

Domestic Credit by Richard Freeman

Fear of the unknown

Chase Manhattan's acknowledgement of the 'end of distress borrowing' means bankruptcies have only started.

For the first time a major bank, Chase Manhattan, has put the bankruptcy wave in perspective, a noteworthy event because banks' willingness to carry along struggling borrowers is at the moment the principal near-term determinant of how the financial crisis will proceed.

In its May 24 *International Finance* newsletter, Chase entitled a commentary, "Distress Borrowing Cannot Last." The relevant portions read:

"The surge in short-term corporate borrowing so far this year has exceeded most observers' expectations [although not ours—R.F.]. The levels of commercial and industrial bank loans and non-financial commercial paper outstanding have grown at an annual rate of nearly 23 percent since January. By normal standards this growth is unusual, given the weakness in the economy, the sizeable inventory liquidations that have occurred, and the depressed state of corporate investment spending plans. . . .

"Debt-to-total-asset ratios on a book value basis have risen from an average of less than one-third in the early 1970s to over one-half today . . . firms have been reluctant [and unable—R.F.] to commit themselves to long-term debt obligations at existing high interest rates . . . requir[ing] them to refinance periodically at historically high interest rates, swelling the magnitude of their interest payments.

"As profits and cash flow have deteriorated because of sagging consumer spending, these firms have found themselves in financial distress, needing to borrow an increasingly greater amount to finance their heavy interest commitments in order to avoid bankruptcy. . . . If economic activity does not rebound, more over-leveraged firms will go bankrupt."

Only the fact that this is stated by a major lender, not the content as such, makes it news. It confirms, after the Braniff failure and the media preparations for an International Harvester failure in August, that banks are gritting their teeth and preparing to take major losses. This slight policy shift is occasioned by the fact that some major debtors, like International Harvester, operating at less than 30 percent of capacity and losing money at a \$1 billion annual rate, simply cannot be sustained by bending the normal rules of banking.

The policy shift is also evident in the spectacular increase in the rate of corporate bankruptcies, already 80 per 10,000 corporations, "within shot of" the 100 per 10,000 record set in 1933, as the *Wall Street Journal* put it.

But what bankers fear is not the handful of airlines or floundering behemoths like Harvester or Chrysler that have made the headlines, but rather the unknown: in a corporate environment in which two-thirds of the cash flow of the *aver-*

age corporation is consumed by debt service, and corporate repayment capabilities continue to sink with the depression, the number of potential Chryslers is in the high hundreds. This was not the case during the 1930s, when large numbers of smaller banks folded, but virtually all the "name" corporations made it through unscathed.

Corporations are sustained not only by banks, but by the highly volatile market for unsecured commercial paper, whose holders stand to gain nothing (unlike the bankers) in the course of a bankruptcy, and by suppliers' credits. Commercial paper has been funded, to a great extent, by the burgeoning growth of the money-market funds. A significant shift of "preference" towards Treasury securities on the part of the money-market funds, who may fear withdrawal by safety-conscious investors of their own unsecured funds, could tip the entire apple cart.

As the depression deepens, banks themselves will find that the attrition of their capital compels them to shut off loans at an accelerating pace, pushing more debtors under, and further attriting their capital. This point has been made with a vengeance by British commentators in the public press, although treated somewhat gingerly on this side of the Atlantic.

Combined with another market incident like the May 19 Drysdale failure (see Banking), which could occur on virtually any of the financial or commodity markets with equal ease, or a significant default of a Third World borrower, the above weaknesses could surface within hours. The economy is marching towards a fall crisis which no central bank can control.