

An Interview with Paul Volcker

Martin Feldstein

Martin Feldstein is George F. Baker Professor of Economics, Harvard University, and President Emeritus, National Bureau of Economic Research, both in Cambridge, Massachusetts.

Martin Feldstein interviewed Paul Volcker in Cambridge, Massachusetts, on July 10, 2013, as part of a conference at the National Bureau of Economic Research on “The First 100 Years of the Federal Reserve: The Policy Record, Lessons Learned, and Prospects for the Future.” Volcker was Chairman of the Board of Governors of the Federal Reserve System from 1979 through 1987. Before that, he served stints as President of the Federal Reserve Bank of New York from 1975 to 1979, as Deputy Undersecretary for International Affairs in the U.S. Department of the Treasury from 1969 to 1974, as Deputy Undersecretary for Monetary Affairs in the Treasury from 1963-65, and as an economist at the Federal Reserve Bank of New York from 1952 to 1957. During the interludes from public service, he held various positions at Chase Manhattan Bank. He has led and served on a wide array of commissions, including chairing the President's Economic Recovery Advisory Board from its inception in 2009 through 2011.

## Ending Gold Convertibility

Feldstein: Let me start with your experience at the Treasury department in the early 1970s. President Nixon suspended gold convertibility in 1971 and that led to the collapse of the Bretton Woods arrangement. I have three questions about that. First, what was your view at the time of the desirability of that policy? Second, what is your view in retrospect? Did the United States have any choice? And finally, how much do you think that action contributed to the sharp rise in inflation in the remainder of the decade?

Volcker: I certainly was a major proponent of suspending gold convertibility, in fact the principal planner. I had come to the conclusion that we needed to negotiate a sizable exchange rate adjustment. At the time, we didn't have a choice, as I saw it, to suspending convertibility as a transition to a reformed system. In the end, the Smithsonian agreement<sup>1</sup> was not a very reasonable outcome from my point of view because I didn't think the changes in exchange rates were big enough to instill confidence. The United States didn't accept any responsibility itself by the way of any kind of convertibility to support the new rates, so the foundation wasn't there for a long-lasting solution in my view.

But my thought always was we suspend convertibility, get the necessary exchange rate change, and then we would redesign the international monetary system. President Nixon had no interest in redesigning the international monetary system, I think it's fair to say. Nor did Mr. Connally<sup>2</sup> have much interest, which led to, I

---

<sup>1</sup> At the Smithsonian in December 1971, representatives of ten countries—Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, the United Kingdom, and the United States—established a new set of fixed exchange rates.

<sup>2</sup> John Connally was U.S. Secretary of the Treasury from 1971-1972.

think, a more unsatisfactory situation internationally where it was easy to make the impression that we were being irresponsible.<sup>3</sup>

Feldstein: So given that you didn't get the second part of what you were hoping would happen, does it still look like the right decision in retrospect? Or, as you say, there was really no choice? You couldn't negotiate something different?

Volcker: I think it was the right decision. The question was what happened afterwards. The whole international exchange rate situation got out of hand. Federal Reserve policy, in my view, was not particularly credible at that point. I was in the Treasury. Every time I went on a trip abroad I would try to get to [Federal Reserve chairman] Arthur [Burns] to say, "Don't ease up while I'm abroad anyway."

The inflation took hold, as you know, and never was really brought under control for some time. It was an unsatisfactory economic situation.

Feldstein: Some people think that that was related to the fact that we had gone off the gold convertibility. How much do you think that actually contributed to the inflation that happened in the remainder of the decade?

Volcker: I didn't think we had any choice about the gold convertibility. I suppose, you know, we could have devalued, as we did eventually and then try to defend a new rate, but we didn't have enough credibility to do that. I think we didn't accept any kind of constraint during that period, the early 1970s. The exchange rate fell abruptly at one point or several points. We never had a reaction until late in the decade. I think there was a lack of discipline that would have been useful at the time, which was not recognized and wasn't acted upon.

## October 1979

Feldstein: Let me move to a later time. When you moved from the New York Fed in 1979 to become Chairman of the Board of Governors, consumer prices by then were rising at more than 10 percent a year. You decided to push short-term rates up even higher than the rate of inflation.

Volcker: The market pushed those rates up.

