The gold standard and Paul Volcker's legacy compared

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Last week I published a note in which some elements of comparison were drawn between the first one hundred days of Franklin D. Roosevelt's presidency and the first one hundred days of the Trump presidency (still to come). The main thrust of that note is that although these two episodes share several features in the economic context of their corresponding times, Trump's agenda could make a significant difference with respect to FDR's when it comes to diplomatic issues.

It was also mentioned that previous to these two men being elected, the American economy was haunted by a long spell of deflation and high unemployment, and that following the election of both men a new wave of changes took (and are taking) place that are likely to revert this trend. This note focuses on a comparison between the state of the U.S. economy previous to the election of FDR and the state of the U.S. economy previous to the election of Donald Trump.

FDR's coming to power was preceded by a stock market crash (1929), four years of economic stagnation, low inflation and high unemployment, whereas Trump's coming to power was preceded by a stock market crash (2008), eight years of sluggish growth (despite the considerable efforts of the Obama administration), low inflation and high but falling unemployment. The remainder of this note focuses on the period previous to the stock-market crashes of 1929 (the gold standard) and 2008 (Paul Volcker's legacy) and draws some parallels.

The gold standard as a monetary system

The gold standard is understood as the informal set of rules[1] that several countries (except Spain and other smaller economies) followed roughly from the mid-twenties to the mid-thirties. Certainly, these countries maintained exchange rates pegged to gold and this is the reason why the system bears its name. However, it must be mentioned from the outset that gold convertibility was *not* the ultimate goal of the system. Its main goal was rather the implementation of the 'rules of the game' of relative currency values among countries exchanging financial assets and physical goods, which ultimately provoked a deflationary bias that favors financial markets at the expense of the real sector[2].

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[1]As compared to the Bretton Woods system, which was a formal set of rules.

[2]One of the reasons why deflation may be good for the financial sector is that, in the absence of inflation, currency values (and thus the value of financial assets) increase, which raises financial profits denominated in the corresponding currency. At the same time, if non-financial firms depend on credit in order to finance investment, deflation makes debts more difficult to reimburse and, as a consequence, firms curtail their investment and lay off workers or replace them with foreign labor or machines.

Clearly, the then emerging superpower (the United States) was a key player in this system, so that the economic policies implemented in this country had repercussions in other countries adhering to the gold standard.

During this inter-war period several economies went 'on' and 'off' gold, but the fact that the two main holders of gold reserves were actually 'on' gold (France and the U.S.) was clearly what mattered most for the system to provoke its own collapse via currency over-valuation and deflation, thus creating the basis for contagion of the Great Depression.

To be sure, "[t]he length and depth of the deflation during the late 1920s and early 1930s strongly suggest a monetary origin [of the Great Depression], and the close correspondence (across space and time) between deflation and nations' adherence to the gold standard shows the power of that system to transmit contractionary monetary shocks" (Bernanke and James, 1991, p. 33).

From the mid-(roaring)-twenties up to the stock-market crash of October 1929, financial markets in Western economies were unusually profitable (at least as compared to the previous two decades) and this, of course, was reinforced by the fact that deflation predominated and, as a consequence of this and other major developments proper of the time[3], financial markets behaved predominantly as *bulls*. Of course, the tragic end of this wave of financial folly was the stock-market crash and the period known as the Great Depression that almost naturally followed.

Modern conventional economic wisdom has it that when a financial crisis hits, private sector agents face major financial problems and thus curtail their spending, and that the government may decide to let the automatic stabilizers[4] activate via debt-financed public spending and/or progressive taxation in order to palliate and eventually solve the crisis. This was, however, not the logic back in 1929. As a consequence, the crisis lasted until April 1933 (at least in the United States), when this was effectively done.

One of the main features of the gold standard was that the economic authorities of the principal economic powers of the time engaged in a deflationary dynamic in order to attract financial investment, this contributed to the crisis and the Depression, and the solution was devaluation, which in turn favored the real side of the economy. If we fast-forward to the present, we see the same pattern in the recent past: a strong preference for financial investment since the early 1980s, a financial crisis comparable to that of 1929, a Great Recession... and now the solution is also a devaluation that gives some breathing space to the real sector.

