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Collapse in the consumer sector

With the onset of the Volcker credit crunch last month, the Chairman of the Federal Reserve told the U.S. Congress: "The standard of living of the average American has to decline." If his policy isn't quickly reversed, this statement may prove to be one of the few economic predictions by a Federal Reserve Chairman ever to be vindicated.

While economists have discussed the supposed impact of the Volcker Oct. 6 measures ad infinitum over the last month, the feature that emerges unmistakably is the attack on American living standards.

The first sectors of the credit market to be impacted by the Oct. 6 measures were, as planned, consumer installment and home mortgages. Credit-dependent, consumer-oriented industrial sectors like auto and housing are now reeling from the effects. (The Fed has continued to pump out banking reserves to selected banks via its discount window, and those banks in turn have continued to make credit available to their "best corporate customers.")

The attack on the consumer sector of the economy has operated as follows: personal income, adjusted for inflation, dropped at a 10 percent annual rate in September. However, the full effects of that drop, were postponed by a record 7.6 percent expansion in consumer installment credit outstanding during the month. Then the Volcker crunch hit, and banks began "reviewing" their policies on consumer lending. The rapid expansion of *new* consumer installlment loans undoubtedly slowed in October—in tandem with the 1.7 percent nominal drop in retail sales over the month from September levels. The volume of consumer credit outstanding may have continued to grow in light of the growing delinquency rate on loan repayments by illiquid consumers.

Volcker's high interest rate policy has been simultaneously undermining the savings banks, the traditional depository of consumer savings and the mainstay of the American homebuilding industry. Caught in the squeeze between the rising cost of money and their fixed-rate mortgage assets, a significant number of veteran savings banks and savings and loan institutions are operating at a loss for the first time in their history. In states where usury laws are still in force, mortgage activity has almost ceased because of the widening spread between the banks' cost of funds and the statutory ceiling on mortgage loans. In states where usury laws don't exist, mortgage rates have soared out of reach of Mr. Volcker's "average American."

Statistics disseminated by the National Association of Home Builders show that if mortgage rates rise to 14 percent—where they are presently headed, then only 8 percent of all American households will be able to purchase an average priced home. With rates currently in the 12 to 13 percent range, less than 13 percent of the nation's households can afford to carry a mortgage on an averaged priced $65,000 home. The era of the single-family home—once considered the "American Dream"—is ending abruptly.

The November issue of the "Morgan Guaranty Survey" takes this scenario one step further, recommending a sweeping change in policy direction for housing in the 1980s: the federal housing agencies such as the FHA and VA—which have been the backbone of the U.S. homebuilding industry since they were created in the 1930s—should leave the financing of single family homes to the private mortgage market (which has shown a distinct preference for shopping malls) and concentrate instead on rehabilitating the nation's aging urban housing stock.

And what will become of consumer savings in this overhaul of the nation's credit markets and institutions?

The deficit economy

The on-going unravelling of the U.S. economy—starting with the consumer-oriented sectors—is the predictable result of cutting off credit to an economy which has become hooked on short-term debt. As noted above, in September, prior to Volcker's Oct. 6 credit-tightening announcement, consumer installment credit soared by 7.6 percent, reflecting both a hefty extension of new loans and a drop-off in loan repayments by illiquid consumers. During the same period, short-term bank loans to commerce and industry were expanding at a near-record 32.9 percent annual rate.

These figures indicate the rate of credit expansion required to barely sustain consumer purchasing power and business operating rates. But the stated intention of the Oct. 6 package, of course, was to slow the rate of credit expansion and puncture the economy. At the time, a source close to Volcker hypothesized that the Fed's goal was to knock the growth of the monetary base (banking reserves and cash in circulation) down to zero for the rest of the year and reduce short-term loan growth to a 5 percent annual rate.

Indications are that Volcker has been "successful" in slowing the rate of consumer borrowing—witness the 1.7 percent slump in current dollar retail sales in October—and the reported slowing of corporate borrowing. The growth of C&I loans on the books of the

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nation's major commercial banks dipped to a 7.1 percent annual rate during October, which led money market analysts to proclaim last week that "interest rates have peaked."

