No recovery is in sight for the U.S. economy

by David Goldman, Economics Editor

May's U.S. industrial production decline of 0.2 percent confirmed a trend noted previously in *EIR*, i.e., a modest improvement in consumer durables overbalanced by a rapid decline of capital-goods output. Since a "recovery" of consumer-goods production, for example the 10 percent improvement in auto output during May, has been under way since January, but has been insufficient to compensate for the collapse of business equipment production, the question is: Why should anyone try to look for a consumer-led recovery?

The outlook

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 has fallen (including raw materials such as steel) 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 month-to-month 10 percent increase in auto production, linked to non-recurring (and immensely costly) auto rebates, does not augur well for June or July.

What is evident from the available data on 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 destabilization of the lending markets, no inroads against the current investment tax incentives, no financial panic—all of which are 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.

As *EIR* will demonstrate through the case history of steel in next week's issue, 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.

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 last year's fourth quarter to only $169 billion in the first quarter.

$16 billion 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 apparently stopped in April's 0.2 percent rise in inventories, 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 borrowing has remained high from corporate users, there is no indication of such a burst; as *EIR* reported, 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 Managers' report 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 market 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.

If Sen. Robert Dole's 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 enabled 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 cancelled. 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."

An additional factor is the rise in interest rates, already evident in the rise in the federal funds rate from less than 14 percent to 15 and one-half percent between June 9 and June 16. The Bank for International Settlements' staff warned the press June 16 that it expected a general rise in interest rates through the second half of the year. Bank of America Chief Economist John Wilson expects a 16 percent certificate of deposit rate (which implies an 18 percent prime) by September. Wilson may exaggerate slightly, but only because any upward move in the prime rate would undermine the small improvement already registered in the consumer-durables sector.

'Exogenous variables'

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 United States federal budget, the American corporate problem, and the LDC debt situation, will not sit and wait. In the high councils of the Reagan administration, such as they are, this has become the general expectation. One close advisor to the President, who was a cabinet member in the Ford administration, comments, "I hate to say it, but I can detect no sign of progress on the budgetary front. The Versailles conference [which recommended budgetary austerity—D.G.] is all well and good, but I've sat in on these meetings; they're a bunch of international economists, and what they say won't do you much good in the House Ways and Means Committee. Congress needs a shock, on the order of the Ford Motor Company going bankrupt—of course I am not saying that Ford will go bankrupt tomorrow, but something of this nature."

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.