When Volcker Ruled

Lessons from the man who led the U.S. through four decades of economic storms

Volcker: The Triumph of Persistence
By William L. Silber
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BY JOHN B. TAYLOR

WHOEVER WINS the election in November, high on the president's agenda must be the task of reviving a flagging economy. Just as important as figuring out what to do will be actually making it happen—getting something done despite the inevitable obstacles and infighting.

William Silber's "Volcker: The Triumph of Persistence" thus comes at the perfect time, for Paul Volcker is one of those rare Washington figures who know how to think shrewdly about the economy and also how to make broad intentions into hard political realities. As Treasury undersecretary and as Fed chairman in the 1970s and 1980s, he got very big things done indeed. Mr. Silber offers fascinating subplots and revelations along the way—not to mention a portrait of a tough and colorful man—but his main storyline concerns two of the most dramatic-policy changes in economic history, one international, the other domestic. Mr. Volcker played a key role in both.

At the end of World War II, the major world economies had entered into the so-called Bretton Woods system, tying the value of major currencies to the dollar even as the dollar itself remained tied to gold. It was a system of fixed exchange rates, and it simply could not last, especially when inflation started to erode the value of dollar in the late 1960s and early 1970s.

On Sunday evening, Aug. 15, 1971, President Richard Nixon announced that the United States would no longer sell gold to other governments at $35 per ounce—the dollar would no longer be convertible into gold at all. Although no one quite realized it at the time, the era of fixed change rates was over. In memos and briefing books, Mr. Volcker, an undersecretary at Treasury, had been arguing for an end to gold temporary inflationary effects from untethering the dollar from gold.

The freeze, though, was an extreme measure, at odds with economic logic, and it took policy in a highly interventionist and damaging direction. George Shultz, then heading up the Office of Management and Budget, had argued against such controls but had lost the battle. It is indicative of how quickly Nixon was veering away from free-market principles that, when the president told Connally to brief Mr. Shultz on the plan, he added: "Tell Shultz that he cannot talk with Milton Friedman."

At that time no one knew what exactly would replace the Bretton Woods system. In December 1971, the U.S. and other countries agreed to continue with fixed exchange rates, with a somewhat devalued dollar, but the agreement quickly fell apart. Soon it became clear that a completely new international monetary system was needed. What would it look like?

Answering that question was Treasury's great task when Mr. Shultz replaced Connally as secretary in May 1972, with Mr. Volcker remaining as undersecretary, responsible for international monetary issues. Mr. Shultz had long been in favor of a flexible exchange-rate system of the kind that Milton Friedman had advocated, in which the value of foreign currencies in terms of the dollar floated as determined by the forces of supply and demand. Mr. Volcker, with his experience in international policy circles, was more skeptical. He worried that, if rates were allowed to fluctuate, speculating traders would destabilize markets. When Mr. Schulz arrived at Treasury, Mr. Silber writes, "nothing could have been more threatening to Volcker, except perhaps if Milton Friedman himself had set up a classroom inside the Treasury Building."

> The mind behind Nixon's move off the gold standard; the hand that kept interest rates high to whip inflation.

Mr. Silber goes on to describe the first conversation between Mr. Shultz and Mr. Volcker about Treasury's plans for reforming the international monetary system. Mr. Volcker confessed to the secretary that, when it came to drawing up plans ahead of a big September meeting of the International Monetary Fund, "we're not that far along." Mr. Shultz pressed him to get going. "Are there any guidelines?" Mr. Volcker asked. "Yes," Mr. Schultz replied, "something that has a chance to work."

So Mr. Volcker went to work that summer of 1972. The eventual plan—called "Volcker's plan X" in Mr. Silber's chronicle—involved a mix of flexible and fixed exchange rates. Countries with trade deficits would regularly lower the value of their currency, and countries with trade surpluses would regularly raise theirs. As an incentive, the U.S. would allow countries that were willing to work within this new system to convert their dollars into gold. Mr. Volcker got support for the plan from other members in the administration. Mr. Silber writes that Mr. Shultz accepted the plan and thus rejected Milton Friedman's call for a system of flexible exchange rates. "Shultz put his Chicago colleague's proposal on the back burner," Mr. Silber writes.

As it happens, I have recently been talking to Mr. Schultz (a colleague of mine at Stanford's Hoover Institution) about his experiences in Washington, as part of a research project of my own. He has a different memory of this hinge moment. What Mr. Silber calls Plan X, Mr. Schultz says, was in fact Milton Friedman's idea, not Mr. Volcker's. The purpose of the plan was to get our European and Japanese trading partners—accustomed to fixed rates—to warm up to the idea of exchange rates moving regularly. Mr. Shultz describes circulating his IMF speech to his European colleagues in advance to get their input and, ultimately, their buy-in. His aim was to build a consensus without seeming to impose an American "solution" on everyone else.

Regardless of whose idea Plan X was, it was a reform strategy—and it worked. Almost exactly as scripted, the skeptical and reluctant Europeans themselves ended up broaching the

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idea of moving toward a flexible exchange-rate system. In March 1973, at a meeting in Paris, Helmut Schmidt, then the German finance minister, raised the possibility of a joint European float against the dollar. He asked Mr. Shultz how the U.S. would respond. Mr. Shultz replied with diplomatic understatement: "It is something we would consider sympathetically."