However, all of the arguments to the effect that 1) interest rates have now peaked, and 2) partially as a result of this peaking of rates, the current recession will be a mild and manageable one, simply ignore the most fundamental point about the U.S. economy: its underlying illiquidity. Both households and the corporate sector have been running at a severe deficit since 1971 and have increasingly relied on short-term debt to make up the deficit.

It may not be so easy to stop the expansion of consumer credit at present, for example. As Chase Manhattan bank argues in the Nov. 12 issue of its "International Finance" publication, no matter how hard the banks come down on issuing new consumer loans, the growth of consumer credit may continue due to an uncontrollable drop-off in loan repayments. In September, in fact, half the growth of consumer credit was attributed to a decline in debt repayments by illiquid consumers.

General credit conditions over the decade—i.e., historically high U.S. interest rates—have impeded capital formation and investment in new productivity-increasing technologies to the point where industry and agriculture cannot generate sufficient real profits to finance even operating costs and barebones capital expenditures and are increasingly dependent on borrowed funds. Hence the folly of the "interest rates have peaked" theorists.

The last several weeks' experience has shown that credit demand which is suppressed in one market is popping up in another. The drop off in corporate loan demand in October—more accurately, the selective denial of corporate loan requests by lenders—was accompanied by a marked take-off in commercial paper issuance by finance companies. Commercial paper is the designation for short-term unsecured IOUs issued by corporations and sold to investors, usually other corporations. In the four weeks ending Oct. 31, commercial paper issued by nonfinancial corporations grew at a 55 percent annual rate. Commercial paper issued by finance companies—including the finance subsidiaries of the auto companies—rose at a 26 percent annual rate, up from 4.9 percent in the previous four weeks. The increase mostly reflected the issuing of new debt by the auto companies' subsidiaries to finance inventories of cars which could not be sold because of the shut-off of consumer credit.

This development is a strong indication that credit demand will not drop off "naturally" in response to the new stratospheric interest rates, because the requirements of inventory financing under conditions of collapsing sales will actually intensify credit demand. Various sources in Washington and at the New York investment banks have drawn the conclusion that *de jure* credit controls—including the activation of the Credit Control Act of 1969—are therefore inevitable before long.

Contrary to what the "mild recession" prognosticators are still forecasting, the fast eroding liquidity positions of certain sectors of the economy are making those sectors especially vulnerable. A recent run of the *Executive Intelligence Review*'s computerized Riemannian econometric model showed that the total economy will drop about 15 percent into the negative by the end of 1980 with the most illiquid sectors—auto, construction, and agriculture—going first (see Vol. VI, No. 43, Nov. 6-12).

November auto production schedules have already been cut by 22 percent from November 1978. And a troublesome inventory built up from year-ago levels in auto and other durable goods industries portends further major production cuts and layoffs by the first quarter of 1980.

The relatively low inventory-to-sales ratio for all business is deceptive and hides a very differentiated inventory picture for the various industrial sectors, according to a recent analysis by Manufacturers Hanover Trust's economics department. Over the last year, both employment and inventories have increased much faster in the durable goods group (transportation equipment, machinery, "big ticket" consumer items like refrigerators) than in the nondurables group (apparel, food, other consumer software). At the beginning of October, the I-S ratio in durable goods was 1.97 compared with 1.84 a year earlier, with the rise concentrated in transportation equipment where the I-S ratio shot up from 1.46 last year to a current 1.85. Also up are inventories of stone, clay and glass, fabricated metals, machinery and instruments. By contrast, nondurable goods producers reported an I-S ratio of 1.09 down from 1.19 a year ago.

These inventory-to-sales ratios correlate with the relative liquidity ratios—as is to be expected—and confirm our model's projections of a sharp downturn in durable goods industries such as auto and its feeder industries and construction.

Faced with growing inventories, worsening liquidity, and Mr. Volcker's "anti-inflationary" high interest policy, the nonfinancial corporate sector has been at pains to raise prices where possible. This tendency is evident in the breakdown of the producer price index for October: while the rise in the overall index moderated, in line with a slowing in the rate of increase of energy prices and a slight decline in food prices, the cost of finished goods increased significantly—1.0 percent on top of a 1.4 percent increase in September. Needless to say, it is the consumer who foots the bill for these price increases.