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Domestic Credit by Richard Freeman

Consumption cuts throttle recovery

Volcker's policies have slashed incomes—and productivity. His defenders call for more of the same.

The sharp drop in individual consumption since the initiation of the credit squeeze pulled on the U.S. economy in October 1979 by Federal Reserve chairman Paul Volcker precludes any U.S. recovery based on reducing consumption, contrary to lower Manhattan's consensus.

The drop in consumption over the past nine months is far steeper than any economic commentator would like to admit, and takes far more out of the economy's purchasing power than it can afford to sustain. According to the June *Survey of Current Business* published by the U.S. Commerce Department, the drop in inflation-adjusted wages and salary disbursements was truly stupendous. Rarely has it dropped this far so quickly.

Between November 1979—one month after Volcker announced his interest rate policy—and May 1980, the wage and salary bill for the entire economy rose from $1.271 billion to $1.306 billion, an annualized rate of 4.7 percent. The rise in wage disbursements for goods-producing workers from $446.5 billion to $453.7 billion was 2.8 percent. However, during this period, the rate of inflation, as measured by the Consumer Price Index, was clocked at 15 percent. This means that the living standard of wage and salary earners in general fell by 10.3 percent, and the living standard of goods-producing workers fell even more steeply at a 12.2 percent rate. The increase in unemployment benefits offset this income decline, but only marginally, as the total net increase in all types of transfer payments during the second quarter was only $5.5 billion, a relative drop in the bucket.

Moreover, the nominal wage bill of income earners rose, and pushed them into higher tax brackets, gouging an additional 1 to 2 percent from paychecks. For goods-producing workers this brings the drop in living standards for the period to between 13.2 to 14.2 percent. Consumer installment credit turned negative by April; consumers could not offset their wage loss through increased borrowings.

There is no reason to believe that the consumption picture improved in June or July. Wage earners have experienced a 13.2 to 14.2 percent cutback in nine months.

It can hardly be expected that continued reduction in consumer goods production and the overall consumption level of the U.S. population until at least late 1981—another 18 months of cuts—will generate a recovery. Yet this perspective is now proposed by the Carter administration, the Reagan campaign, and the Federal Reserve.

The shapers of a consumption-cut based recovery have what they imagine to be a production-led recovery in mind. One advocate privately mentions the Soviet example, where consumption was kept low to feed the growth of producer goods! This analogy is totally grotesque applied to the U.S., the world's richest, most industrialized nation. In any case, the Soviets have always invested heavily in such intangibles as education, while Carter, Volcker and Reagan plan to slash or freeze education budget expenditures. Second, as indicated in the Aug. 11 issue of *Business Week* in its cover story, "The New Defense Posture: Missiles, Missiles, Missiles," it is thought by some U.S. consumption-cut strategists that investment in basic U.S. industries such as steel can be bypassed. This is wishful thinking the Soviets would never engage in.

The basic truth of the matter is that attempting to build up the U.S. investment fund by 18 months or longer of further consumption cuts is economic lunacy, especially when other options exist to generate new investment funds. Indeed, the U.S. recovery of a fundamental sort is only as good as its basic commitment to the technological upgrading of the workforce and its standard of living.

Perhaps the most characteristic expression of the consumption-cut perspective came in the Aug. 4 newsletter of Manufacturer's Hanover Bank, which stated that though U.S. productivity plummeted by 3.2 percent in the second quarter, and has been half the rate of other industrial countries over the last decade, the U.S. can boast that its unit labor costs have increased at a lower rate than other countries, and that has given the U.S. international competitiveness. The notion that the falling wage rate directly contributes to the falling productivity never crossed the writer's mind.

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