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Most analysts believe that the savings bank industry as a whole is liquid enough to meet anticipated outflows through the sale of short-term assets. The savings banks in particular—which have greater flexibility than the thrifts in where they can invest—built up an ample cushioning of Treasuries, Federal funds, commercial banks certificates of deposit, and other short-term assets as a hedge against eventualities like the present.

The pressure on savings banks to liquidate these assets combined with equal pressure on commercial banks to liquidate treasuries and bonds to satisfy loan demand—and forestall bankruptcies of their debtors—will feed the interest rate spiral and intensify the problems currently facing these lending institutions. The liquidation of Treasury securities and bonds intersects an exceptionally heavy fourth quarter borrowing by the U.S. Treasury and hefty pent up demand for long-term funds by corporate treasurers. The prospect of heightened competition for long-term funds between the Treasury and corporations contributed to the 400 basis points plunge in the corporate bond prices in the three banking days following Volcker's momentous announcement Oct. 6.

The Treasury, which bet on rates peaking by the fourth quarter, must finance some $15 billion in new cash needs by the end of the year, in addition to refunding more than $5 billion in maturing securities.

Corporate treasurers who have been taking on short-term debt at near record amounts since the beginning of the year—expecting that interest rates would ease later in the year—are now under great pressure to shift their borrowing to the long-term market. However, look at the experience of top-rated IBM Corp. last week.

As was well publicized, IBM's $1 billion financing ended with the biggest underwriting loss in history last week. Investment
high as $30 million was suffered by underwriters who got stuck holding unsold securities when the bond market went into its slide.

One inside source revealed that the loss was even more of a disaster than the public realized. The much favored IBM issue, which had reportedly sold $800 million of the $1 billion offered by early last week, had only sold $500 million. The rest was unloaded by the underwriters through illegal swaps for Treasury securities. The cancellation of this dubious business by a senior partner of one of the leading underwriting firms broke up the syndicate on Oct. 10 and left the bonds selling at 94.5 percent of par.

—*Lydia Schulman*

Volcker's 'little depression'

Several New York City money center banks told the *Executive Intelligence Review* this week that they and their Fortune 500 industrial borrowers will escape the effects of a credit crunch initiated by the sharp tightening of domestic credit this week by Federal Reserve Board chairman Paul Volcker. "Consumer installment credit and the housing market will be hit by Volcker's move," a Citibank official stated Oct. 10, "but the

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larger-sized companies will not be much affected." He added that "this country can use a strong dose of Volcker's medicine."

A review of U.S. corporate liquidity and sales reported for the first nine months of 1979, however, demonstrates that the force of Volcker's actions will bring down the entire economy, and will not spare the large companies which imagine themselves safely sheltered. In short, the U.S. economy is too interconnected for one section of the economy to collapse without other areas being seriously damaged. Volcker and the New York City banking community's conceit, that they can run, in their own words, "a controlled disintegration of the U.S. economy," is rooted in wishful thinking.

Indeed, the very financial sections that Volcker proposes to triage first, housing and auto credit, are precisely those, as every analyst will admit, which have kept the economy from visibly plunging into collapse for the last 24 months.

A credit crunch will very likely force a repeat of the 1973-'74 U.S. depression, when unemployment rates hit 8.5 percent, industrial production collapsed by more than 10 percent, and inflation continued rising, not falling. The British Broadcasting Corporation, in heated anticipation of a U.S. collapse, nonetheless accurately tagged the huge Oct. 10 panic in the stock market following Volcker's tightening: "The only difference between now and 1929 is that now there are no bodies."

Corporate liquidity is not good

Volcker raised the discount rate to a record post-war high of 12 percent, allegedly "to halt inflation and bank

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credit growth." While Volcker claimed that this will not lead to a credit crunch, William Griggs of J. Henry Bank and Trust Co. said Oct. 11, "there is the chance that because so much of the American economy is based on the functioning of credit and borrowing, Volcker's action could be timed incorrectly and the economy will be tipped into depression."

The sectors to be hit hardest by Volcker will be consumer credit-related sectors such as auto and the housing sector. Despite the sharp run-up in consumer credit, auto sales are down between 12 and 15 percent this year from last, and housing starts for 1979 are expected to hit only 1.5 million units, nearly a 25 percent yearly drop.

Yet, the critical area of the economy in the short-run will be the second and third tier U.S. corporation. With the prime rate up to 14½ percent, and the newly imposed 8 percent increase in reserve requirements on certain categories of liabilities adding another 1 percent cost, second tier corporations can expect to pay 16 to 18 percent interest on loans, according to one New York investment house analyst. This will be especially hard on second tier companies because of the sharp rise in their short-term debt.

Total corporate indebtedness is up by 10 percent this year to slightly more than 400 billion dollars, and short-term debt now accounts for almost 6 percent of the total invested capital in an average large company, compared with 5.5 percent just one year ago. (Only a rise in equity offerings kept the ratio from going alarmingly higher.) While the exact figures for this same ratio for second-tier companies don't exist, reliable estimates place this ratio at a staggering upward of 10 percent.

Companies took on this debt in the first half of the year, with the rosy expectation that, with interest rates rising, they would borrow short for long term operating needs, but lock into long-term liabilities this fall, when, it was thought, interest rates would have fallen. But the peak hasn't come yet, and is not expected, according to Schroeder's Briggs, until January of next year or later. The short-term debt has to be rolled over at 16 to 18 percent interest rates, directly gouging profits.

Increasing the middle-tier firms' liquidity problems is the fact that they are being boxed out of the commercial paper and corporate bond markets, where other sources of funds might be available. With BAA or less Standard and Poor's ratings, the middle-tier companies could find no takers for their paper this week, and won't for several months. A Manufacturers Hanover Trust economist commented this week, "there is no way that bankruptcies among non-Fortune 500 companies can be prevented because of Volcker's actions." The unraveling of Chrysler Corp., which is a special extreme case and normally a Fortune 500 company, exemplifies the potential bankruptcy process.

The middle and lower tier companies are the parts-suppliers, construction companies, etc., that are the foundationstones for the large companies' growth.

More than one danger sign

Corporate illiquidity is only one of several signs. Those who took solace at the temporary drop in the national unemployment rate to 5.8 percent in September had better take a deeper look.

Contract orders for plant and equipment, the key to all capital formaton, in inflation-adjusted dollars, fell from the second to third quarter, although precise figures have not been released by the Commerce Department. This category of orders fell a sharp 10 percent from the first to second quarter this year. Manufacturer orders for consumer goods and materials had also been declining since winter.

The overall inventory-to-sales ratio for the U.S. economy is, as many analysts have pointed out, better than the 1974 period. But on the retail sales level, the 12 month percentage change from Sept. 1978 to Sept. 1979 is 8.3 percent in current dollar retail sales, while the 12 month rise in inventories is 11.3 percent, showing a slow, but steady inventory-growth-over-sales of nearly 35 percent.

If retail sales collapse, corporations will have sizeable producer inventories to get rid of. Though smaller as a percentage of retail sales in 1974, the inventories are far larger in actual volume than in 1974. The incentive toward liquidation is that the cost for credit—and therefore, of warehousing the inventories—is much higher now than at the worst point of 1974.

Under these conditions, as the economy begins to unravel following a credit market collapse, there will be no way to cordon off the effect on the large Fortune 500 companies, nor on the large New York money center banks. "Controlled disintegration" will quickly give way to "uncontrolled disintegration," spreading from the second to first tier companies. The New York banks, who bet on being unaffected, will, once again, as in 1929, have bet on a sure thing and lost.

—Richard Freeman