THE THREAT OF CORPORATE DEBT

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1. Introduction

External financing of corporations historically involved cyclical patterns. Corporations' debt to equity ratios generally deteriorated in recessions and improved in recoveries. As a recession approached its end, corporations typically restored their balance sheets, issued both debt and equity, and used the proceeds to repay short-term debt and to rebuild their liquid assets. This was the period where corporations tended to lengthen the maturity of their debt (i.e. fund their debt). In the latter part of a recovery, by which time interest rates were usually high, corporations eschewed long-term debt and instead sought short-term debt financing. Recently, many corporations have deviated from this pattern and have fallen behind in restoring their balance sheets.

In the post-Korean War period, the character of the corporate balance sheet has changed significantly. In 1960, manufacturing corporations had slightly more than $4 of equity per dollar of debt. The amount of equity per dollar of debt has since declined to $2.07 [1]. The ratio of debt to total funds employed and the ratio of short-term debt to total debt have both increased considerably. At the end of the fourth quarter of 1960, the ratio of short-term debt to total market debt was 29.5%. By the end of 1982, it had risen to 47.9% [2]. There also has been a tremendous increase in the burden of debt servicing. In the 1960–1982 period, the interest coverage ratio, defined as pretax profits plus interest payments divided by interest payments, fell from 14.4 to 2.7 [3]. This decline indicates that pretax corporate profits were barely sufficient to cover interest payments on debt. Not only is there a large debt on which to pay interest, but the interest rates at which the funds have been borrowed have risen markedly. In 1960, the average rate on long-term Treasury bonds was 4.01% [4]. For the same securities in 1982 the average rate was 12.76% [5].

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I am indebted to my colleague Jamshed Ghandi for reminding me that the threat of corporate debt must be viewed in the broad rather than the narrow context.

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Furthermore, the average maturity of debt has declined, which has caused the debt to be turned over more frequently [6]. Finally, the liquidity ratio of firms, the ratio of liquid assets to short-term credit market debt, has declined substantially from 113.7% in 1960 to a mere 37.7% in 1982 [7]. The deterioration of U.S. corporate balance sheets indicates that firms are becoming more highly leveraged, less liquid, and increasingly compelled to borrow for short time periods.

These conditions have combined to increase the probability of widespread default. Many observers of the capital markets, such as Henry Kaufman, have expressed great concern over these developments [8]. This article assesses the factors which have caused the deterioration of corporate financial health and assesses the significance of that situation.

2. The fragility of international finance

French and German analysis of what the Americans call business cycles is called conjuncture analysis; the conjunctures of circumstances which result in the economies becoming very fragile. The current conjuncture of circumstances poses significant risks for the international financial system. In brief, many corporations are financially vulnerable and consequently unable to withstand any significant shock. Concurrently, banks on the international scene, having discovered liability management, also have stretched their leverage. The banks have found that after an orgy of international lending, they hold billions of dollars of loans of dubious value. The adequacy of the capital of banks is of considerable concern, especially that of U.S. banks to U.S. authorities.

Some of the countries to which the money was lent are on the verge of default and efforts are being made to prevent such occurrences. In fact, defaults have already occurred which, for very good reasons, no one is willing to admit. The banks are reluctant to declare a default and go through the fruitless motions of trying to collect the funds due because if the banks declare the loans in default they will have to write the debts off. The banks simply do not have enough equity to absorb such writeoffs. The loans of the five largest banks in the Unites States (as measured by capital) to Argentina, Brazil, Mexico, Venezuela, and Chile at the end of 1982 constituted from 141 to 263% of their capital. The loans of three of those banks to Brazil and Mexico alone exceeded 100% of their capital [9].

The banks have been compelled to engage in forms of involuntary credit extension. Initially, when countries such as Brazil and Argentina began to have difficulties servicing their debt, they were lent the money with which to make the payments due. This extension of credit was not actually voluntary, but was forced on the banks by the need to avoid declaring a default. Some countries, however, have begun to fail to make the requisite payments and consequently
many banks are reluctant to extend further credit. The reluctance of the banks to declare even these countries in default is also a form of involuntary credit extension. However, with the general improvement in the economic climate that has taken place in 1983, the prospects for increased exports, and therefore an improved ability to cope with debt, have brightened considerably.

