

Economic downturn bears out EIR's year-end warning

by David Goldman

Adolf Hitler reacted to his 1943 disaster at Stalingrad by promoting the German commander to field marshal, and the U.S. Department of Commerce celebrated the third-quarter decline of U.S. output with a "flash estimate" that Gross National Product had risen at a 3.2% annual rate during that period. Although the supposed "economic recovery" has depended heavily on statistical fraud to begin with, two months' consecutive decline in the Federal Reserve's industrial production index puts the "flash estimate" in a class by itself.

A Reuter wire of April 17 announced laconically: "The dollar continues its slide today as a larger than expected increase in the Gross National Product failed to shake the market's skepticism over U.S. economic strength, dealers said. 'No one believed the GNP numbers,' said one dealer."

The United States economy began a new, "bouncing-ball" descent during the first quarter, precisely as *EIR's Quarterly Economic Report* warned at year-end.

Three developments are pushing physical output downwards:

- 1) a sharp contraction of credit issuance to the non-financial corporate sector;
- 2) the crash in commodity prices, led by oil; and
- 3) the decline of the U.S. dollar on foreign markets.

As we warned, these changes mark a reversal of the perverse twist in financial affairs which permitted the United States to import one-sixth of its total physical consumption bill, and mask the unabated disintegration of our agro-industrial base.

The falling dollar raises the current and anticipated costs of production components obtained from overseas sources. Meanwhile, the commercial banks are taking pre-emptive action to limit their exposure in the face of a catastrophe now building in the oil-producing states. On top of this, the collapse of oil and other commodity prices disrupts precisely

those industrial sectors which gained prominence after 1979, when oil prices and interest rates both doubled.

In consequence, the Federal Reserve index for U.S. industrial production fell by 0.5% in March, following a 0.7% decline in February, the Fed reported April 17. Continuing declines in oil production, which have brought the mining index down 6% since March 1985, contributed to the drop, along with declining auto production, and consequently reduced steel and related durable-goods production. That is not to endorse the Fed index, which *EIR* has repeatedly exposed as a forgery conforming to the Fed's policy whims. What the decline shows is, simply, that the Fed can no longer cover up the accelerating rate of decline of output.

General Motors had already announced an additional 4,600 layoffs at the beginning of April, the largest number since the 1982 "bouncing-ball" decline. Contrary to popular impressions, the decline of the dollar does not help the U.S. auto industry; its main foreign competitor, Japan, adopted export quotas three years ago, placing an absolute limit on the size of foreign competition. On the contrary, "foreign sourcing" of auto components accounts for about 25% of the value of American-made automobiles. The 30% decline of the dollar since September 1985 represents a 7.5% increase of automakers' production costs.

For all practical purposes, the rise in production costs due to the collapsing dollar places an immediate clamp on production. The auto industry has managed to maintain sales only with the help of expensive subsidies for car purchasers' borrowing costs, which cost the industry between 3 and 4% of the average price of each new car sold. Even with the subsidies, General Motors and Chrysler have built up an 80-day inventory of automobiles, against the industry's 60-day norm. An increase in the cost of each car in the range of several percent is sufficient to make these marketing

techniques prohibitively expensive, and force a cutback of production.

What applies to the automotive industry is true for a broad range of manufacturing, including electronics, household appliances, and heavy machinery. America cannot subsist with only 17% of its civilian workforce employed in goods-producing industries; the remainder of our requirement for physical goods has been provided by other countries, through the trade deficit. Long before consumers notice the increase in the price, for example, of Japanese automobiles and microwave ovens, industrial purchasers of foreign materials and components will have to reduce production.

Federal Reserve chairman Volcker's efforts to the contrary, the dollar has resumed its decline. Volcker and Treasury Secretary Baker began maneuvering last January for a reduction of European and Japanese interest rates, in order to provide cover for the Federal Reserve to throw money into the endangered American banking system. Japan's and Germany's central banks agreed to such a global cut in rates last March, temporarily arresting the dollar's fall; but their failure to agree to another round at the April 11 meeting of the International Monetary Fund in Washington sent the dollar tumbling again. The dollar had fallen to little over DM 2.20 before the March agreement to reduce interest rates, and then rose to DM 2.42; on April 17, it closed below DM 2.25. Significantly, dealers cited European worries about U.S. economic statistics. A self-feeding spiral of dollar-dumping and economic decline is under way.

