LABOR CENTER REPORTER

UNIVERSITY OF CALIFORNIA, BERKELEY
CENTER FOR LABOR RESEARCH AND EDUCATION
INSTITUTE OF INDUSTRIAL RELATIONS
BERKELEY, CA 94720
(415) 642-0323

Number 6
January 1980

ANOTHER MONETARY SQUEEZE

The Fed's Recent Actions

In response to a major international crisis of confidence in the dollar, the Federal Reserve Board announced last October 6 its intention to clamp down tightly on the rate of growth of the nation's money supply. As the principal architect of monetary policy in the United States, the Fed has the power either to increase or to decrease the amount of money in circulation. This in turn affects the amount and the price of money available for consumer loans and business investments. The Fed often undertakes policy actions to affect the money supply, but what makes the October actions particularly noteworthy is the dramatic publicity surrounding a sharp change in monetary policy.

In a rare Saturday evening news conference, Federal Reserve Chairman Paul Volcker signalled his firm resolve to combat inflation, for which he has since received many accolades from members of the business and banking communities. But others, including trade unionists, have expressed fears about the impact of his inflation-fighting policy on the economy's apparent slide toward recession. Volcker tried to deflect criticism on this count, citing the country's recent economic performance as more robust than had been expected. But new AFL-CIO chief Lane Kirkland has described the Fed's actions as "the wrong move at the wrong time," and has expressed fear that what might have been only a moderate recession will now become a full-blown and serious one.

There can be no doubt that the Fed's moves will have adverse effects on the economy's unemployment rate. Three days after the announcement, the Wall Street Journal reported one economist's forecast that unemployment will reach 7.7% of the U.S. labor force in the second half of 1980. Prior to the Fed announcement, that same economist had anticipated a 6.7% rate at that time.

The current rate hovers around 6%, so it cannot be argued that the Fed was pursuing an expansionary course before its most recent actions. Yet the earlier and somewhat less restrictive policy had failed to put a dent in the double-digit inflation bedeviling the American economy. Some economists are now predicting that the October actions will reduce next year's rate of inflation by 2 points below what it otherwise would have been. While we must be wary of placing too much stock in such economic forecasts (especially given the volatility of the world energy market), what is once again apparent is the familiar tradeoff between inflation and unemployment.

The ultimate choice about which side of the scale to tip is undeniably a political choice. And a political "tug-of-war" may develop as presidential campaigning heats up in the election year of 1980. Supporters of the new policy warn that the Fed must remain firmly resolved in its application of "tight money" if its inflation remedy is to work. Opponents question the validity of this approach because of the great personal and social costs of high unemployment.

2. Mechanics and Consequences of Monetary Policy

How does monetary policy work and what are some of its specific effects on the economy? Most simply, monetary policy refers to the government's plans to expand or contract the supply of money. In the current case of a contracted money supply, spending of all types is restrained, relieving some inflationary pressures. Reduced spending causes a build-up in inventories of unsold goods, and thus restrains the rate at which businesses are prone to raise prices. At the same time, reduced spending translates into a cutback in employment as overall production of goods and services in the economy is reduced.

Economists differ somewhat in their analysis of how or why the constriction in the money supply leads to spending cutbacks. Some claim that rising interest rates, which accompany such policy, raise the price of borrowing money and hence choke off investment spending and credit financed consumer spending. Others focus on the premise that a limited availability of money is primarily responsible for decreased spending. In either case the results are the same. Whether borrowers are less willing or are less able to take out new loans, overall spending will decline. When loans are expensive or simply unavailable, some businesses will fail to undertake investments and production will be cut back. First there will be fewer jobs and then there will be less consumer spending due to lost incomes. At the same time, consumers find it more difficult to obtain credit, and so consumer spending is further restricted.

Particularly hard hit by tight money is the construction industry, since the cost and availability of mortgages is so sensitive to swings in the money supply. The resulting slowdown in new housing construction sends many construction workers to the unemployment lines. Even local governments' borrowing--and spending--is crimped, and when business people start competing with governments for scarce credit, calls for reduced government budgets tend to become all the louder.

3. What's Ahead?

Immediately after the October announcement, observers were predicting that the prime interest rate would rise to 15% by early 1980, and were speaking of the hardships that we were going to have to endure in the fight against inflation. But as of this writing, the rate at which banks lend to their best corporate customers is already at 15-1/4%, having surged even higher before retreating a bit. Bankers have noted a moderation in the demand for loans and are themselves screening borrowers more closely in anticipation of the coming recession. The unemployment rate was down slightly in November, surprising everyone, but will now begin to inch up from its already high level. The Wall Street Journal reports the general conviction of economy watchers that "credit will become scarce enough and the economy troubled enough to drag inflation out of its terrible teens."

In the post-World War II American economy, restrictive monetary policy has often preceded recessions which have thrown many Americans out of work and restrained the "bargaining power" of those hanging on to their jobs. Most of these recessions have followed periods of what might legitimately be called "economic prosperity." But in the most recent "recovery to prosperity," the average real hourly wages and weekly earnings of American workers never returned to the peaks from which they had fallen during the last recession. And they are now falling once again.

Speaking recently to a group of bankers, Chairman Volcker vowed that the Fed would continue to push up interest rates and restrict credit "until everybody starts hurting." But one doubts that it is amongst this audience that the real "hurting" will be felt.

Sean Flaherty

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