Under these circumstances a number of scenarios could occur. First, everyone simply could ignore these developments. Banks would merely record a decline in profitability because they would not be paid the full interest coming to them. If the world economy improves sufficiently, financial disaster may be avoided. Second, there could be a loss of confidence in the banks. If the banks are not helped by a massive infusion of central bank funds, a major international financial crisis could result. Third, there could be a loss of confidence accompanied by central bank intervention to avoid an international crisis. This could produce a raging inflation.

Even the first scenario, however, could necessitate a massive infusion of funds through central bank intervention. For example, the banks, recognizing the precariousness of their positions, might cut loans to firms with precarious financial structures. Those firms could then run into difficulties. They could find themselves unable to pay other creditor banks. Unlike sovereign governments, corporations can go bankrupt, and upon default, the banks cannot deny the worthlessness of the loans extended. Writing off these debts could deplete the equity of the banks. In the absence of Federal Reserve intervention, such developments could precipitate a domino effect which would not be confined to the borders of the United States and which could precipitate an international financial crisis. Consequently, a likely development would be a massive infusion of funds and the fueling of a potentially damaging inflation.

The financial problems emerging from the banks' extension of credit to countries that are now unable to repay are exacerbated by some uncomfortable economic circumstances. As noted above, sovereign governments do not go bankrupt. There are few assets that can be seized by creditors. The only way in which the debtor countries can meet their debt obligations is by a significant expansion of their exports. Unfortunately, although the world economy is improving, expanding imports is difficult because of the protectionist mood of many of the countries to which the debtors would naturally export. The free world seems to have become convinced that the only way to curb inflation is to curb the money supply regardless of the impact on employment. Indeed, monetarists count on unemployment to reduce the upward pressure on prices. Unfortunately, labor in industries with foreign competition tries to minimize the unemployment by pressing for protectionist measures which, if implemented, make it impossible for the debtor countries to extricate themselves from their difficulties. In addition, those who suggest that these debtor countries curb imports and impose an austerity program overlook the political reality of those countries. A banking consortium's attempt to impose such
austerity can destroy the political stability of the country and make it possible for less level-headed elements of the population to take over and foolheartedly declare a moratorium which the banks could no longer ignore.

Distorted corporate financial structures pose a significant threat to a very fragile international financial order. If the financial difficulties encountered by a firm trigger an adverse financial reaction throughout the economy, refunding can be made difficult for other firms. This, in turn, may jeopardize the banks and interfere with monetary policy. For example, in the aftermath of the Penn Central bankruptcy, Chrysler found financing difficult and the Federal Reserve had to step in with remedial measures which increased the money supply. The possibilities of generating financial panic are increased when corporations rely heavily upon short-term funds and the banks have thin capital and carry debts which perhaps should have been written down. The necessity for renewing loans gives rise to the occasions on which panic may occur.

Thus, the weakness of the real sector, the fragility of the financial structure of the real sector (i.e. of non-financial corporations), and the weakness of the banking system have all come together. This conjuncture raises multi-dimensional implications regarding domestic capital, stabilization policy, and the stability of the economy. Unfortunately, an examination of most of these is beyond the scope of this paper. Discussion is confined to the financial structure of corporations, the transmission mechanism by which the risk of the real sector gets transmitted to the financial sector. If the burden of corporate debt merely threatened the ability of a number of corporations to continue operating, the fears expressed by observers such as Kaufman would be exaggerated. However, in the context discussed above, the threat of corporate debt becomes menacing.

