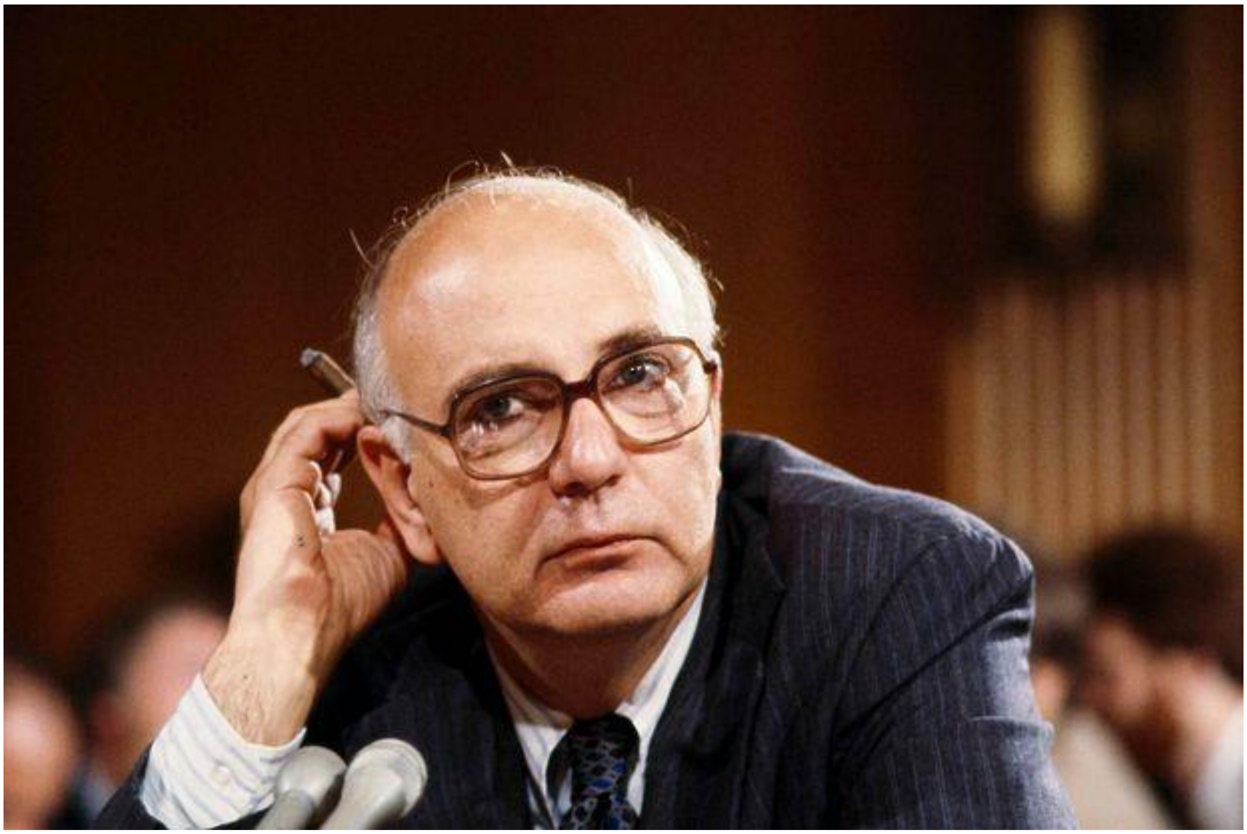
A Remembrance: The Pragmatism of Paul Volcker

The former Fed chairman died Sunday at his home at 92 years old



Paul Volcker appears before the Senate Committee on Banking, Housing and Urbans Affairs in 1979. Photo: Charles Harrity/Associated Press

By
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Dec. 9, 2019 4:48 pm ET

When I started covering the Federal Reserve in 2001, Paul Volcker had long since left the building, and yet he was everywhere. Every time he spoke, he made news.

