The traps ahead for the U.S. credit markets

by Richard Freeman

"The biggest part of the recession has yet to come. And it will come, because half the corporate balance sheets are so illiquid that the corporations don't deserve to survive. The amount of money that must be borrowed to pay interest on debt service is crazy. There will be a period of pay-down by corporations; either it will come quickly or slowly, but there will be the biggest number of bankruptcies in the first few years of this decade that have been seen in a long, long while. I think that this crisis will break in the spring of this year."

This assessment was made to *EIR* on Feb. 24 by Peter Canelo, chief money market economist for Merrill, Lynch. It points to the time-bomb embedded in the world financial system: a U.S. economy and banking system approaching a spring credit market blow-out. Every parameter of the financial system is sending up distress signals: the rate of corporate and financial bankruptcies for the week ending Feb. 12 was the highest in 40 years; the loan/credit ratio, which is a measure of health for banks, is at its lowest level since October 1929, and the percentage of interest debt service paid by corporations, measured either as a percentage of operating capital or of total new corporate borrowings, is at an all-time high.

Shrinkage of production

The equity and real income base of the U.S. economy is contracting, while more and more debt is being levied against the income base. One standard practice of the Federal Savings and Loan Insurance Corporation (FSLIC) reveals the danger. Last year, the 3,800 S&Ls and 400 mutual savings banks suffered a withdrawal of funds in excess of deposits totalling a staggering $39 billion, and a profit loss of $6 billion. According to industry figures, the thrift industry lost 15 percent of its net worth in one year.

As Kathy Burdman shows in this issue, the policy of the Reagan administration and FSLIC is to let most of the S&Ls bleed to death, and to merge the most troubled into larger, healthier ones. This avoids the formal declaration of bankruptcy, but only by spreading bank equity more and more thinly against a greater volume of debt. The equity of the relatively sound savings and loan institution is now called upon to support its own debt and also the debt of the equityless S&L it is merging with.

Bankruptcy rate

The most stunning tip-off to the state of the economy is the increase in the bankruptcy rate. According to the latest figures released by Dun and Bradstreet, commercial and industrial failures stood at 374 for the week ending Jan. 28; jumped to 449 for the week ending Feb. 4, and then rocketed to 529 for the week ending Feb. 11: the largest single weekly level of failures in 40 years.

The increase of bankruptcies since Volcker began his credit shut-off upon taking over the Fed chairmanship in August 1979 is mind-boggling. In 1979, 7,564 companies went bankrupt. In 1981, 17,043 industrial and financial firms went belly-up, the highest level since 1933. For the first 6 weeks of 1982 there have been 2,560 failures, or an average of 427 per week, versus a total of 1,801, or an average of 321 per week for the comparable period last year.

The bankruptcies map directly onto the decreasing level of profitability and liquidity even for the largest U.S. corporations. Seasonally-adjusted after-tax profits of U.S. corporations, adjusted for inflation (in 1976 constant dollars), plunged from a level of $140 billion at the start of the first quarter of 1980 to $96.4 billion at the end of the fourth quarter of 1981, a fall of 31 percent.

When the factory capacity utilization operating rate was announced for January to be 70.4 percent—just a shade over the March 1975 all-time low, and down almost three percent from the December 1981 level—it became evident that sales and therefore profits will continue to deteriorate.

Sapping the strength from the industrial sector is the sky-high level of interest rates. According to Merrill, Lynch's Canelo, "Corporations are borrowing money to pay interest on what they borrowed. They have minimal working captal. For example, look at corporate net operating margins. This treats interest payments as a percentage of essentially the corporation's fund for interest rates plus retained earnings and a few assets [that is, interest payments as a percentage of aftertax profits—R.F.]. In 1979, this ratio was 25-to-30 percent. At the end of the fourth quarter of 1981, this ratio was up to 45 percent. That's unbearable."

An economist at Chase Manhattan Bank reported Feb. 23 that, "according to our calculations, 66 cents of every dollar of corporate working capital is going into paying interest debt service."

Commercial bank insolvency

The commercial banking system is showing the strain as corporations are unable to keep up with their debt service shedules. While attention has been focused on the S&Ls as the weak sisters of the financial system, Continental Illinois National Bank and Trust of Chicago, America's sixth largest commercial bank, announced Feb. 15 that its non-performing loans had risen sharply.

Conti Illinois reported that these loans—loans that are proving to be uncollectible, usually because the borrower can't pay interest payments—jumped from $453 million to $653 million between the third and fourth quarter of 1981, a staggering increase of 44 percent. This represented 1.9 percent of Continental Illinois's total loans outstanding. This is still less than the 5.8 percent that the bank reached during the height of the 1973-75 recession, but with such loan customers as the troubled International Harvester, the near-bankrupt $1 billion-plus American Invsco real estate trust, the ailing AM International, and Poland, and a downward-turning economy, Conti Illinois can expect the number of its "non-performers" to increase.

Keefe, Bruyette, the leading bank stock analyst firm on Wall Street, reports that non-performing loans for all money center banks nationwide has risen from 1.5 percent of total loans in the fourth quarter of 1980 to 2.0 percent in the fourth quarter of 1981. According to Robert Planner, an analyst at the firm, "we can expect that the ratio will get worse if interest rates stay high."

"There's no way of knowing how bad the situation of non-performing loans may be with the banks, because the figures are usually calculated and scribbled onto the back of an envelope," reported a Lazard Frerès banker Feb. 24.

Certain parameters are already known. Reports Merrill, Lynch's Canelo: "Banks are refinancing individuals and corporations at a ridiculous rate just to prevent the worst from happening. For the last three months, bank loans to businesses grew by 20 percent." In fact, for the last 6 weeks the rate has grown at 36 percent per annum."

Spring credit crisis

Thus the time is more than ripe for a major financial dislocation by early spring. Many of the financial forces connected to the Venetian and British oligarchy are actively organizing for such a crash. They want the U.S. economy to blow up in the face of Ronald Reagan, and so destroy his ability to govern. A Swiss banking official, close to the Basel, Switzerland-based Bank for International Settlements told *EIR* two weeks ago, "If Volcker keeps interest rates high for six to twelve more weeks, there will be a major credit market crisis in the U.S."

The likelihood of such a development increases while the prime lending rate stays in the stratosphere. At this point, U.S. money supply, reflecting the tremendous growth of corporate borrowing for survival—as well as the increase of individuals putting money in NOW accounts which are counted as M-1 to save something in case the economy goes into a free-fall depression—is growing at an 11.7 percent rate for the last 13 weeks. The $1.2 billion increase in money supply for the latest reporting week, ending Feb. 17, shows that the spectacular $11 billion increase in the money supply a month ago won't wash out. And since the Fed, under Volcker's monetarist direction, has made control of money supply the leading focus of Federal Reserve policy, the swell of money supply will be met by a new ratchet of credit tightening and thus higher interest rates.

The United States, in the midst of an industrial collapse reaching a 20 percent per annum rate during the last six months, simultaneously finds itself in the pathological condition of increasing borrowing and therefore increasing money supply and raising interest rates. Thus, the U.S. financial system is like a dog chasing its own tail until it dies of exhaustion.