3. Factors in the decay of corporate balance sheets

3.1. Inflation and the corporate income tax

A number of factors have contributed to the deterioration of corporate balance sheets in the United States. Corporate tax rates and inflation, especially in combination, encouraged corporations to substitute debt for equity. Consider an interest rate of 10%, consisting of 3% reflecting a real rate of interest and 7% reflecting compensation for anticipated inflation. Imagine a loan of $100 for one year at a rate of 10% when inflation is proceeding at the rate of 7%. In real terms, unless the investor receives $107 in return for every $100 lent, his principal will deteriorate. The $7 of "additional interest" is thus not really a payment of interest at all, but a repayment of principal [10]. The whole $10, however, is considered a payment of interest for tax purposes. At a 50% tax rate, the after-tax cost of servicing a $100 debt is only $5. In effect, the
borrower repays only 98% of the real value of the loan. The government subsidizes the remaining 2%. Thus, borrowed funds, far from costing money, actually have a negative real rate of interest. Under the circumstances that have prevailed in recent years, it is hardly surprising that corporations substituted debt for equity and the debt to equity ratio increased.

Two recent developments may halt or reverse the deterioration of corporate balance sheets. First, the tax rate applicable to corporations has declined significantly. Many corporations presently pay a very low rate of tax. Accordingly, the subsidy available to corporations through interest deductibility is reduced. Consider the example given above, with a 3% real rate and a 7% inflation compensation. If the tax rate is only 20%, it costs $8 to service a $100 loan. With a 7% inflation rate, the real cost of funds is now 1% rather than −2%. At the present time, when the real rate appears to be a major component of the nominal rate, the advantage of using debt is reduced even more. Returning to our example of a $100 loan at 10%, if the inflation rate is 3% and the real rate is 7%, with a 50% tax rate, the real rate is +2%. With a 20% tax rate, the net real cost of funds rises to 5%. Assuming that corporations respond to these inducements to reduce reliance on debt, the question remains as to whether the collapse of the financial system will be delayed long enough to enable corporations to strengthen their financial structures and thereby strengthen the financial system itself.

The pace of inflation accelerated, first because of the Vietnam War, then because of the energy crisis, and finally from its own momentum. The consequence was not only higher interest rates, but also depressed equity prices. In 1972 the Standard and Poor index of the stock market peaked at approximately 110. Not until 1980 did the market recover significantly. Even if the effective interest rate had not been negative, corporations would not have been very willing to issue equity. Since the 1951 Treasury–Federal Reserve accord, interest rates have drifted upward. Time and again, corporations postponed funding their liabilities because interest rates were high, hoping that they would be able to fund when interest rates subsequently declined. Unfortunately, interest rates kept climbing, although not monotonically, and the opportunities for funding were scarce. Frequently, when interest rates started to fall, corporations rushed into the market, checking the fall.

3.2. High debt–equity ratios in a high interest rate environment

3.2.1. Preference for short-term debt

In a high interest rate environment, investors tend to prefer to invest in fixed income securities rather than equities. High rates tend to be associated with high volatility, which shifts investor preference to short-term fixed income investments. The high interest costs cause the interest component of corporate expenses to increase and thus to depress profits. Corporations also are re-
luctant to encumber themselves with such high costs for extended periods and thus seek short-term financing. The need to resort to short-term debt creates problems with rolling over the debt, because the assets financed by the debt will require continued financing long after the original debt matures.

Even when corporations do not resort to strict short-term financing, they tend to increase their use of financing techniques that involve some increase in the turnover of debt. The floating rate note is typical. The note is attractive because it reduces the lender's interest rate exposure while reducing the borrower's roll-over risk. It permits the lender to make the equivalent of short-term loans while protecting the borrower, to a limited extent, from an inability to roll over the loan. A floating rate note is the equivalent of a sequence of short-term loans in which renewal is guaranteed. While shifting from long-term debt into floating rate notes with maturities of five or even ten years does not increase the debt service burden as significantly as switching to short-term financing, it still results in a more frequent turnover of debt than the financing that would have occurred in a low interest rate environment.