Feldstein: Yes. Absolutely. With a little facilitation from folks on Constitution Avenue.<sup>4</sup> Anyway, that succeeded in bringing inflation down to 6 percent in 1982, and 3 percent in 1983. I've got several questions about all of that. First of all, why do you think inflation had gotten so high at the end of the 1970s?

---

<sup>3</sup> Silber (2012), in his biography, covers this more fully.

<sup>4</sup> The headquarters of the Federal Reserve Board of Governors is on Constitution Avenue in Washington, DC.

Volcker: I guess I have to say the Federal Reserve policy contributed to it, but there was the oil crisis in the early '70s and then repeated again in the later '70s. It made a profound impression on me if nobody else that Arthur Burns titled his valedictory speech "The Anguish of Central Banking" (Burns 1979). That was a long lament about how in the economic and political setting of the times the Federal Reserve, and by extension presumably any central bank, could not exercise enough restraint to keep inflation under control. It was a pretty sad story. If you were going to follow that line you were going to give up, I guess. I didn't think you could give up. If I was in that job, that was the challenge as the chairman of the Federal Reserve. You inherit a certain challenge.

Feldstein: Some people thought at the time that it was just going to be too costly in terms of lost GDP and higher unemployment to get from where inflation was at that point down to low single digits. I think there was a recommendation, at least among some academic economists, to stop further increases in inflation, but not to try to bring inflation down because that would be so costly.

Volcker: The favorite word at the time, which was very popular within the Federal Reserve, but I think popular in the academic community generally, was "gradualism." I don't quite remember them saying, "Don't bring it down at all." But instead, it was "Take it easy. It will be a job of, I don't know, years, decades, whatever, and you can do it without hurting the economy." I never thought that was realistic.

The inflationary process itself brought so many dislocations, and stresses and strains that you were going to have a recession sooner or later. The idea that this was just going to go on indefinitely, and the inflation rate got up to 15 percent, it was going to be 20 percent the next year.

One little story—I think of all these stories. Shortly after we began the disinflation, somebody, I think Arthur Levitt who was the head of the American Stock Exchange, brought in some businessmen—they tend to be small businessmen—to talk to me at the Federal Reserve. I had them for lunch and I gave them my little patter about, "This is going to be tough, but we're going to stick with it and the inflation rate is going to come down," and so forth. The first guy that responded said, "That's all very fine, Mr. Volcker, but I just came from a labor negotiation in which I agreed to a 13 percent wage increase for the next three years for my employees. I'm very happy with my settlement." I always wondered whether he was very happy two years later on. But that was symbolic of the depths. He was happy at a 13 percent wage increase.

Feldstein: Did you have a sense of what the "cost" would be--that is how high was unemployment going to be? How long was this going to last?

Volcker: I had no sense that interest rates were going to be so high. In October 1979, we took the full panoply of restrictive measures and emphasized the money supply, and so forth. I thought this was all done to convince people we were really serious. We had already raised the discount rate two or three times in the space of two or three months. The last increase in the discount rate was by a 4 to 3 vote. I was a neophyte Federal Reserve chairman. It was all right with me. I knew I had four votes. If we had to raise it again I'd still have four votes. That's not the way the market interpreted it. They said, "Ah, they're at the end of their string. They can't command the unified majority any more on the board. So it's the end of the day for any Federal Reserve restraint."

I decided we had to change the play book a little bit and we threw everything we could into the October 1979 announcement. I had this naïve hope, I knew the short-term rates would go up, but I thought, "Ah, we will instill confidence and long-term rates will not go up." Long-term rates went up, too, just about as much as the short-term rates, which was a disappointment. But it showed how strong the psychology was.

Feldstein: The inflation came down, I think, much faster than outsiders, in any case, expected. Remember the tax cuts that were put in place in 1981 were based on the idea that inflation would continue to increase tax revenue because of bracket creep. We didn't start indexing income tax brackets for inflation until 1985. Yet inflation, as I quoted a minute ago, was down to 6 percent in 1982 and half that the next year. Were you surprised at how fast the process worked?

Volcker: I don't know that I was surprised, but I sure was relieved. I didn't know how long that could have gone on.

Feldstein: Can you say a little more about what it took to persuade the Federal Open Market Committee and the Board of Governors to go along with this?

