporations last year ($77 billion in debt, $8 billion in equity) is that virtually none of it went into the type of long-term capital investments that guarantee future profitability. The whole $85 billion in new liabilities, heavily weighted to the short-term side, were incurred merely to: 1) make up the shortfall of internally generated funds for replacing disfunctional plant and equipment and replenishing inventories; 2) build up corporate cash funds for "overnight" investments; and 3) finance acquisitions and mergers.

Graph 1
Components of Real Nonresidential Fixed Investment



Source: U.S. Department of Commerce, Bureau of Economic Analysis

With the effects of inflation — specifically the inflated cost of replacing the plant and equipment and inventories that are "used up" in a given business quarter — the internal funds available to nonfinancial corporations from retained earnings and depreciation fell short of fixed investment (plant and equipment, etc.) and inventory financing by $35 billion in 1977, more than double the $15 billion shortfall in 1976. The shortfall is expected to grow in 1978, because of the eroding effects of inflation on internal funds, further increasing corporations' debt-dependence.

Inflation, in turn, is being fueled by the mounting interest costs on this expanding short-term indebtedness of the corporations, the propensity for short-term speculative investments, and the efforts to artificially boost prices through cartelization of industry (see accompanying article). The U.S. economy had entered a dangerous self-feeding inflationary spiral where high rates of inflation are discouraging corporations from making long-term capital investments and impelling them into "high profit" speculative investments, which breed more inflation, further discouraging long-term investments, and so forth. In the process, corporations are forced to become more and more debt-dependent, merely to offset the eroding effects of inflation on internal cash flow.

According to *Business Week's* estimate March 13, the top 400 corporations in the country are sitting on top of some $60 billion in cash — almost triple the amount they had at the beginning of the 1970s — as a result of their bypassing investment in new plant and equipment and research and development. Leading the list of cash-rich companies, IBM had $5.4 billion in cash and short-term securities to play around with at the end of 1977. Exxon was second with $4.2 billion, while Ford and General Motors followed with $3.3 billion and $3.2 billion respectively. Some fairly large corporations are holding as much as 30 percent of their assets in cash.

What are they doing with this money? Corporate treasurers are investing in everything from 90-day Treasury bills which now yield around 6.5 percent to riskier investments such as the CDs issued by the London and Cayman Islands branches of U.S. banks (which yield around 7.5 percent) to 180-day Mexican bank time deposits (11 percent)! As *Business Week* commented, "The growing willingness of companies to shift funds from one country to another in search of the highest return is putting still more strains on an international monetary system that is already under intense pressure — to say nothing of the effect of these operations on the real economy.

Additionally, some corporations are using their large cash reserves to acquire other companies. Why invest in new capacity when somebody else's company is selling below book value?

Corporations with large amounts of cash are, on the other hand, also prime candidates to be taken over. One reason why J. Ray McDermott and United Technologies fought over Babcock and Wilcox last summer was probably B and W's $145 million in cash. Kennecott, with over $1 billion in cash after it was forced to sell Peabody

Coal last year, rushed to purchase Carborundum to dispose of some of the cash that was making it a vulnerable takeover candidate. This game is known as "asset stripping." You acquire a company for its cash, and then liquidate the rest of its assets. Curtiss-Wright, the aerospace company, recently filed a disclosure notice with the Securities and Exchange Commission revealing that it had acquired 9.9 percent of Kennecott's stock and intends to wage a proxy fight against the present management and then sell off some or all of the leading copper producer's assets!

The improvement in corporate liquidity (if one can call it that) is by no means evenly distributed among industries. Between the last quarter of 1974 (the nadir) and the second quarter of 1977, the ratio of cash and government securities to short-term debt seriously deteriorated in the following basic industries: coal and petroleum, iron and steel, nonferrous metals, and mining — precisely those industries which are exerting the greatest inflation push on the rest of the economy — as well as the wholesale trade.