Troubled organizations tapped him when they needed a fixer whose personal integrity and moral clarity were beyond reproach. In 2008, President-elect Barack Obama appointed him head of his outside economic advisory board. His successors regularly paid him homage for defeating

Yet for all the respect Mr. Volcker commanded up until his death Sunday, on the big macroeconomic issues of the day—inflation, government deficits, bank bailouts—his successors treated him as a hawkish anachronism.

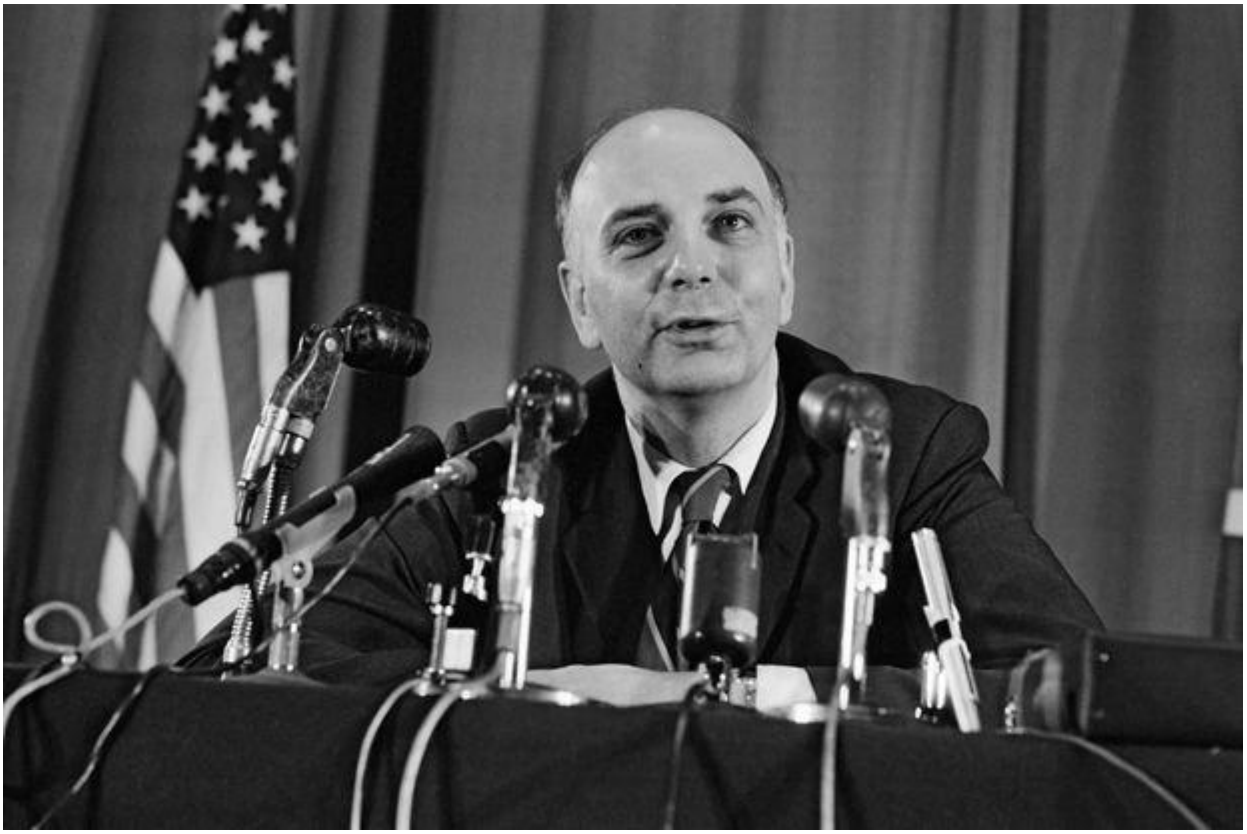
When the Fed engineered the bailout of Bear Stearns at the start of the financial crisis in 2008, Mr. Volcker criticized it for going to “the very edge of its lawful and implied power, transcending certain long-embedded central banking principles and practices.” Undeterred, the Fed went on to do even bigger bailouts.

