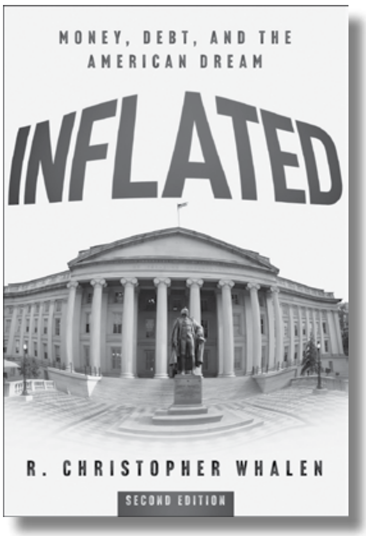
THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
www.international-economy.com
editor@international-economy.com

Shock Treatment



An excerpt from
Inflated: Money, Debt and the American Dream
by R. Christopher Whalen (Wiley, second edition, 2025).

The actions of a great man.

Fed Chair Paul Volcker, a self-described "Brooklyn Democrat," was born in Cape May, New Jersey, and grew up in Teaneck. He was appointed by President Jimmy Carter at the end of his term in 1979 and inherited by Ronald Reagan, a converted Democrat and former labor leader and California governor. Reagan understood the connection between money and inflation.

During a talk to the Prosperity Caucus in Washington in the early 1990s, syndicated columnist Robert Novak revealed that Reagan's favorite economist was Frédéric Bastiat, a nineteenth-century French economic philosopher and author of *The Law.* It was the fact of inflation that led to the defeat of both Gerald Ford and Jimmy Carter, and created groundwork for the election of Ronald Reagan. Years later, in 2024, inflation was the leading issue with voters still.

By October 1979, the United States was facing its most serious economic crisis in generations. Inflation was rising and the dollar was falling. Saudi Arabia's finance minister said that his country was considering new cutbacks in oil production because of the eroding value of the dollar. Wall Street welcomed the appointment of Volcker, but the honeymoon would be especially short for the economist from New Jersey.

As Volcker moved from New York to Washington, statisticians at the Labor Department confirmed that over the previous six months the United States experienced the steepest spiral of inflation in nearly thirty years. But more disturbing were the comments seen more and more in the media, and in the political discourse, of a nation living on accumulated wealth. Concerns about foreign trade and offshore competition were growing especially sharp in Washington during this period and increased in the 1980s.

R. Christopher Whalen is Chairman of Whalen Global Advisors.

In 1979 with the Iranian hostage crisis as a backdrop, Americans worried about losing their economic edge in the world; that the situation might be too far gone to correct. The income of the average American household doubled during the 1970s, but real purchasing power had risen only one-tenth that amount. For many Americans, the reality of the two-income household was already becoming the norm.

The inflation of the dollar was widely seen as the villain in the global economic bust, which had seen a series of mini crises erupt after the Nixon decision to close the gold window at the Treasury in 1971.

The dollar slid dramatically over the decade prior to the appointment of Paul Volcker as Fed chairman. He had been deeply involved in managing the process, first at Treasury and then at the Fed of New York. Bringing Volcker to Washington to lead the Federal Reserve Board was the perfect move at the right time, but one that occurred only because of the intervention of a number of people, including Tony Solomon. Roger Kubarych relates how Solomon, who served in the Treasury as undersecretary for monetary affairs, was tasked by [Treasury Secretary] Mike Blumenthal and [Council of Economic Advisers Chair] Charlie Schultze to convince Jimmy Carter to appoint Volcker to the Fed. Solomon succeeded and took over from Volcker as president of the Fed of New York, a fitting culmination to a remarkable career of public service.

The actions of the Volcker FOMC marked the effective nationalization of the private market for overnight bank reserves, also known as "federal funds."

The Volcker appointment also allowed President Carter to replace Treasury Secretary Michael Blumenthal with Fed Chairman [G. William] Miller, an arrangement that far better fit the latter's talents, including leading the federal bailout for Chrysler. Miller was better suited for politics than the world of the central bank, which in those days was seen as being "above politics." This meant, of course, that the Fed was entirely political, but in a nonconfrontational way. Miller was far too honest and direct for the world of central banking. Volcker, on the other hand, was an economist from New Jersey who had worked for Chase Bank. He knew how to behave in public—namely, to be vague, noncommittal, and inoffensive in a political sense.