Households

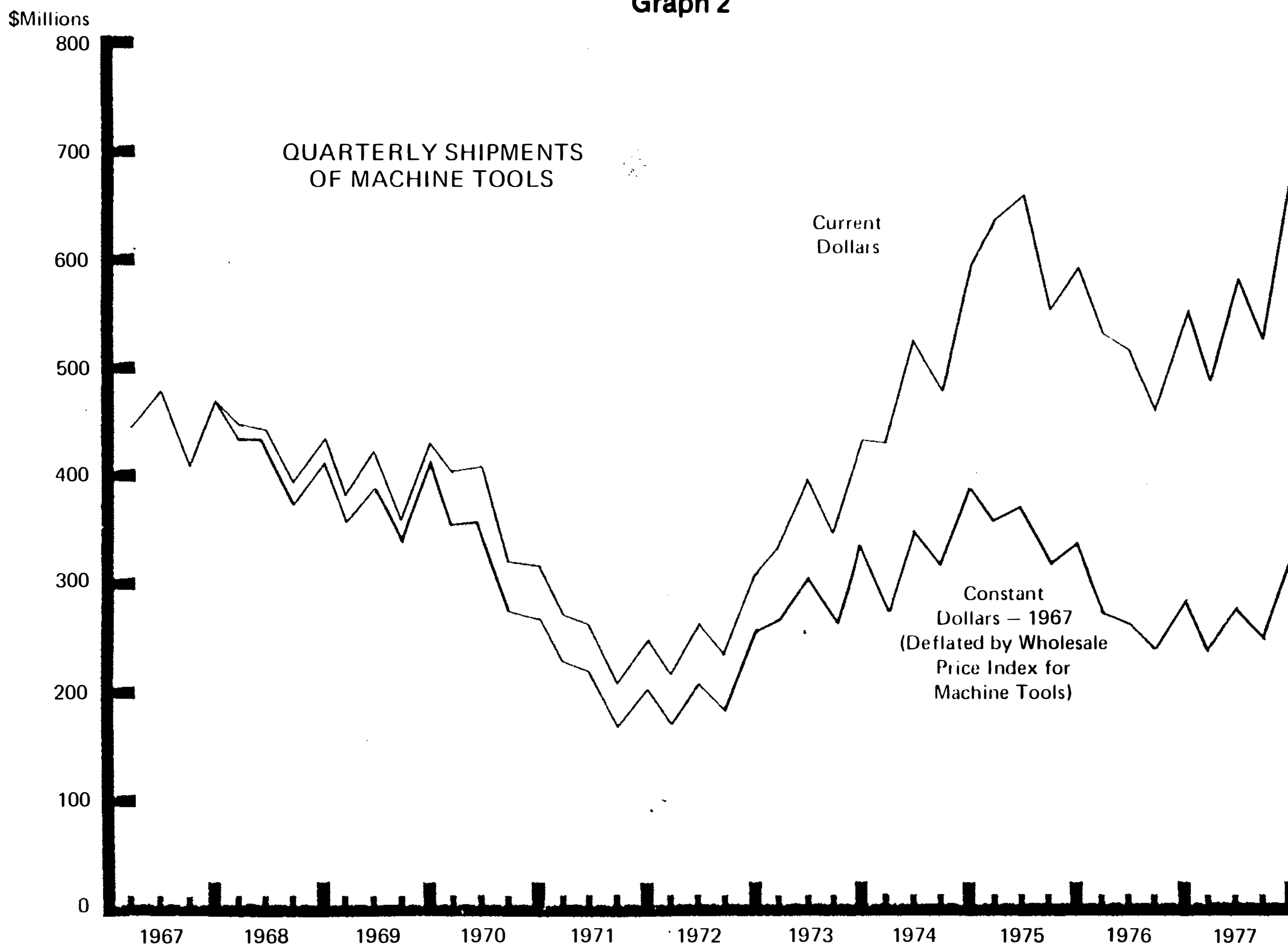
Home mortgage debt increased by close to $100 billion in 1977 ($90 billion in home mortgages, $7 billion in multi-family residence mortgages). Various analysts estimate that roughly half of this expansion reflected second mortgages or the refinancing of existing mortgages on the basis of higher property equities — property values that had been bid up by wild speculation which has pushed the average price of the single-family home above $55,000.

Consumers took out second mortgages or refinanced old mortgages for everything from buying new more expensive homes to making tuition payments. At the end of 1977 total mortgage debt outstanding in the U.S. stood at $1 trillion or almost one-third of total debt outstanding, making it by far the largest category of debt in the whole economy.

The cost of supporting this real estate bubble has spilled over into the government sector, where the entire projected margin of increase in borrowing in 1978 is attributable to three government sponsored agencies which support the housing market: the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan banks, and the Federal Home Loan Mortgage Corporation. With those agencies accounting for the total increase, borrowing by government-sponsored agencies is expected to surge to $17.2 billion in 1978, from $7.0 billion in 1977.

In the case of Fannie Mae and the FHLMC, the increase follows the expected jumps in mortgage purchases, and in the case of the Federal home loan banks, it is due to the expected sharp decreases in repayment of

Graph 2



Source: National Machine Tool Builders' Association

past advances by savings banks and the FHLMC — both trends are a function of disintermediation.