Volcker: First of all, raising interest rates quite visibly and openly is not the easiest thing in the world for central bankers or anybody. It's much easier to lower interest rates than it is to raise interest rates, I think it's fair to say, in almost any circumstances. That 4-3 vote that I referred to reflected something of that reluctance.

Three or four years earlier, there was some pressure in the Open Market committee to adopt a much stricter money supply approach. So it wasn't entirely unknown to the Federal Reserve. Now that approach had always been rejected when it was raised. But there was a little bit of feeling, I knew, among some of the Open Market committee members—in particular outside of the board, the regional Reserve Bank presidents had a certain amount of sympathy. You had among some people some kind of instinctive support. I think people were upset and tired about the way things were happening, they were looking for something different, something new, something that had some hope. They realized, I hate to overdramatize, this was a last chance. That's overdramatizing a bit.

People were willing to get together on the new policy. We knew pretty well that it would have a sharp impact on short-term rates. It was meant to be highly restrictive, no doubt about that. But the board, the Open Market committee, was pretty united.

Feldstein: If I remember correctly, history has you warning President Carter that something like this was going to happen, getting his at least implicit consent, and then when it actually happened, he was a very unhappy man and acted up.

Volcker: I don't think it was quite that way.

Feldstein: You were there, and I wasn't, so tell us.

Volcker: When I was appointed in August 1979, I had made clear to him that I thought Federal Reserve policy was too easy at the time. If I was going to be chairman, I was going to be advocating a stronger policy. I remember I thought I wasn't going to be appointed after that conversation. But I was appointed anyway, so that shows the difficulty of the time.

Then when it came to making the so-called October 1979 decision, I had warned the Secretary of the Treasury and the chairman of the Council of Economic Advisers at the time, Bill Miller and Charlie Schultze.

We had to go to the annual IMF meeting in Belgrade at the end of September. I told them on the plane this was what I was planning to do. They were not too happy about it.

Feldstein: You told them on the plane going to Belgrade?

Volcker: To Belgrade.

Feldstein: To Belgrade? That's an important piece in history.<sup>5</sup>

Volcker: It was important for another reason. By some bit of serendipity, Helmut Schmidt, who was then I guess Chancellor of Germany, had requested that we stop and talk to him in Hamburg. I don't know how many people here know Helmut Schmidt, but he could be pretty acerbic to say the least. He wasn't exactly happy about the United States.

He sat there and lectured us for about an hour about the irresponsibility of the United States in letting this inflation get out of control, not having tight enough policies, and what was the matter with us, we were the leaders of the world, we'd better shape up and do something. I sat there rather happy about this lecture.

---

<sup>5</sup> Silber (2012, p.166) reports an interview with Schultze that confirms this account.

We went to Belgrade. I was aiming for an announcement later that week. This was probably over the weekend, I don't remember exactly. The President was informed about it, not by me. It may have been a deficiency on my part, but I didn't tell him. I would have told him, I guess, when I got back, but he had already been told by the time I got back.

He took the position, I'm told, that "I don't like it much, but I just appointed the guy and I'm not going to make a public fuss about it." There were one or two people in the administration that I knew who kind of came to me and said, "Go ahead and do it." Now that wasn't the unanimous view, but there was no sharp reprimand, there was no head-on fight.

## Credit Controls

Feldstein: But President Carter went on television and he triggered some legal provisions which had some effect.<sup>6</sup>

Volcker: No, not then. This was a later catastrophe so far as I was concerned. You may not remember this. This was later when interest rates got up to, I don't know, 20 percent or so maybe by the end of 1979.

Carter announced a budget in early 1980 which was very poorly received. Nothing was happening. The Federal Reserve staff kept saying, "We're having this recession. The recession is beginning." There was no recession. In spite of all this, the economy kept rising.

Carter was obviously under pressure, so he triggered a provision of law that permitted the Federal Reserve to put on credit controls. He said, "I want to put on credit controls. I want to show I'm on the team, sort of. We're going to go together and I've got to change the budget. I'm going to make the budget more restrictive. I want to announce there will be credit controls." We were going to tighten policy again. That was all part of the package: "You wait to tighten policy. We'll announce credit controls."