3.2.2. Potential adverse effects of shortening debt maturities

Shortening maturity tends to produce a Catch-22 situation. High interest rates reduce the earnings coverage of interest. To avoid being permanently saddled with such a reduction, many corporations switch to short-term funds. Because short-term funds often have an even higher cost than long-term funds in a high interest rate environment, the interest coverage is reduced even more. Because of the fall in interest coverage, the corporate debt ratings are reduced. Because the ratings are reduced, the interest costs rise even more.

Another difficulty with high debt-equity ratios is that the flexibility of the firm is reduced. At any particular degree of leverage, the rate of growth of the firm depends upon the return on assets and the rate of interest. If interest rates rise, the growth of the firm can be maintained by increasing leverage. If leverage is already high, however, the firm may be unable to further increase its leverage as a means of improving the return on equity because of the large rise in its interest payments resulting from the deterioration of the company's creditworthiness. For the economy as a whole, however, resultant increases in the probability of bankruptcy can be a catharsis. They can eliminate inefficient firms and make room for the growth of more efficient ones.

In addition, given that the attractiveness of a proposed capital expenditure is a function of the expected return on that asset compared with the cost of funds, there is a rate risk involved in mismatching maturities. This is clearly seen in the case of a financial institution. If a financial institution finances a loan with funds of a shorter maturity, it runs the risk that when its own borrowing has to be refinanced, the rate it will have to pay will exceed the rate being earned on the loan originally made by that institution. An industrial firm is in exactly the same position. If an asset was worthwhile acquiring when it
could be financed at a rate of 4%, it may not be worthwhile holding if the net interest cost should rise. There is some virtue in financing the asset with a loan which has a maturity comparable to the economic life of the asset.

If, as a consequence of increased obsolescence, the economic life of the asset declines, a decline in the maturity of corporate debt would hardly have an ominous significance. If, however, because of the high debt–equity ratio, business firms become reluctant to take risk and thus prefer assets with shorter economic lives, the declining maturity of corporate debt becomes reflective of a malaise which merits concern. In addition, corporations may shorten their debt because the market is less willing to accept the maturities which the corporations prefer to issue. Taken overall, the decline in the maturity of corporate debt may reflect a significant reduction in the health of corporations.

The shortening of the maturity has another adverse impact on the economy. Rolling over debt is not a costless operation. A shortening of the maturity and an increase in the frequency of rolling over the debt means that more resources of the economy have to be shifted into the financial sector and this increases the overall cost of operating the economy.

These factors may combine to depress equity prices and, in turn, to discourage corporations from using equity to finance expansion. In this type of environment, management views the equity of the firm as underpriced.

3.3. Differential effects of high leverage on firms

3.3.1. Business risk and financial risk

A high degree of financial leverage affects firms in different ways depending on the firm’s income stream. Even a moderately fluctuating revenue stream can give rise to a fairly volatile net operating income if substantial fixed operating costs exist. The amount of financial leverage that a firm can tolerate is a function of this basic business risk. Interest is paid out of the net operating income. For a firm with a relatively stable income stream, the ratio of interest to total expenses can be higher than otherwise.

It is not clear that corporations, in their pursuit of higher debt–equity ratios, recognized that business generally has become more risky. Business risk has increased as a result of the growing intensity of recessions, increased international competition, and the acceleration of the obsolescence of production equipment. These factors affect the volatility of revenues, and, given the structure of fixed costs, there is an increase in business risk. Because the amount of financial leverage a firm can tolerate depends on business risk, the corporate response to the developments listed above should have been either to reduce debt–equity ratios or decelerate growth. Neither alternative has occurred. As described in section 1, debt–equity ratios have actually increased. Also, although it is unclear whether managements decided to slow their firm’s growth, it is clear that growth continued.
Business firms were able to expand their debt-equity ratios because the environment was conducive to businesses increasing their leverage. It is not clear that the financial community recognized that risk increased as a consequence. If the financial sector wished to lend funds to a particular industry, a firm which kept pace with the increase in the debt-equity ratio with the other firms in the industry was not likely to be penalized.