Other types of consumer borrowing increased by $35.6 billion in 1977, from $23.6 billion in 1976 and $9.4 billion in 1975. With the ratio of installment debt to income heading toward the historic high, most analysts expect the increase in consumer debt to moderate over the next year — pulling the plug on the "consumer-based recovery."

The Real Economy

As the accompanying charts and graphs illustrate, the real economy has been stagnating under the enormous growth of debt. The two key measures of the future profitability of the economy, the condition of the labor force and the economy's plant and equipment, continued to deteriorate over last year. Bureau of Labor Statistics figures show that the spendable average weekly earnings (wages after Social Security and Federal taxes) of a married worker with three dependents stood at a mere $92.30 in 1967 dollars in January 1978. Average weekly earnings in constant dollars were below their 1972-73 prerecession level.

The latest survey of expected plant and equipment expenditures by the Commerce Department in November-December 1977 showed that businesses planned to increase their expenditures by 10.1 percent in 1978. Respondents also estimated that they expected the prices of capital goods purchased by them to rise 8 percent, leaving only a 2 percent margin of real increase. The 6 percent real increase in 1977 was preponderantly spent on motor vehicles used by businesses and replacement of worn out equipment; new real investment in plants was negative.

The Solutions

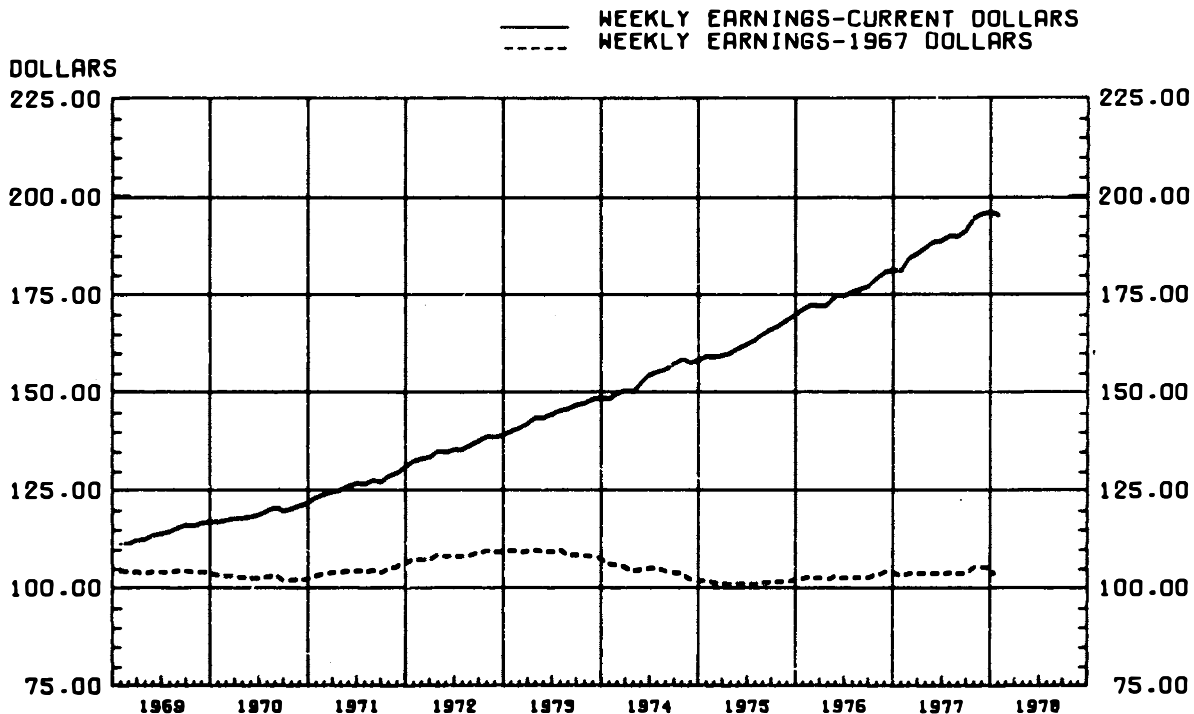
The solutions that are being advanced to deal with the so-called "underlying" rate of inflation which is eating away at real profits and undermining capital investment — alternately the income policy approach of the Anglophilic *New York Times*, Federal Reserve Bank of New York, and others, or the "cut the money supply growth" credo of the "conservatives" at the *Wall Street Journal* and other haunts of the followers of Milton Friedman — will actually aggravate the tendency for inflation by further crippling the productive sector.