We didn't like the idea because expansion of credit was not a problem at the time, and we didn't want to get into all the mess of managing credit controls. We thought it muddied the picture. I felt I didn't like it, but how can we rebuff the president of the United States who is asking us to put on credit controls? Theoretically, we could have said no, but the Board reluctantly went along at my urging.

Feldstein: He managed to ask you on television in March 1980.

---

<sup>6</sup> For a transcript of President Carter's televised address of March 14, 1980, in which he called upon the Federal Reserve to impose credit controls, see Carter (1980).

Volcker: I guess maybe he did.

Feldstein: It was not a secret to the American public that he had that view.

Volcker: No, it wasn't a secret. Anyway, this was a phenomenon engraved in my mind.

We decided, "All right. We'll put on the most modest controls we can think of. We will not put on any control over anything to do with housing," which is the biggest source of credit. I think we exempted automobiles. There's nothing the matter with automobiles.

So the only thing that was left, and in those days it was of little importance, was installment credit that was not related to housing or cars, and credit cards, which was not a very big area of the market. We said, "Okay, you're going to have a reserve requirement on credit cards—if credit cards exceed past peaks, you would have a reserve requirement." We did that knowing, we're now in March, the peak in credit card use comes in November and December. We were way below it so there was no possibility that this was going to become a factor for some time. This was all announced at a big White House ceremony [laughs].

The economy at that point fell like a rock. People were cutting up credit cards, sending in the pieces to the president as their patriotic duty. Mobile home and automobile sales dropped within the space of a week or so. The money supply, we didn't know why the money supply was dropping, but all of the sudden the money supply was down 3 percent in a week or something.

What happened was everybody was paying off their credit card debt by drawing down their demand deposits and the money supply fell. We went into what the National Bureau of Economic Research later determined was a recession, and interest rates and the money supply dropped sharply.<sup>7</sup> Well, it was a recession alright, the economy went down, but it was an artificial recession. As soon as we took off the credit controls in June the economy began expanding again. Then things really got tough. We reversed the easing during the recession and interest rates resumed rising, including a discount rate increase a month or so before the election. That was the only time President Carter expressed concern.

## **High Real Interest Rates and the Debt Crisis in Latin America**

Feldstein: Let me look a little further down the road. Even after inflation had dropped to 3 percent, you kept, or the market kept, interest rates very high. Treasury Bills were 8 and 9 percent in 1983 and 1984, so we had real rates on Treasury Bills of 5 and 6 percent. Why were they so high?

---

<sup>7</sup> For the June 3, 1980 press release from the Business Cycle Dating Committee, see National Bureau of Economic Research (1980).



Volcker: Oh geez, I don't remember precisely. First of all when the economy began expanding, it was expanding very fast. There was no problem with poor economic activity at that point.<sup>8</sup>

Then, in the spring and early summer of 1984, you had the potential banking crisis of Continental Illinois. A little bank in Oklahoma went bust. But it had sold a lot of oil patch loans to Continental Illinois and other banks, and there was this sort of a banking crisis.<sup>9</sup> When Continental got in trouble, that had an effect on overnight bank lending. That kept for a while—that was during the election period, actually—kept interest rates higher than we anticipated and really higher than we wanted to.

There was quite a debate at the Board of Governors at that time whether we should react to what seemed an artificial increase in interest rates by easing our policies or whether we would tough it out.

Feldstein: You still had very high real rates, short real rates. Was it a concern about inflation coming back?

Volcker: If I put myself back in that position, I think we were totally satisfied at what the economy was doing. You still had some inflation. Why would we be easing up when the economy was expanding 6 or 7 percent a year? We're getting back to where we were. Everything was fine. Sort of fine.

Feldstein: Another development at about his time was the debt crisis in Latin America. What role did the high interest rates of the early 1980s play in causing severe debt problems in emerging economies? What options did you consider to deal with this?"

Volcker: That's an interesting question. This is something like, I suppose, the sub-prime mortgage thing. To understand what happened in the early 1980s, we need to start earlier.

The '70s were characterized by a lot of liquidity growing out of the oil crisis and the excess money that the Arabs had, and all the rest. That money was flowing through the big banks to Latin America in a way that arguably looked constructive for a while but was ultimately unsustainable.