3.3.2. Financing strategies in an inflationary and high interest rate environment

It is literally impossible for a firm without any debt to go bankrupt. With a small amount of debt, a firm's cash flow can cover all debt service charges, including any repayment of principal in the foreseeable future. Such firms are said to be engaged in hedge financing [11]. As the debt-equity ratio grows, there comes a point at which it can be anticipated that there will be times when the debt can be serviced only by rolling over maturing debt. Such firms are said to be engaged in speculative financing [12]. Finally, the situation can so deteriorate that the cash flow will not even cover interest payments in all foreseeable periods and the firm can anticipate having to borrow to make those payments. This can easily be recognized as Ponzi financing [13].

Clearly, the debt-free firm is impervious to variations in interest rates and many firms engaging in speculative financing are almost impervious. However, the latter group will include firms that only marginally qualify for inclusion. A sufficient increase in interest rates or a setback in sales can drive them into the group engaging in Ponzi financing, which has to borrow even to make interest payments. With rising interest rates, the financing of the last group becomes increasingly precarious.

Insofar as high interest rates reflect an inflationary environment, firms with high ratios of liquid assets to debt will be adversely affected as compared to firms with low ratios. While a major reason business firms have become relatively illiquid in the inflationary environment we have experienced in the last decade or so is the attempt to utilize funds more efficiently, there may also have been an attempt to reduce liquid balances in order to minimize the adverse effect of inflation on liquid assets. An aspect of high interest rates generally overlooked, however, is that the economic value of long-lived capital assets declines more than the economic value of the liabilities, if these liabilities have sufficiently short maturities. This is reflected in a profit squeeze.

If all firms increased their debts pari passu as inflation increases and as interest rates rise, output presumably is priced to reflect the higher cost of funds. However, insofar as different firms issue debt at different times, some first may find themselves at competitive disadvantages. Those firms which manage to acquire long-term funds at a low cost have a clear advantage over other firms which need to raise funds in periods of high interest rates. The latter find that they will be at a permanent disadvantage relative to the other firms in the industry if they raise long-term funds in such an environment.
However, if they raise short-term funds while they are only at a temporary disadvantage, that disadvantage may be even greater because frequently the yield curve is inverted in a high interest rate environment [14].

In addition, the shortening of the maturity of the liabilities relative to the assets makes the firms more vulnerable to equity erosion, in the true economic sense, when interest rates rise. As noted, although it is not reflected on the books of the corporation, the present values of the cash flows generated by the assets and liabilities both decline when interest rates rise. Because distant flows are more severely affected by increases in interest rates than nearby flows, if the maturity of the debt is reduced relative to the maturity of the economic lives of the assets, the present value of the assets is depressed more than the present value of the liabilities.

One unfortunate consequence of the increase in the debt-service burden associated with shorter maturities is that firms may be discouraged from undertaking many long-term investments and may be placed at a competitive disadvantage with respect to foreign competition. High interest rates appear to be more volatile than low interest rates. This introduces an element of uncertainty in the evaluation of long-run projects and reduces their attractiveness. Furthermore, the recent rise in real rates raises the question of whether what is profitable now will be profitable over the life of the asset under consideration. Thus, modernization of plants and the utilization of the state of the art may be delayed in a high interest rate environment. It nevertheless has been argued that because of technological changes, the economic life of assets used by business has been shortened and business does not need funds with the same long maturities that it needed hitherto [15]. The decline in the average maturity appears not to be quite as consequential or as frightening as at first glance. This, however, should not provide us with great comfort.

3.3.3. The debt threat and efficient firms

It is hardly inevitable that the firm that is least likely to get into trouble is the efficient firm. As a consequence of the hazards of timing, the physically efficient firm may find itself more heavily burdened by debt-service charges than a relatively inefficient firm. It is quite possible under such circumstances that bankruptcy will drive out, not the inefficient, but the efficient firm, thus leading to a distortion in the allocation of resources.