The deflation-inflation cycle is apparently back on the inflation side and this can have favorable consequences for the real sector. The trouble with that is that this may be associated in the future to a man with a dangerous (and shady) policy agenda.

[3]These developments are elegantly and thoroughly analyzed in Shiller's 2000 book *Irrational Exuberance*.

[4]Automatic stabilizers activate 'automatically' after a crisis by reducing the government's financing capacity. This takes place via a reduction in public receipts (from taxes that troubled firms and unemployed workers either avoid or are no longer able to service) and an increase in public outlays (via transfers to troubled firms and/or unemployment benefits paid to laid off workers).

Paul Volcker's legacy

Paul Volcker is a major figure in international policy making, and his influence around the world is nowadays undeniable. Some may know him for the rule that bears his name that the Trump administration is now trying to abolish. But others know him better for his policy-making legacy back in the early 1980s.

Broadly speaking (and in order to avoid technical jargon), the Volcker rule aims at avoiding another big crash of the size of the 2007-08 crisis. Paradoxically, however, Volcker himself greatly contributed to the creation of the financial troubles of our day.

In the midst of the second major oil shock that began halfway through 1979 Paul Volcker (a democrat) was appointed as Federal Reserve chairman by James E. Carter. Volcker's predecessor at the head of the Fed, William Miller, lasted less than a year in the corresponding position and was forced to resign because (among others) he refused to push interest rates beyond a limit that could endanger employment and economic growth. This was not a problem for P. Volcker, who in less than two months after he replaced Miller raised interest rates to historical levels, successfully ending inflation.

Starting October 6, 1979 the Fed implemented a set of measures to 'slay the inflationary dragon'. These measures were quite unpopular, so much so that it may have cost Carter his reelection, and Volcker several unpleasant messages from businessmen and workers who were suffering the consequences of his tight monetary policy (see Volcker and Gyohten, 1992).

Volcker and the FOMC are responsible of the consequences (good and bad) of their policy actions. The combination of stagnation and inflation that prevailed in the second half of the seventies ended right after Volcker became chairman, and a new era of stagnation-only began. This new era eventually transformed itself in the current state of affairs in which policy-makers ranked price stability high among their policy objectives, leaving maximum employment below in their lists.

The period that goes from 1980 (when contractionary monetary policy began to bear the expected results) to 2016 *has not* been a period of continuous stagnation. It has been rather characterized by a long wave of unemployment, rapid increases in technical change, widespread promotion of R&D and human capital, some bursts of economic growth (the most spectacular being that of the stock-market boom of the late 1990s), outsourcing of production to emerging countries like China and (above all) low inflation.

In light of these (informal) arguments, Volcker's legacy can be seen as a modern day gold standard that favors low inflation over high inflation, sluggish economic growth over higher economic growth, financial markets over the real sector, high unemployment over low unemployment.

With the beginning of the new non-inflationary era came a set of changes that followed that affected the livelihoods of a large part of the world population. For instance, non-financial firms that were financed mostly via debt were deeply affected once inflation ended, for the value of their stock of debt increased drastically as the value of the currency in which they were denominated rose. Once the 'inflationary dragon' was slain, these firms could no longer piggy-back on inflation to finance their investment via debt, and were forced to lay off workers, replace labor with machines and outsource production.

To be clear, I am not suggesting that everything that happened following the 1979 Volcker shock is bad. The main message of this note is rather that anti-inflationary policy making has gone too far and is now reaching its limits, just as the gold standard reached an unbearable limit back in the thirties.

The current expected inflation may be a good thing in the years to come, for it is likely (although not at a 100%) to foster employment and growth. The problem with the previous state of affairs is that as inflation targeting went too far, so did the percentage of voters that turned either to the extreme right, the extreme left or were extremely confused and this, other than enhancing political polarization, has also been accompanied with more income inequality.

Current conservative economic thinking is such that it favors (among others) a strong currency, low inflation and low public indebtedness. Some modern day economies, such as the U.S. and Europe, need exactly the opposite... although under the leadership of reasonable politicians.

References

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