---

<sup>8</sup> Silber (2012, p.237) cites the 1984 Annual Report of the Council of Economic Advisors on the role of the full employment federal deficit: "federal borrowing to finance a budget deficit of five percent of GNP ... means the real rate of interest must rise."

<sup>9</sup> The Oklahoma bank in question was Penn Square Bank. For an overview of the events surrounding the Continental Illinois banking crisis that came to a head in 1984, see Federal Deposit Insurance Corporation (1997).

Arthur Burns, to his credit, was the Paul Revere on this thing. He'd go around and make speeches, "This can't continue. It shouldn't be continued. We've got to do something about it."<sup>10</sup>

I was in the New York Fed then. We tried to do something about it, which was totally ineffectual, I must say. But, it went on and nobody was willing to say, "If you did something that was really effectual—if that's a word—you would have a crisis in Latin America if you shut off the flow." Nobody much wanted to be all that aggressive.

By the early 1980s, interest rates had gotten very high - I don't think it was the interest rates - the banks suddenly stopped lending to Mexico because they thought they were overexposed, so you had a crisis. Once one stopped, they all stopped.

This had been building up. The figures were known. The president of Mexico then, a left-wing guy, was being told by his own finance minister and central bank governor, "We ought to stop this or slow it down." He sent some people around to talk to foreign banks and ask, "Is this a problem?"<sup>11</sup> They all said no. This was in the summer of '81. Now we come to '82. He got rid of the finance minister. He wasn't going to get rid of the borrowing, but his finance minister instead. It's true.

The borrowing continued until the winter when a couple of banks stopped lending. Mexico ran out of money. What do you do? You had a big crisis now. The high interest rates were a burden for Mexico over time, but they didn't make the crisis. They hadn't been in effect all that long. But there's no question that high interest rates aggravated the problem.

What were you going to do? Were you going to conduct an easy-money policy and go back on all the policy you'd undertaken to try to save Mexico, which wouldn't have saved Mexico anyway?

We did save Mexico, but by other means. It wasn't just Mexico. People forget. This is a commentary on age. This was '82. How many years ago was that? Thirty one or two years ago. I hear all this talk about crisis. Nobody ever remembers the Latin American debt crisis. Memories only go back to, somehow, the savings and loan crisis in 1990 and didn't make the leap back to '80.

The big U.S. banks and some of the big foreign banks had more exposure to Latin America than they had capital. It wasn't something you could just say, "Okay. Knock off the loans by 50 percent or something and everybody will be happy."

---

<sup>10</sup> For example, see Burns (1977).

<sup>11</sup> The President of Mexico from 1976 to 1982 was José López Portillo. The Director General of the Bank of Mexico during this period was Gustavo Romero Kolbeck, who resigned in September 1982 protesting the nationalization of the banks. Portillo's finance minister during this time was David Ibarra Muñoz. He was fired in March 1982, nine months before the end of Portillo's term of office, and replaced by Jesus Silva Herzog.

They all would have been bust. You look for other approaches and it took nearly a decade until Mr. Brady came along and settled them.<sup>12</sup>

## The Federal Reserve in the Recent Financial Crisis

Feldstein: Let me now turn to more recent events after you left the Fed. First about the crisis and then about current policy. There were of course many causes of the financial crisis, and I don't want to review all of those. I want to ask what role you think the Fed played in causing the crisis? How could Fed policies have prevented it?

Volcker: I want to make a point that I think is important and it's underrated. We had a very mild recession, it was hardly a recession, in 2000 and 2001. I remember there was a meeting we both attended. You said it wasn't a recession. I said it wasn't a recession. The National Bureau of Economic Research later said it was a recession, but it was hardly visible. Anyway, we had these low interest rates in the early 2000s. We were running a big balance of payments deficit. It got bigger and bigger. More and more money came from Japan and China in particular. Interest rates were kept very low. It seemed to me, inevitably, this is the kind of doomsday scenario, sooner or later, that you couldn't go on to the point of borrowing 5, 6 percent of the GDP. Interest rates were very low and parts of the economy were expanding unsustainably rapidly. What to do about it?

I made a speech about it once.<sup>13</sup> I didn't say anything except we've got to make sure we maintain price stability and budget discipline. I didn't directly criticize the Federal Reserve at the time because I wasn't sure—I mean, I would have been happy if he [Alan Greenspan] had been a little tighter, frankly, but I didn't think that was going to cure the situation because it was really an international monetary problem. There was no discipline in either the United States or in China. Nobody even raised the question, and it all ended up very unhappily.

