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Domestic Credit by Richard Freeman

Illiquidity out of control

Paul Volcker has created a nightmare of mounting interest payments for corporations.

Most key indicators of corporate liquidity and debt maturity plummeted at a catastrophic rate during the first three quarters of 1981, a preliminary *EIR* survey on this subject has found.

Most key ratios of corporate liquidity had badly deteriorated over the last two decades. In 1981, the ratios suddenly went altogether haywire, because high interest rates are forcing contractions in production, and also leaving corporations with no protective cushion in the event of a call-in of bank lending. Quite literally, U.S. non-financial corporations have become addicted to short-term debt financing, which carries with it interest rates above 15 percent. The U.S. economy is now completely non-resilient, and Paul Volcker is promising to keep credit tight even as the U.S. economy enters into recession. Such pressure is enough to snap the daisy-chain of corporate financing and unleash bankruptcies on the scale of the 1930s.

The measure of dependency on short-term debt is evidenced by the fact that during the first three quarters of 1981, U.S. non-financial corporations added $65.5 billion of short-term debt obligations—short-term bank loans, commercial paper borrowing, banker's acceptances, finance-company loans etc. This debt expansion shows up in the debt-maturity ratio that measures long-term debt divided by short-term liabilities. In 1945, this ratio was 4.44, meaning that for every dollar of short-term debt, a corporation had $4.44 in long-term debt. Since long-term debt carries lower interest rates, and has to be rolled over less often, it is far less draining and destabilizing for corporate treasuries. By 1980, this ratio had fallen to 2.62. It plummetted to 2.54 during the first quarter of 1981; 2.45 during the second quarter; and 2.33 during the third qurater; a decline of 11 percent in the ratio in nine months. Corporations are desperate to fund out long, that is, transform some of their short-term debt into long-term bonds, but possibilities are very limited overall.

Next, there is the ratio of liquid assets to short-term indebtedness, known as the liquidity ratio. This ratio indicates how long a company can run on internal sources of funds if need be, particularly in the event that some or all of its debt is called in. The broadest and most accurate liquidity ratio is liquid assets (cash and securities, usually Treasury bills, that can readily be turned into cash) in relation to short-term liabilities, which include not only short-term corporate borrowings from a bank, but also commercial paper issued by corporations, bankers' acceptances, finance-company loans to corporations, and so forth. In 1945, the ratio was 4.84, meaning that in the event of emergency, for every $1 of short-term liability, a corporation had $4.84 in liquid assets in its treasury to cover the liability—a very secure position indeed.

The deterioration in this ratio has been steady, accelerating downward during the 1970s. In 1977, the ratio was 0.74, meaning that for every $1 in short-term liabilities, corporations only had 74 cents in corporate liquid assets. By 1980, this ratio was 0.62; and it fell to 0.59 by the third quarter of 1981.

The tremendous cost of debt service is the force undermining these ratios. In 1960, all U.S. non-financial corporations paid a total of $5.28 billion in interest charges on debt. In 1970, that figure was up to $23.36 billion. By 1978, the interest charge on debt service was $70.6 billion.

Then it started to zoom up at a geometric rate. In 1979, it was $93.1 billion. In 1980, it reached $119.5 billion. By the end of the third quarter of 1981, it stood at $167.7 billion, after a stunning increase of $48.2 billion in just nine months.

To appreciate the magnitude of the increase, compare the increase in interest payments between the end of 1980 and the first three quarters of 1981, that is $48.2 billion, with the increase in total corporate credit extensions of all types between the end of 1980 and the first three quarters of 1981, that is, $81.8 billion. Fifty-nine percent of all new credit extended for the first three quarters of 1981 went just to finance the increase in new interest payments. This ratio compares with 58.5 percent in 1980, and only 35.4 percent in 1977. Corporations are being looted just to pay new interest on debt, or in other words, Paul Volcker's tithes.

Now, given that corporations are loaded up with all these new interest obligations on debt, what happens if Paul Volcker and banks call in credit during a recession?

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