The oil collapse

According to the Bureau of Labor Statistics, employment in goods-producing industries declined 79,000 in March, following an even larger decline in February. The largest decline was registered in the mining sector, which lost 30,000 jobs in March, in immediate response to the oil-price collapse. The BLS added that the decline was offset by a rise of 271,000 jobs in the service sector of the economy. About 671,000 Texans were without jobs in March for an unemployment rate of 7.2%. In the oil patch alone, Texas has lost 40,000 jobs since February 1985, according to government statistics.

Some simple arithmetic shows how devastating the collapse will be. Oil production itself accounts for 7% of durable-goods output, according to the Federal Reserve, and a 40% reduction will knock 3% off total output. Cutting oil-exploration budgets by half will knock another 2% off the total economy, bringing the *immediate* impact of the oil price decline to a 5% reduction in total durable goods output. \$10-12 oil, i.e., the April 17 trading range, will eliminate virtually all investment in oil production, implying a decline of 7% in industrial output. The secondary shocks detonating in the financial sector will be much greater.

We see in these developments confirmation of our December warning that the 1986 rate of decline of the American

economy will fall in the 15-25% range.

Salomon Brothers' Henry Kaufman wrote April 11: "By how much has the record-setting first quarter bond issuance enabled domestic corporations to refinance their outstanding high-coupon debt? The strong level of first quarter refinancing activity amounted to a whopping 35% of the record \$35 billion of new taxable bonds. . . . Corporations raised only a net \$20 billion in long-term funds—no more than in either of the prior two quarters. . . . [Short-term] borrowings were merely \$8 billion quarter to quarter, compared with \$18 billion on average in the first period over the past five years."

Corporations raised \$37.9 billion from all external sources during the last quarter of 1985, and the quarterly average was \$25 billion, against only \$15.5 billion during the first quarter of 1985. The first-quarter rise in commercial paper volume was \$7.5 billion, the smallest in a year. Nonfinancial commercial paper rose by only \$1.7 billion in the first quarter, while bank loans at the large weekly reporting banks declined; that is, virtually no new net credit was extended to the non-financial sector!

Salomon's estimates for first-quarter external financing of non-financial corporations are as follows:

Total external sources of funds (billions)	
1Q 1986	\$15.5
4Q 1985	37.9
3Q 1985	14.4
2Q 1985	28.1
1Q 1985	19.4

Most remarkable is that the boom in the stock and bond markets has contributed virtually nothing to the resources available to non-financial corporations, largely because redemption of stocks by corporations (through leveraged buy-outs and related market manipulation) nearly outweighs total long-term debt issues by the same corporations.

Corporations retired \$81.7 billion of stock between the first quarter of 1985 and the end of the first quarter of 1986. In the same period, corporations issued \$113.9 billion of long-term debt. Since the non-financial corporate sector, as a whole, finances stock purchases by issuing long-term debt, these two developments find themselves on opposite sides of the same equation. That leads to a remarkable conclusion: Roughly speaking, we can say that two-thirds of all long-term bond issues during the past five quarters financed stock-market speculation, directly or indirectly. Nothing like this happened in 1928.

The principal source of financing for current operations of non-financial corporations was short-term debt. On average, they borrowed \$19 billion during each quarter of 1985. Their short-term borrowings, in Salomon's estimate, were a bare \$7.6 billion during the first quarter of 1986, 60% below the 1985 average.

Equity repurchases by corporations, including leveraged

buyouts, are a combination of stock-market speculation and tax wingding. If the equity appreciates, the operation is doubly profitable, since the additional interest paid against debt issued to buy the equity is simply written off the corporation's tax bill. If the operation fails, and corporate cash flow declines, the operation becomes a disaster, for lenders in particular.