That kind of fed the boom in the United States. I think the Federal Reserve and all the banking regulators did not catch up with this. I don't know if anyone ever would, but they didn't. It got out of hand and collapsed in a way that I wasn't anticipating particularly, but it did. I had no idea, myself—I'm just sitting around reading newspapers—how big the sub-prime mortgage problem was. When I found out, it startled me.

You remember these little personal incidents. I was at some meeting and I was asked to comment on the U.S. economy I guess in the spring of '07. Question:

---

<sup>12</sup> Nicholas Brady was Secretary of the Treasury from 1988 to 1993. In 1989 he announced what came to be known as the Brady plan for addressing the problem of Latin American debt. It involved negotiating with creditors to accept “Brady bonds” in exchange for their holdings of Latin American debt. The Brady bonds had a lower face value or interest rates than the existing debts, but also were more certain to be repaid.

<sup>13</sup> One such speech was given as the keynote address at the “summit” of the Stanford Institute for Economic Policy Research in February 2005, partly available on YouTube at <http://www.youtube.com/watch?v=4aTatmAiiuY>. Volcker (2005) is a newspaper op-ed piece adapted from the talk.

"What about that mortgage market?" I said, "I don't know much about that mortgage market. But I can't believe the financial system is so weak that this minor business in the mortgage market of subprime mortgages would upset it. I got back and I called some friends in the Federal Reserve. "How big is this subprime mortgage thing?" I must admit, the answer I got from them first was, "I don't know." Then, they called me back later and they told me, "Well, it looks like it's over a trillion dollars." I had no imagination that this sub-prime mortgage thing was over a trillion dollars. It was a phenomena of, what, three years maybe. From basically a standing start, in three years it was a trillion dollars. Obviously that was kind of the focal point of the crisis when it finally came. Look, this banking regulation stuff is very hard to deal with. But I think there had been a relative lack of interest in it, which was unfortunate, to understate the matter.

### **The Volcker Rule**

Feldstein: Let's talk for a moment about the Volcker Rule, which I remember you were saying at the time . . .

Volcker: That's my favorite rule.

Feldstein: It's your favorite rule. Well, if I had a rule named after me, it would probably be my favorite rule as well.

Volcker: We were at an international level meeting last weekend. Somebody had a paper saying that was the most important part of financial reform. I have never said that, but she said it.

Feldstein: That was my question. How important was proprietary trading, which I take it is the essence of the Volcker Rule?<sup>14</sup> How important was it as a cause of the crisis?

Volcker: I don't know whether I'd rank it as a prime cause of the crisis, but it was a contributing factor in the sense it led to a lot of, once the crisis started, exposure on proprietary trading and money market funds, and hedge funds.

This crisis kind of started with the hedge funds of Bear Stearns in 2007, and the institution came under strong pressure in early 2008. That failure began shaking psychology and so forth. That was essentially a proprietary trading operation. I have seen figures that say the banks collectively lost as much money in 2008 as

---

<sup>14</sup> The Volcker Rule, broadly understood, is that financial institutions that are eligible for deposit insurance and have access to the Federal Reserve and FDIC insurance should be limited in the risks they take with their proprietary trading. For an early presentation of this argument, see Group of 30 (2009).

they made on proprietary trading and hedge funds in the whole previous decade all in one fell swoop. But obviously the weakest part of the banking system was bad loans.

The difference is banks are there to make loans. That's an essential part of the economy. They're not there, in my opinion, to trade for their own account basically. That's a distinction that I try to make. That's obviously a complicating factor, if it wasn't the prime factor in the crisis.

The worst part of it in a way, in my view, is a cultural, a psychological question. It's not just the risks that are involved directly for the whole institution.

Take this JPMorgan thing. They lost \$6 billion or whatever it was with one little play in the derivatives market—one big play in the derivatives market.<sup>15</sup> They can survive \$6 billion But what is the psychology that leads people to take that kind of risk? Traders know that the rewards are huge—of a kind that have not been at all normal in commercial banking now or in history. When you've got that kind of cleavage between the culture on the investment banking side of the house and the traditional banking side of the house, obviously the people in the commercial banking side say, "I want to make money, too. Maybe I can make some big risks and I'll get some mortgages together, and I'll package them up. Let's securitize them and stick them out. We'll make a commission on it. It's not a relationship matter. We're going to stick this out, we'll stick somebody else with it." It's a different culture.

