Click here for Full Issue of EIR Volume 14, Number 34, August 28, 1987

Italian banker forecasts the end of the great bubble

by David Goldman

To the regret of hospital orderlies, madmen have improbable strength; to the regret of central bankers, market bubbles have improbable durability. The Dow-Jones average of the New York stock exchange closed Aug. 21 at a new record of 2,709, just three-and-a-half times its level of Aug. 13, 1982, when the bull market took off.

The improbable endurance of the stock-market bubble prompted Italian financier Guido Carli, a former governor of his country's central bank, to warn in an interview published in *La Repubblica* Aug. 14 that the madcap discrepancy between underlying earnings and stock-market prices had prepared the conditions for a new crash.

In a page-one editorial, entitled, "The Real Cause of the Fall of the Stock Exchange," Carli writes,

"The reason for the rise of the U.S. stock market is to be found in the decision of the Federal Reserve in 1982 to create more credit, to avoid the banking collapse following the Mexico insolvency. . . . In Italy, the rise in stock prices was provoked by a . . . bank-credit expansion, estimated to be the double expansion of income in nominal terms. . . .

"It appears that while there was an increase of 233.6% in stock prices from August 1982 to August 1987, this fact does not seem to be in line with the development of the underlying real economy. In particular, there was a paper gain of $1.8 billion, while the companies represented on the Stock Exchange lost 10.8 million jobs. . . . Even if it is true that U.S. unemployment decreased from 9.7 to 5.9%, it is also true that the new jobs have been created in low productivity sectors, and that this has been possible in a country that does not respect the laws of the balance of payments, and thus takes real resources away from the rest of the world, while demanding more financing from abroad.

"Italy cannot follow such an example," Carli concludes.

In fact, a close look at the real earnings of the U.S. economy suggest that Mr. John Law's Mississippi Company was a better investment just before its famous crash in 1721, than U.S. common stocks in August 1987.

The real bull is to be found in corporate balance sheets. Except for a set of swindles now unwinding at a terrifying pace, there are no profits in the U.S. economy. The $2.3 trillion market in U.S. corporate equity is not simply overvalued; there is no way to ascribe any underlying valuation to it.

These swindles boil down to the following:

1) The faking of U.S. bankers' books to show accrual of interest on non-performing loans, which otherwise exceed the shareholders' capital of those banks;

2) The overvaluation of the U.S. dollar not merely against the Japanese yen and German mark, but above all, against developing-sector nations' currencies, permitting U.S. purchasers to obtain goods at less than half of their domestic purchase price;

3) A consumer debt-bubble which has pushed consumer installment debt to more than a fifth of consumers' disposable income, from a seventh in 1982; and

4) A boom in real-estate values, which has brought corporate real-estate holdings up to $600 billion, according to a recent survey, or 26% of the total market valuation of U.S. common stocks.

Where the status of these swindles is concerned,

1) U.S. banks lost $10 billion during the second quarter, and face an additional $20 billion in loan-loss-reserve additions for Brazil alone, to be applied either in the second or third quarters;

2) The dollar has resumed its collapse (see *Foreign Exchange*);

3) Consumer credit extension stalled during the first half of 1987; and

© 1987 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

4) The combination of a 25% national vacancy rate for corporate office space in prime markets, and the elimination of the 1981 tax code's advantages for real-estate investment as of the 1986 "tax reform," have produced a slow-motion collapse of real-estate values.

Where's the beef?

On paper, U. S. corporate profits have risen by 68% from the last quarter of 1982, i.e., the beginning of the bull market. That means nothing. For example, real-estate holdings of the Fortune 500 alone are now valued at about a quarter of all corporate equity, and a huge amount of earnings was derived from real-estate transactions in a market just as speculative as the stock exchange.

Not what profits corporations may report, but what they can actually earn, give some sense of the economy's capacity to support the runup in stock prices. The only transactions which support earnings, ultimately, are sales of goods, since all "sales of services" constitute an overhead-cost component of goods production. A step closer to the truth is taken by looking at the profits of goods-producing industry only, since ultimately, cash flow from sales of goods, supports the economy's entire cash flow.

Here the picture is quite different. Profits of non-durable manufacturing industry were $54.2 billion in the last quarter of 1982, and only $41.0 billion in the first quarter of 1987, a decline of 32%. Durable goods manufacturers showed a net loss in 1982 of $2.5 billion, and a meager profit of $43.1 billion in the first quarter of 1987.

The financial sector debacle

Where did the big rise in profits come from? The fastest growth occurred in finance, insurance, and real estate, of slightly over 200%. The big banks' $10 billion loss during the second quarter of 1987 not only wiped that out, but knocked down overall corporate profits by 20%. The financial sector (see *Banking*) faces much, much worse losses to come.

Almost as large was the profit increase for transportation and public utilities, which showed 100% growth. But this jump occurred from extremely low levels, motivated by the massive losses of the airline industry during the early 1980s. The airlines are still in big trouble, so the percentage growth is of minor relevance.

The most important component of profit growth occurred in wholesale and retail trade, i.e., the consumer-debt bubble, where profits grew 73% over the cited period. In absolute terms, this sector's profit grew to $58.1 billion, the largest single component of corporate profits. That is not surprising, since distribution was the main beneficiary of the American economy's reversion to import-dependency after 1982. A fifth of the U.S. economy's physical consumption today represents net imports. About 40% of these imports come from developing countries, where they are purchased at a fraction of their American cost of production, and often (especially in the Ibero-American debtor countries) at less than their local cost of production. A big retail chain that can purchase directly from overseas manufacturers, could buy at garage-sale prices abroad, and sell at American prices at home—as long as consumers could keep adding to the debt-mountain which has brought installment debt up to 20% of their pretax income, from only 14% in 1982.

To summarize so far:

1) Profits of the manufacturing and transportation sector continue to stagnate.

2) The financial sector faces devastating losses.

3) Wholesale and retail trade remain profitable only by virtue of the dollar's overvaluation, and consumers' declining ability to absorb more debt.

However, the wholesale and retail sector, i.e., distribution, produce virtual, but not actual profits. America now employs more than 25 million workers in retail and restaurant trade, against merely 17 million in manufacturing. Why should it be necessary to have three workers to sell what two produce? In competent national-income accounting, the distribution sector as a whole represents an overhead cost for the productive sector. Its profits mean nothing, if the products are not there for it to distribute. In fact, insufficient domestic production is available, and the distribution sector makes the great majority of its profits by selling foreign goods at a high markup in the U.S. home market.

The absence of domestic production finds its complement in the absence of domestic high-wage industrial employment; hence the staggering dependence on consumer installment credit to continue consumer purchases, increasingly of imported goods. The distribution sector will be crushed between two problems, namely, America's inability to continue purchasing foreign goods with a falling dollar, and the consumers' inability to keep absorbing debt.

Real estate

But the worst of it all is the real estate bubble, whose commercial component entails $800 billion in outstanding mortage debt. According to a recent study by LaSalle Associates, corporations list $350 billion of real estate on their books, amounting to 15% of the market value of all U.S. common stocks. But speculation has pushed this market value (supposedly) up to $600 billion. Numerous corporations have found that their most profitable operations involve trading their real-estate portfolios.

Assuming an illiquid real estate market during the next several years as a consequence of tax reform, hundreds of billions of dollars of corporate assets will be devalued. For the financial sector in particular, that is no small issue; Bank of America and other troubled banking institutions saved their necks by selling off headquarters buildings at prices ranging in the hundreds of millions of dollars. Their inability to realize the paper value of real-estate assets may be sufficient to break them, at a time when they are compelled to write off more than their shareholders' capital.