In spite of the *Wall Street Journal* editors' thoughts to the contrary, the only way to reverse the tendency for inflation and get capital formation going is through the dirigist intervention of the Federal government. The government has to create the right environment, through opening up export markets via the Export-Import Bank and ensuring favorable credit terms and tax treatment for high-technology production, to redirect private credit flows away from speculative investments and debt rollovers into expanded production and research and development.

The Federal Reserve system has the power to create a "two-tier" credit system which would make a supply of

GRAPH 3

PRIVATE NONFARM AVERAGE EARNINGS
SEASONALLY ADJUSTED



SOURCE: BUREAU OF LABOR STATISTICS

low-interest credit available to business for productive investment and dry out speculative markets, such as the secondary real estate market, with prohibitively high rates. A credit policy of this type would have to be implemented in conjunction with measures redirecting the activities of "Fannie Mae" and the other housing-related agencies toward providing funds for new housing only, as well as measures to protect savings banks from any repercussions in the markets and keep them supplied with funds for issuing mortages for new construction.

Secondly, the Executive and legislative branches of government must immediately open up expanded export markets for U.S. producers through the expansion of the Export-Import Bank. They must also support a freeze on outstanding indebtedness of Third World countries, which are the potential markets for U.S. capital goods and technology. An export policy is not merely an adjunct to U.S. economic policy.

The lack of the appropriate export-orientation has been a prime cause of the recurrent recessions of the postwar U.S. economic history. The economy has gone through a succession of "recoveries" based on consumer credit expansion or military production, followed by recessions. The key to the unimpeded expansion of the U.S. economy is making export policy the very centerpiece of U.S. economic policy.

—*Lydia Dittler*

– Chart 2

Real Spending on Plant and Equipment

	current $	1972 $
1972	$ 88.44 bil.	88.44
1973	99.74	96.05
1974	112.40	97.45
1975	112.78	85.26
1976	120.49	86.87
1977	137.02	93.86
1978	150.90 est.	

Source: Department of Commerce

A Case Study: Industrial Materials' Inflation

A major source of the inflationary pressures in the U.S. economy are various schemes for cartelizing and rationalizing world production and trade. The general belief, fostered by the press and most economists, that inflation is the result of some mysterious underlying pressures, or bad weather, or any number of other generally accepted excuses, serves merely to divert attention from the actual causes.

In the most recent monthly survey conducted by the National Association of Purchasing Managers, the majority of purchasing managers interviewed stated that the prices they paid for raw materials rose in February for the third consecutive month. Materials most often mentioned included steel, sugar, aluminum, paper, and chemicals.

Look at Steel

The increases in steel and sugar prices are no mystery, but the direct result of policies initiated by the "British" faction within the Carter Administration. The steel price increases, which are expected to total 11.6 percent over the course of the year, are the result of the Solomon Plan, named after Blumenthal's Undersecretary of the Treasury, Anthony Solomon. This plan is in the early stages of implementation, and combines the rationalization already taking place in the U.S. steel industry with protectionist measures in the form of reference (or floor) prices on a wide range of steel imports. Under the plan, any steel brought into this country below the reference price is subject to an immediate Treasury investigation for dumping.

By forcing up the price of imports and reducing capacity, U.S. steel producers have already been able to raise prices on the average of 5.5 percent with another increase expected later in the year. During 1977 Bethlehem Steel, the nation's second largest steel producer, closed down its Lackawanna, N.Y. plant and greatly curtailed production at its Johnstown, Pa. facilities. And Lykes Corporation, which owns Youngstown Sheet and Tube announced the closing of Youngstown's Campbell Works, while the Allan Wood Steel Company was forced into bankruptcy by its creditors. Additional closings of "marginal" facilities are expected this year.

The Solomon Plan and its European counterpart, the Davignon Plan, are paving the way for the rationalization of the world steel industry.

In the mode of what the Solomon Plan has done to steel, the recently enacted International Sugar Agreement has already artificially raised sugar prices, through increased tariffs and quotas. Prices are also up in the aluminum industry as a result of a shortage of production capacity brought about by the industry's failure to expand over recent years.

The Impact

The inflationary impact of these price increases is already being felt throughout the economy. In January the consumer price index rose 0.8 percent, double the rate of the previous two months. In February food prices rose 3 percent, largely due to the increase in the cost of sugar. Also in February, the wholesale prices of finished goods, a key indicator, surged ahead 1.1. percent, its biggest jump in over three years.

This 1.1 percent increase, equal to a 13.2 percent annual rate, represents the cost of goods at the final stage of manufacture, and therefore strongly reflects the rise of raw material costs. It is also an important indicator of what direction the consumer price index will move several months down the road, when the finished goods