FORTUNE

3 Lessons for Today's Economy from Former Fed Chair Paul Volcker's Long and Storied Career

Erik Sherman

December 10, 2019

Paul Volcker's death closed the career of an unusually influential, important—and controversial—economist.

His role in finally ending the use of the gold standard during the Nixon administration still leaves some disgruntled. Millions still resent the double-digit interest rates and runaway inflation they were meant to stop of the 1980s when he was chairman of the Federal Reserve. Many bankers have pushed for years to weaken the Volcker Rule that put limits on the risky transactions commercial banks could undertake and whose development he oversaw for the Obama administration.

But a review of Volcker's record—as Nixon administration official, Fed chair, and economic éminence grise—illuminate three important lessons financial policy makers would be wise to heed.

In 1973, Volcker was Treasury undersecretary of international monetary affairs for Richard Nixon. The world had been on the gold standard streaks, cautioned by the hyperinflation that followed World War I after countries freely printed money to pay for the conflict. Under the Bretton Woods agreement of 1944, the U.S. dollar, tied to the value of gold, became the global currency the central banks of countries set fixed currency exchange rates.

However, the arrangement came with problems. "Having a fixed exchange rate system worked against markets," because they couldn't readily adjust to new conditions, says Jeffrey Bergstrand, a finance professor at the University of Notre Dame's Mendoza College of Business and former Federal Reserve economist.

In the 1960s and 1970s, as Japan, France, and Germany regained their economic strength after World War II, standards of living rose, which should have driven an upward appreciation of their currencies. The higher currency values would then have attracted more investment and allowed additional growth.

Although countries periodically met to modify the exchange rates, there was insufficient regular flexibility. "The dollar came under pressure because it was essentially overvalued," Bergstrand says. Imports were unnecessarily inexpensive and U.S. exports were too costly to be competitive.

To brace and improve the U.S. economy, it was necessary to consider the global one. Other countries needed the freedom to be fiscally stronger. By pushing for an end to the Bretten Woods agreement, Volcker realized countries couldn't live in economic isolation and that prudence required all to be able to thrive.

The end of Bretton Woods did not ensure a golden economic age. Volcker faced massive challenges when Jimmy Carter nominated him to become Fed chairman in 1979. Stock markets hadn't gained in a dozen years, inflation rose from 5% to 13.3%. After-inflation returns on bonds dropped to an annual 3% loss. The dollar was weak and then OPEC drove up the price of oil.

There was an irony because removal of the gold standard allowed what came next. "Paul Volcker played key roles both in allowing the inflation of the 1970s to begin and in bringing price increases under control," says Gary Richardson, professor of economics at the University of California, Irvine and former Federal Reserve System historian.

That happened through the most extreme increases in Fed interest rates ever seen. Rates eventually topped out at 20%. "Volcker actually steered the country into a deep recession to bring down prices and stamp out the notion that consumer prices could just keep rising forever," says Caleb Silver, editor-in-chief at Investopedia. "It wasn't a popular decision, to say the least, but Volcker wasn't afraid to shock the economy using monetary policy in order to bring it back into line."

It was a step that his immediate predecessors hadn't wanted to take. "Several previous Federal chairs failed to do it and claimed that it simply not possible," says George Selgin, director of the Cato Institute's Center for Monetary and Financial Alternatives. "I don't think that Reagan or Carter ever threatened him. But other people in the administration were very unhappy with Volcker. The fact that he took that stand and risked not being reappointed set a very important example for future central bankers. I think that may be his most important legacy, showing that you can stand up to the president, to the administration, and that is now something we expect central bankers to do."

With an eye to higher profits and economic activity, many in business and public policy have frequently pushed to lower regulatory boundaries to the financial services industry. That has made many things—from online commerce to cryptocurrencies—possible.

The drive for progress has also caused potential dangers, as the financial collapse ten years ago showed. After the disaster, during the construction of Dodd-Frank, Volcker has a role developing the eponymous rule that limited the types of investments and risks commercial banks could take. The danger, as he saw it, was that federal insurance could turn the taxpayer into the ultimate backstop for bad decisions that ended in massive losses.

"Commercial banks always have been treated differently, and they should continue to be treated differently from other financial institutions, such as investment banks and hedge funds," Volcker said in a set of Federal Reserve oral history interviews. "The opposing view is, 'No, that's old fashioned. Everybody's a hedge fund now.'"

"That's what the opposition to the Volcker rule said: 'Well, maybe it's a good idea. We'll leave it up to the regulators.' I know what will happen then. [Laughter.] They'll study it and say, 'We haven't had a crisis yet, and we don't have to do it now!' They'll do more and more and more studying. And then, it's, 'Oh, no! Now we've got a crisis. Too late.' [Laughter.] That's the life of a banking regulator."

Volcker was the "honest broker that nearly everyone trusted," which is why he could accomplish what he wanted to, says Kathleen Day, lecturer at the Johns Hopkins Carey School of Business and author of *Broken Bargain: Bankers, Bailouts and the Struggle to Tame Wall Street*.

"People say I'm an old fogey, that I don't know the new world, and so forth," Volcker said in that Fed interview. "I've got an answer to that now. Somebody said to me the other day, 'You know, you remind me of a movie I saw 5 years ago, 10 years ago. The name of the movie was *Back to the Future*. … So that's my slogan: I want to go back to the future."