4. Internal funds

The increase in the leverage of corporations appears to have been a consequence of a downward drift in the ratio of internal funds to other funds. The shift in sources was not to external equity but to debt. There are two ways in which a firm may determine its pattern of finance. It may decide that it
wants its equity in a particular area along the risk–return continuum. The riskiness of the equity will be determined by the uncertainty associated with the net income. That uncertainty, in turn, is determined by two factors: the uncertainty associated with the net operating income and the degree of financial leverage. Given a target level of the risk–return ratio, the less uncertainty associated with the net operating income, the more financial leverage the firm can have. Given the equity ratio that is thus established, the firm’s growth rate then depends upon the rate at which the supporting equity grows.

Other firms take a slightly different approach. As is well known, the rate of return on equity is determined by the rate of return on assets and the degree of financial leverage. Thus, given the return on assets and the dividend requirements of the firm, some firms will, up to a point, choose the degree of leverage that will finance the desired rate of growth.

A firm can make its equity grow at any target rate by the simple process of issuing as much equity as is needed to achieve the particular rate of growth. Most corporations, however, are reluctant to allow the number of shares outstanding to grow indiscriminately. They view internal funds as the cheapest source of funds and feel that external equity should be used only under special circumstances. Firms will issue equity if opportunities for investment arise that cannot be financed with internal equity and threaten to give competitors an increasing share of the market. They will also issue equity if management is convinced that the market price of the outstanding equity is high or when the indigestion problem is diminished, as in the case of takeovers and mergers.

One can hypothesize about the cause for the decline in internal funds that has been observed [16]. Internal funds as a proportion of total funds used can decline either because profits have declined or because expenditures have risen. It is quite possible that we have been witnessing an increase in the capital intensity of our production processes and certainly there have been substantial capital expenditures for environmental reasons which may contribute significantly to social net product but negatively to private net product. Quite possibly, energy conservation implementations have increased capital intensity and called for substantial capital expenditures.

To some extent, the decline in the use of internal funds between 1960 and into the early 1970s can be attributed to the increase in corporate capital expenditures. Similarly, the recovery in the late 1970s and early 1980s can be attributed to the sluggish growth in investment spending. To some extent, the fluctuations in utilization of internal funds reflect the fluctuations in corporate profitability, coupled with the sluggishness in adjusting dividends.

A decline in the use of internal funds does not automatically imply an increase in the debt–equity ratio since external equity can be substituted. However, if the shortage of internal funds was actually made up with external debt rather than external equity, it was for some very good reasons. The
deductibility of interest on debt in deriving taxable income made corporate debt relatively cheap. The rising inflation that started in 1966 increased the tax advantage. The fact that inflation created phantom income in the form of understated depreciation and understated inventory costs in the case of firms using first-in/first-out made additional tax shelters desirable.

5. Recent comforting circumstances

The economic recovery of 1983 suggests that the immediacy of the treat of corporate debt has abated somewhat. There have been substantial decreases in inflation and interest rates have moderated. As measured by the Consumer Price Index, the inflation rate has declined from 16% in 1980 to 4% in 1983 [17]. As measured by the GNP deflator, the inflation rate has declined over the period from 11 to 4% [18]. This lower inflation rate indicates that the subsidy effect available to corporations through interest deductibility should decline significantly. Interest rates, as measured by the prime rate charged by banks, also fell from 20.5% in July 1981 to 10.5% in February 1983 [19]. The decline in interest rates should improve corporate interest coverage ratios and enable firms presently engaging in speculative financing to avoid any precarious shift to Ponzi financing. Furthermore, the decline in interest rates should be associated with decreased volatility and a return of investor preference to longer term fixed income and equity securities. This shift in preference should give corporations greater flexibility in matching terms of debt financing with the useful lives of assets purchased. Finally, longer maturity periods will mean less frequent turnover of debt and consequently a lesser use of resources in the financial sector.

Another encouraging aspect of the economic recovery is that corporations have improved their liquidity ratios [20]. The capacity of corporations to generate funds internally will alleviate the need for business borrowing in 1984.