The guy that is most eloquent on this, it surprises me because he never used to be friendly toward the Federal Reserve, is John Reed, head of the Citibank at the time. He was a leader in commercial banks going in the investment business. They bought Salomon Brothers investment bank back in 1998, you may recall. Salomon, that subsidiary went bust later. Not too much later, but it was part of Citibank, so nothing happened. But he is very vocal. "Mea culpa. We made a mistake. It destroyed the culture of the institution."<sup>16</sup> That's my major worry about it.

Feldstein: Another thing you've worried about: the size of the big banks. If I remember correctly, you were in favor of breaking up the big banks during this crisis. Is that true?

Volcker: I never took the view to break up the big banks. I wanted to limit their size, which I guess is in the law someplace—not very effectively. I sort of lack imagination. I don't see how you break them up without a lot of disturbance.

---

<sup>15</sup> For an overview of these events, in which a series of derivatives trades in spring 2012 cost JP Morgan approximately \$6 billion, see the hearings of the US Senate (2013), titled "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses.

<sup>16</sup> For example, see Reed's interview with Bloomberg as reported in Ivry (2009).

But even if you broke them up, you couldn't break them up into small enough pieces so that they wouldn't be systemically significant, or whatever we call it now. You break up JPMorgan in half, or Chase in half, they're the same bank. Bank of America, you slice them in half. They're not one two-trillion-dollar bank, they're two one-trillion-dollar banks. They're still too big.

Feldstein: That view which I've heard attributed to you shouldn't have been attributed to you about wanting to break them up.

Volcker: No. But I wouldn't mind if somebody else does it.

### **The Dual Mandate**

Feldstein: Let me ask you more broadly about the goals of monetary policy. In the 1977 Humphrey-Hawkins Act, Congress adopted the dual mandate: that is, that monetary policy should be set with an eye on both inflation and unemployment. Recently, the Board has set quantitative goals for inflation and unemployment. If I remember in your time there were no such specific goals. You would say something like, "The job of the Fed is to achieve price stability."

Volcker: Right.

Feldstein: I remember that.

Volcker: And I'd excise the word "gradually" every time.

Feldstein: My first question is, "What's your opinion of the dual mandate?"

Volcker: I'm against it.

Feldstein: You're against the dual mandate? You want to say a little more than that?

Volcker: Well, I think it confuses the situation. The danger for the Federal Reserve now is that, implicitly or explicitly, given the circumstances it has acted and has been asked to act in an extraordinary way, it kind of gives the impression that the Federal Reserve has the keys to the kingdom—that they can achieve price stability and low unemployment at the same time, and it doesn't matter what the budget is, and all the structural problems in the economy, and the dislocations in the economy. Monetary policy will solve all problems.

I think that's a bad message to give, because I don't think it's right. I don't think it's possible anyway.

I do think it confuses the situation to say there's a trade-off between price stability, and economic performance, and employment. I think over any reasonable period of time there's not a trade-off. The best contribution of the Federal Reserve can be to maintain price stability.

I frankly don't like this inflation targeting, but that's a minor point—that 2 percent is okay and 1.5 is no good. Everybody kind of knows what price stability is and there's more than one measure of prices.

I think the dual mandate is confusing. I think it makes the Fed's job more difficult. That doesn't mean that policy would be one inch different today than it in fact is. There is no immediate inflation problem or inflation threats, so they can be comfortably very easy, that's what they should be. It doesn't imply any difference, actually, in current policy.

Feldstein: Do you see any political possibility of moving away from the dual mandate any time in the future?

Volcker: I think if the Federal Reserve stopped talking about it, nobody else would talk about it. Congress doesn't pay any attention. That law was passed or amended—the Humphrey-Hawkins Act—in '77, just two years before I became chairman of the Federal Reserve; it was fresh legislation. I do not remember the word "dual mandate" ever passing my lips in all the time that I was chairman.