And so the course of economic history was changed. The fixed-rate system that had governed the global economy since the end of World War II, but that fell apart because of its own rigidity, was replaced by a system in which exchange rates were free to adjust and thereby help insulate countries from policy mistakes and other shocks from abroad. And these benefits were not offset, as some had feared, by massive speculation and turbulence in the markets for foreign exchange.

Even as the major world economies were figuring out a new way of managing their currency relations, the American economy was heading into a period of crisis—and here, again, Mr. Volcker helped to guide a momentous change. By the late 1970s, inflation and unemployment in the U.S. were rising while economic growth and the dollar were falling. The problem of stagflation, as it was called, seemed insoluble. Confidence in the American economy was waning everywhere. In July 1979, President Jimmy Carter appointed Mr. Volcker as chairman of the Fed.

At first, the appointment was well-received by the financial markets. Mr. Volcker's record at Treasury was well-known, and he openly questioned the academic view—defied by the persistence of stagflation itself—that a higher inflation rate would lower unemployment. Mr. Volcker clearly wanted lower inflation, and he knew that a tighter monetary policy was the way to do it. But the markets soon lost confidence in his leadership. On Sept. 18, 1979, he nearly lost on a decision of the Federal Reserve Board to raise the discount rate by 50 basis points—the vote was 4 to 3. The close vote raised doubts about his ability to lead the Fed to change its inflationary ways.

As Mr. Silber shows, Mr. Volcker decided to go on the offensive, though diplomatically. He worked with the Fed's staff to design a new strategy that, if presented properly, might win support among the Fed's governors and its district bank presidents. Its key ingredients were a full percentage-point jump in the discount rate; new reserve requirements on large banks to reduce the growth of credit; and, crucially, a new "operating procedure" for the Fed that would focus on reducing money growth and thus bringing down the rate of inflation. His approach to selling the strategy was similar to the way the new international exchange-rate system was sold by Mr. Shultz a few years before.

According to Mr. Silber, "Volcker recalled his admiration for former Secretary George Shultz, who built a consensus for floating exchange rates with an evenhanded approach, suppressing his preferences to promote an exchange of views. The crisis atmosphere encouraged Volcker to follow suit." After Mr. Volcker laid out the strategy to his colleagues on the Federal Open Market Committee, he announced that he was prepared "to go with whichever way the consensus wants to go as long as the program is strong." He won the unanimous support and buy-in of every member of the Federal Reserve Board. The new policy was announced Oct. 6, 1979.

Angry, idle laborers sent two-by-fours to his office, but Volcker kept interest rates high to slow inflation.

The shift to money-growth targets allowed Mr. Volcker to say that it was the market rather than the Fed that determined the short-term interest rate. Thus he could allow the rate to go higher than it otherwise might by normal Fed procedures, though Mr. Silber reports that Mr. Volker "denied the premise" behind this rationale. (I have to say: He didn't always deny it. I recall a conversation, several years later, in which James Tobin, the Nobel laureate, asked Mr. Volcker why he didn't just lower the interest rate at a certain point, and Mr. Volcker answered that he didn't set interest rates; the market did.)

The high interest rates in the late 1970s and early 1980s—Mr. Volcker continued at the Fed after Ronald Reagan's took office in 1981—slowed the economy for a while, casting doubt on the new strategy. But Mr. Volcker showed fortitude and, yes, persistence.

When the construction industry sent two-by-fours to his office and farmers circled the Fed in Washington, he stuck with the policy. When asked on CBS's "Face the Nation" if he would stop fighting inflation and start fighting unemployment, he answered that he could not stop fighting inflation.

There is some suggestion in Mr. Silber's book, based on the comments of a few White House advisers, that Mr. Volcker did not have the support of President Reagan in his disinflation efforts. But Milton Friedman and Mr. Shultz both said in interviews that Reagan was highly supportive. In any case, the effort paid off: Inflation slowed dramatically and created an economic environment that made possible 25 years of strong and steady economic growth.

Toward the end of "Volcker: The Triumph of Persistence," Mr. Silber tells us that Mr. Volcker nearly became Treasury secretary in the administration of Barack Obama but instead became an outside adviser, though one with enough clout to make the "Volcker rule" a part of the 2010 Dodd-Frank law, curtailing banks from trading securities on their own behalf. It is clear that, even so, the power of an outsider is limited. As we can see from the stories of Mr. Volcker's earlier work, actually implementing major change must come from the inside.

And major change is now needed. The American economy is doing poorly. The federal deficit remains large. The federal debt is soaring, and the Federal Reserve itself is buying huge amounts of this debt (77% in the last fiscal year). A reckoning is due.

The economic answers are as simple as they were in Mr. Volcker's time in office: Get back to sound and predictable fiscal and monetary policy. Though there is a cacophony of views about how to proceed, the differences are no greater than they were when a new monetary system was established in the early 1970s or when American monetary policy changed for the better in the late 1970s and early 1980s. The job today is to forge a consensus and put the needed reforms in place. The experience of Paul Volcker and his colleagues, so compellingly chronicled in this book, shows the way.

Mr. Taylor, a professor at Stanford, a senior fellow at the Hoover Institution and a former Treasury undersecretary for international affairs, is the author of "First Principles: Five Keys to Restoring America's Prosperity."