The disaster in the oil patch, which threatens to topple \$200 billion of Texas banking assets, among other things, appears to have caused an epidemic of sobriety among bankers and their regulators. The deadpan statements of the bank regulators have a clear message: "Head for high ground, boys, the dam's a-bust!" As noted, short-term credit lines to non-financial corporations have dried up, the orgy of leveraged buyouts, corporate equity repurchases, and so forth, has quieted a bit. Net stock repurchases were at \$23 billion in the third quarter of 1985 and \$25.3 billion in the fourth quarter, but fell to \$11.7 billion in the first quarter of 1986.

Not merely oil patch banks, but larger, troubled institutions like Bank of America, are in no position to finance the additional \$100 billion per year or so that America will need to buy the same amount of foreign goods with cheaper dollars.

The disappearance of commercial banking in the international markets is now repeating itself in the domestic markets. In 1981, international bank lending reached a peak of \$500 billion. By 1985, international bank lending had fallen to less than \$80 billion. What replaced the banks was the Eurobond market, funded by international dirty money. From barely \$20 billion a year in 1981, the Eurobond market grew to \$140 billion at present rates. Now, the domestic bond markets have virtually replaced domestic lending; but the bond markets have financed nothing better than 1928-style stock market speculation.

The result is evident from the international trade data, which show that the undeflated dollar volume of international trade was lower in 1985 than in 1980. At home, the first signs of downturn will create a new category of problem loan: the "leveraged buyout loan." Regulators will tear their hair out over corporate over indebtedness, at the same time that oil banks, farm banks, and major international lenders slide further over the edge.

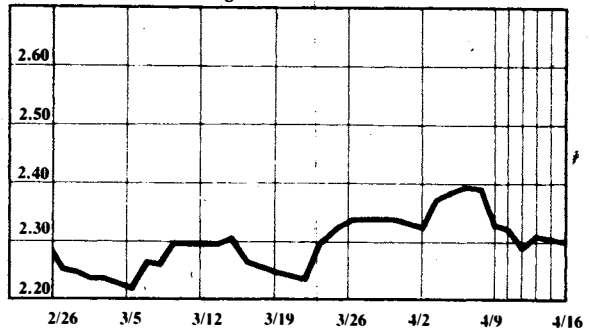
The financial consequences of the current downturn are unpredictable, particularly since \$1.26 trillion of "off-balance-sheet" liabilities on the part of the 15 largest U.S. commercial banks may turn sour very quickly. These include loan guarantees, currency and interest-rate swap agreements which depend on the solvency of the participants, standby letters of credit (guaranteed loan facilities), and other risks.

Without drawing on metaphoric language from the vocabulary of nuclear explosive devices, we can state clearly that the phony stability of the past three years is over, and reiterate our year-end 1985 forecast: a 15-25% downturn of U.S. physical output during 1986.

Currency Rates

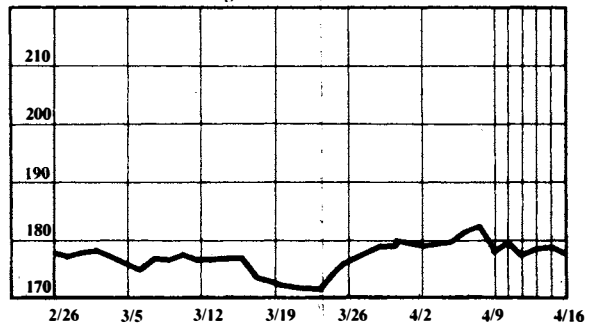
The dollar in deutschemarks

New York late afternoon fixing



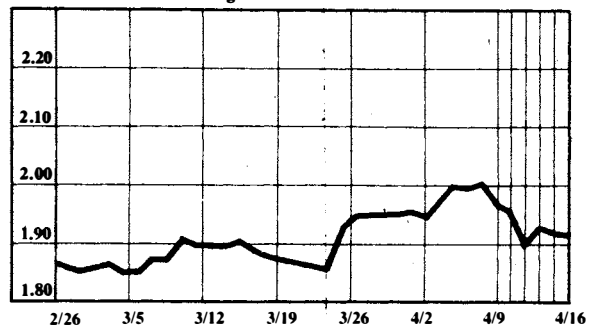
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing

