The Man Who Turned The Tide

By Peter Scholtz
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Back in 1977, Federal Reserve Chairman Arthur Burns continued to be critical of Jimmy Carter's fiscal policies as President. Burns adamantly railed against inflation as the nation's number one economic problem instead of focusing on unemployment. Carter was eyeing re-election in 1980 and worried that tight monetary policy now risked creating a recession leading up to his re-election, a political disaster. Carter felt that Burns had to go when his term expired in March of 1978. The short list of replacements was developed by Vice President Walter Mondale. Only one of the four candidates, Bruce MacLaury, was an economist with Fed experience. Carter announced in December 1977 that G. William Miller, the CEO of Textron, would replace Burns in March as Fed Chairman. The response from capital markets was tepid at best.

Inflation was already over 6% when Miller took office. In hindsight, many believe that Arthur Burn's tough inflation talk was simply that; talk. Miller expressed concern that inflation was the number one problem as well, yet the rhetoric didn't match the actions. The Fed became very passive as the dollar plummeted over 30% against major currencies and inflation started to accelerate. Jimmy Carter couldn't risk a recession and Miller wouldn't let him down. Carter's economic advisors, Charles Schulze and Alfred Kahn, strongly advocated raising interest rates at the April 1979 Fed meeting, but Miller opposed the idea.

In April of 1979, I was at Columbia Business School, taking a course called Federal Reserve Policy. Students in the class would often comment on the rising inflation rate. It crossed 10% and continued up although the Prime rate stayed at 8%, and the federal funds rate was below that. We students thought that we should buy gold and condos, although none of us had any real money to invest. One day after class, we approached our Fed Policy professor to ask, "Why is the Fed so loose with negative (below inflation) interest rates?" He told us he didn't have a clue, but if any of us did, please let him know. What a comment. I felt like running around the halls at school yelling "fire, fire." By graduation of 1979, things continued out of control. Debt creation began to accelerate as consumers tried to front-run the inevitable higher prices. Rumors of Fed researchers imploring the committee to react fell on deaf ears. Miller was known to cut meetings short, ending any debate on critical subjects. Academic protests intensified and Miller was outvoted by the board on an interest rate hike, which was unprecedented. By August, the drumbeat forced Miller to resign, having served as Fed Chairman for less than eighteen months.

My fantasy has always been that the economists then wrestled Jimmy Carter to the ground, threatening him if he didn't appoint the New York Fed President, an expert in global economics, Paul Volcker, as Fed

Chairman. He did and the change was immediate. Under Volcker, interest rates soared and although I knew it would be very painful, it was necessary. The Global Economy was threatened by a potential U.S. economic collapse. Inflation hit mid-teens at one point, but Volker countered, causing short rates to reach the high teens. Money market funds paid 18%. The runaway economy started to nosedive. The Fed immediately started to dramatically lower rates and I thought, "Hey, maybe this isn't so painful." We seemed to have a brief mild recession, but as rates declined, inflation immediately re-accelerated, and the Fed again responded with rapidly raising rates. A double-dip recession was in the works. You can't stop a runaway train on a dime. As rates continued again to climb back to the highs, the economy slipped into the biggest recession since the Great Depression. I knew Volcker would be the most unpopular person in America. He knew it, but had the courage to do the right thing. Once asked how he slept, he said he slept like a baby.

As the unemployment rate increased, the political left started a campaign to do something. Remove Volcker, change the Fed independence, anything. Volcker remained steadfast. Our inflation, tight monetary policy, as well as the recession, were mirrored around the world. Financial politics was being changed as people realized that you cannot undermine the integrity of your currency. The real growth rate during the first quarter of 1983 reached over 9% annualized and we never looked back. In May of 1986, my wife and I attended a Columbia Business School function at the Waldorf Astoria in New York. The venue resembled an opera house and it was a black tie affair. We had balcony seats. Roger Smith, President of GM, was scheduled to speak followed by Paul Volcker. The applause was brief, but polite when Smith spoke. As the tall, lanky Paul Volcker approached the podium, the audience slowly rose to its feet. The ovation lasted a full ten minutes. I had to fight back the tears, unsuccessfully. The man saved the world from total economic collapse, and did so while being hated, isolated and alone.

For the next twenty years, the Fed maintained a sensitivity to the slowly declining inflation rate, tapping on the brakes whenever the pressure built up. By the late nineties, the United States had three years in a row of growth above 4% per year. The world was changed.

In 1994, I went to a brokerage office on Lexington Avenue with my assistant, a block from my office at Citicorp headquarters. A man followed us into the elevator, and I looked in astonishment. "Aren't you Paul Volcker?" I asked. "Who's he?" the man smiled, and I realized of course it was him. "Are you a lawyer?" he asked. "Portfolio Manager," I said, barely able to get the words out. This was my hero, and I acted like a teenage girl next to a rock star. At least I didn't giggle. "How is Greenspan treating you?" he quipped. Greenspan? Thank him, hug him, do something. All I could say was that we were real confused by G. William Miller. He smiled, and got off his floor. His personal office was in the building.

Paul Volcker's passing this past week has special meaning to me. He remained intellectually active to the end. The Volcker Rule shows his endless influence on the financial community. He was strong, humble and lived modestly, a pure public servant. He was my greatest American hero in the post-war period.