A final positive factor is that U.S. industry by November 1983 was operating at 79.4% of capacity compared with a rate of under 70% a year earlier [21]. As capacity utilization rates increase there will be concurrent increases in the demand for fuel, including oil. Nevertheless, to the extent that it appears that the present surplus of oil will continue into 1984, the pressure on prices will be downward [22]. As a result, increased demand for this resource may not have a significant inflationary impact.

6. Conclusion

While it may be argued that recent developments have improved corporate financial health somewhat, the fact remains that in the last decade there have
been significant increases in the debt-equity ratio, and increases in interest rates, as well as a shortening in the maturity of corporate debt. All of these factors contributed to a decline in the financial health of corporations from which they have not fully recovered. Consequently, there has been an increase in the probability of default of individual firms, and of serious financial consequences to the economy as a whole. That is undeniable. Even absent an increase in the interest rates, an increase in corporate debt increases the probability of default and of serious consequences to the economy as a whole. An increase in interest rates accentuates that probability of corporate default. This is especially true if there is not a commensurate increase in earnings. The decline in the maturity of corporate debt clearly increases the corporate roll-over risk and evidences a further decline in the financial health of corporations.

Given the fragility of the financial system, the deterioration of corporate financial strength is indeed worrisome. The need for concern is somewhat lessened by the improvements in the world economy in the current recovery. There remains, however, the very real probability that the magnitude of U.S. deficits may eventually threaten that recovery. In 1983, the U.S. budget deficit reached $195 billion or 6.2% of GNP [23]. By comparison, the deficit in 1973 of $8 billion represented only 0.6% of GNP [24]. Interest payments alone on the current deficit will amount to approximately $20 billion per year [25].

The deficit threatens to be a direct factor in increasing interest rates by adding to the demand for funds. Furthermore, insofar as it is an inflationary force, it may induce a monetarist response which would drive interest rates up again with a net effect of world economic stagnation. This stagnation would undermine the ability of the LDCs to service their debt, which in turn would undermine the ability of banks to survive. A series of corporate bankruptcies would result that would feed on the links interlocking the world's banking system.

This is a very pessimistic view of the world economy. While excessive pessimism is unwarranted, the scenario described above is a very real possibility. The fact that corporate financial health and the worldwide financial system have become fragile, however, does not make collapse inevitable. There is still time to repair the system.
Notes


[10] It is not always recognized that as a consequence, reported corporate income is understated to the extent there are such "interest" charges against income.


[12] Id.

[13] Id.

[14] A positive yield curve in a high interest rate environment is a dismal prospect. It could mean that the community has lost faith in the ability of the country to keep inflation under control.


[16] Two things should be noted about internal funds. The decline seems to have bottomed out in the early 1970s and the availability of such funds has been drifting upward since. The second is that these figures are deceptive. Internal funds are generally considered the summation of profits retained and depreciation. The figures one looks at are generally accounting profits. Accounting profits can be exaggerated if adequate allowance for depreciation is not made. To the extent that is the case, however, the depreciation component is depressed. Internal funds are essentially an approximation of the operating cash flows that are generated. While we may quarrel about the way to divide those cash flows into profits and depreciation, the accounting problems do not appear to affect the total of the two. However, that is deceptive. An inadequate allowance for depreciation exaggerates taxable profits and taxes are paid on so-called phantom profits. The aggregate cash flow consisting of depreciation and net profit before taxes is not affected by the improper measure of depreciation, but the share going to the government is affected. The portion going to the government depends upon the measurement of depreciation. While depreciating only original cost may constitute inadequate deductions in times of inflation, the acceleration of depreciation may more than make up for it. It is, therefore, not clear whether depreciation allowances contribute to an understatement or an overstatement of income. As noted, however, the deduction of "interest" when the rates reflect inflation may result in an understatement of income.


[18] Id.

[19] Standard and Poor's Statistical Service, Standard and Poor's Corp., Basic Statistics:


[24] Id.

[25] Id.

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