When the Fed began targeting 2% inflation in part to keep it from going too low, Mr. Volcker was dismissive: “I don’t get it,” he said in 2009. The Fed is “telling people in a generation they’re going to be losing half their purchasing power.” The Fed went on to initiate ever more aggressive programs to bolster the economy and keep inflation from slipping.

As federal deficits exploded, he joined dozens of other former policy makers and politicians to warn of a “debt-driven crisis.” The federal debt has continued to climb ever since, and crisis has yet to come.

The disapproval was understandable from a man who drove interest rates almost to 20% to slay double-digit inflation in the face of soaring unemployment and popular outrage.

Yet a more nuanced review of Mr. Volcker’s government life shows he was less austere and more pragmatic than his reputation—and his own memory, suggest. In fact, he regularly bent or rewrote the rules to cope with the chaos enveloping the world.



Paul Volcker during a 1971 news conference at the U.S. Embassy in London. Photo: Pierre Manevy/Daily Express/Getty Images

In 1971, trade deficits and inflation triggered persistent outflows of gold, threatening the U.S. dollar's peg to the precious metal, the linchpin of Bretton Woods system of managed exchange rates. Mr. Volcker, then undersecretary of the U.S. Treasury, was tasked by President Richard Nixon with closing the gold window.

"I hate to do this," he told then-Fed Chairman Arthur Burns, according to a biography by William Silber. "All my life I have defended Bretton Woods, but I think it's needed…we cannot continue this way." The move ushered in an era of floating and at times wildly volatile exchange rates that continues to this day.

Upon assuming the Fed chairmanship in 1979, Mr. Volcker sought creative ways to defeat inflation, and decided to target the money supply. That led to wild gyrations in interest rates and two recessions in short order that devastated the economy. In 1982, he began slashing rates even though inflation was still in high single digits.

Vincent Reinhart, a longtime top Fed staffer who is now chief economist at Mellon Investment Management, said Mr. Volcker could accept inflation at 4% because he didn't have a formula that defined price stability—it was "a state of mind." More important, he feared high rates were destabilizing the world-financial system. Throughout 1982 he became increasingly worried Mexico would default, imperiling the dozens of big U.S. banks that had lent to it. The Fed lent to Mexico to cover up its shrinking foreign currency reserves, and Mr. Volcker arranged meetings between Mexico and its creditors. They agreed to reschedule its debts, avoiding loan write-downs that could have rendered some insolvent.

Federal Reserve Board Chairman Paul Volcker, right, meets with President Ronald Reagan in the Oval Office in 1981. Photo: J. Scott Applewhite/Associated Press

Two years later, crisis loomed again when Continental Illinois, then the country's seventh largest bank, teetered on collapse because of risky corporate loans, especially in energy, and dependence on skittish, uninsured deposits. Mr. Volcker worried that if Continental Illinois failed, depositors would flee other big banks in similar circumstances. So the Fed lent to Continental Illinois and the Federal Deposit Insurance Corp. bailed out its uninsured depositors. The FDIC ended up taking over the bank altogether. The episode prompted a congressman to coin the term, "too big to fail."

In 1989, two years after stepping down from the Fed, Mr. Volcker attended a conference of economists in Cambridge, Mass., on financial crises. Mr. Volcker warned the attendees that policy makers, by repeatedly intervening, could be "reinforcing the behavior patterns that aggravate the risk in the first place." Then, revealing how he felt torn between the urgency to act and the avoidance of moral hazard, he related that as head of the Fed's New York district back in the 1970s, "I often said to myself, 'What this country needs to shake us up and give us a little discipline is a good bank failure. But please, God, not in my district.'"

In 2013, while researching “Foolproof,” my book about crises and risk, I visited Mr. Volcker in New York, and asked him about that remark. He replied with a smile: That “was just a confession of my personal weakness.”

It was actually a reflection of his pragmatism, a recognition that the merits of austerity and moral hazard look different inside the central bank from outside. Which leads me to believe that, for all his public disapproval, if Mr. Volcker had been running the Fed for the past 10 years, he would have made many of the same decisions his successors did.

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