Volcker needed all of his considerable credibility to convince the world that the United States had not lost its way. Since 1971, foreign nations had accumulated tens of billions of dollars in offshore deposits—Eurodollars—and they were anxious about further erosion in value. As already noted, under Fed chairmen like [Arthur] Burns and even [William McChesney] Martin, the Fed had responded to political pressure to lean in favor or ease at critical periods. Volcker had to do the opposite and govern monetary policy by a clearer set of rules in order to help the U.S. Treasury and the dollar regain the respect of the world markets.

In late August 1979, the Federal Open Market Committee raised the federal funds rate from 10 percent to 10.5 percent, a record. The Fed continued to keep policy tight, driving the U.S. economy into recession in 1980. The Fed paused in its efforts to throttle inflation prior to the 1980 election, but when prices again started to rise—by now inflation was 1 percent per month and mounting—Volcker

Continued on page 64

American Hero

Fed Chair **Paul Volcker**

Fed Chair Paul Volcker needed all of his considerable credibility to convince the world that the United States had not lost its way. Since 1971, foreign nations had accumulated tens of billions of dollars in offshore deposits—Eurodollars—and they were anxious about further erosion in value. As already noted, under Fed chairmen like [Arthur] Burns and even [William McChesney] Martin, the Fed had responded to political pressure to lean in favor or ease at critical periods. Volcker had to do the opposite and govern monetary policy by a clearer set of rules in order to help the U.S. Treasury and the dollar regain the respect of the world markets.

—R.C. Whalen

Continued from page 49

and the Federal Open Market Committee took U.S. interest rates up until the federal funds rate almost reached 20 percent. Yet in addition to fighting inflation, the actions of the Volcker FOMC marked the effective nationalization of the private market for overnight bank reserves, also known as “federal funds.”

Noted economist Frederic Mishkin made an important comment about Paul Volcker in the *Financial Times* in a September 2022 opinion piece. The former Fed chairman and president of the Federal Reserve Bank of New York was both a good economist and an astute politician. Truth is, every Fed chief since Governor Charles Hamlin needed to consider political trends and events, but especially since the end of World War II. Mishkin wrote:

> *Paul Volcker is considered to be a GOAT (greatest of all time) central banker because he and the U.S. Federal Reserve broke the back of inflation in the early 1980s. However, less talked about is the serious policy mistake that the Volcker Fed made in 1980. The result was a more prolonged period of high inflation that required even tighter monetary policy, which then resulted in the most severe U.S. recession since the second world war up to that time.*

Volcker and the FOMC in 1980–1981 put the U.S. economy into a wrenching recession that would see unemployment soar into double digits.

The fateful mistake Mishkin describes was the decision by the Federal Open Market Committee to reduce interest rates in May 1980 even though inflation was still rising, a situation not unlike 2001. “This action was taken despite the fact that inflation reached a peak of 14.7 percent in April,” Mishkin recalls nearly half a century later. Fact is, Paul Volcker blinked and Ronald Reagan won the White House in 1980.

By dropping interest rates, the Federal Open Market Committee seemingly helped President Jimmy Carter, a fellow Democrat, but in fact the election of Ronald Reagan was already done by midyear. Inflation-related interest rate hikes over the previous year and the Iran hostage crisis had sealed Carter’s fate. Volcker knew that Reagan was the likely winner, in large part because of the political advice he received from Richard Whalen, who had been a confidant and speech writer for Reagan going back to 1976 and for candidate Richard Nixon before that. He also remained a loyal friend and political confidant to Volcker and his successor, Alan Greenspan.

Independent or not, Volcker and the Federal Open Market Committee in 1980–1981 put the U.S. economy into a wrenching recession that would see unemployment soar into double digits. In heartland manufacturing states such as Indiana, Michigan, and Illinois, joblessness reached into the teens. The U.S. economy was mired in recession for three years. This illustrated the level of adjustment that the two oil price increases of the decade, 1973 and 1979, required literally to squeeze the inflation out of the system.

In a 1982 memo from Paul Krugman and Larry Summers, who were both then working in the Reagan White House, to William Poole and Martin Feldstein on the White House Council of Economic Advisers, the two economists predicted that inflation would again begin to accelerate because the reduction in inflation engineered by the Fed was only temporary. But Summers, Krugman, and many other liberal economists were wrong about inflation.

The inflation of the dollar was widely seen as the villain in the global economic bust, which had seen a series of mini crises erupt after the Nixon decision to close the gold window in 1971.

The relentless rate squeeze by the Fed and a lot of positively coincidental and mostly external trends broke the inflation in the United States, but did not really instill fiscal sobriety. Paul Volcker broke the momentum of inflation and also took sufficient demand out of the economy to give the crucial impression of price stability for a short time. ◆