Now, I could get by with it because inflation was very high and if somebody asked me the impact on the economy, I would say, "Look, over time the best thing we can do for the economy is to get rid of the inflation." Sitting there saying with 15 percent inflation—well, then when we started we didn't have high unemployment—but even then when the unemployment rate got very high, and the inflation rate was still 10 percent or whatever it was, to say, "Let's get the inflation rate up a little bit so we can get the unemployment rate down." It didn't make sense. The literal reading of the dual mandate presumed that's what you would do. I think you're better off focusing on price stability.

That's the advice I would give to the current chairman of the Federal Reserve.

Feldstein: You've got a chance to do that now. That probably tells me something about what you think about the idea of unconventional policies. Maybe it doesn't, so you tell us.

Volcker: I think this crisis required some unconventional policies, there's no doubt about that. Extremely unconventional is the kindest word you can say about it when you go back a few years ago.

Let's talk about this current version, this so-called QE3.<sup>17</sup> It's a matter of judgment. I don't get alarmed about it and I think they can manage their way out of it. Chairman Bernanke has made that quite clear and I think he's right.<sup>18</sup>

It does have the dangers of speculative excesses. It's got plusses and minuses. The plusses I don't think are very large. The minuses don't seem to be tremendous right at the moment either.

Since I can say it, if I was conducting these policies, I don't really understand why we're paying interest on excess reserves when we're worried about getting interest rates as low as possible. The Federal Reserve pays more on their excess reserves than the banks can get from lending to each other. So why pay them?

Feldstein: You would stop paying interest on excess reserves?

Volcker: Yes I would. It never dawned on me to pay interest on excess reserves—I guess a limitation of my own imagination. I was always in favor of paying interest on required reserves.<sup>19</sup> But the idea of paying interest on excess reserves never occurred to me until the Federal Reserve began doing it. I can see, in some circumstances, it may have some advantages. But I think you're going to find it has some disadvantages, too. Some day you have to make that rate pretty high if you're going to do it, I guess, when you want to tighten policy. We'll see how that goes.

Feldstein: You mentioned the word "deficits." Let me read another question that came in. "Can the U.S. continue for long as the financial global hegemon with the persistent large fiscal deficits?"

Volcker: What's a large fiscal deficit?

Feldstein: A large fiscal deficit is what we have.

Volcker: Yes, that's what we have. I think it's hard, particularly the uncertainty over the decades ahead when Medicare, and Social Security, and so forth seem to widen

---

<sup>17</sup> QE refers to the "quantitative easing" policies in which the Federal Reserve purchased financial securities like US Treasury bonds and mortgage-backed securities. The first round of these policies, QE1, started in November 2008; the second round, QE2, in August 2010; and the third round, QE3, in September 2012.

<sup>18</sup> For example, see Bernanke's (2010) Congressional testimony concerning "The Federal Reserve Exit Strategy."

<sup>19</sup> Traditionally, the Federal Reserve did not pay interest on the reserves that it required banks to hold, nor on any additional or "excess" reserves beyond the legal requirement that banks choose to hold. The Financial Services Regulatory Relief Act of 2006 authorized the Federal Reserve to pay interest on reserves beginning in October 2011. That authority was accelerated to October 2008 by the Emergency Economic Stabilization Act of 2008, and the Federal Reserve began to pay interest on reserves on October 9, 2008. For additional explanation and interest rates that are paid, see the Federal Reserve website at <http://www.federalreserve.gov/monetarypolicy/reqresbalances.htm>.



the deficit. The deficit, that's more up to the point to me, is the balance of payments deficit. I think we're back, in a way, in the Triffin dilemma.<sup>20</sup>

In the 1960s, we were in a position in the Bretton Woods system with the other countries wanting to run surpluses and build their reserve positions, so the reserve position of the United States inevitably weakened—weakened to the point where we no longer could support the convertibility of currencies to gold. Now, how long can we expect as a country or world to support how many trillions of dollars that the rest of the world has? So far, so good. The rest of the world isn't in a very good shape, so we look pretty good at the moment.

But suppose that situation changes and we're running big deficits and however many trillion it is now, it's another few trillions. At some point there is vulnerability there, I think, for the system, not just for the United States. We ought to be conscious of that and do something about it. It's not so easy to do something about it because that comes back to the whole question of international monetary reform, which is a favorite subject.

Feldstein: The Chinese have been major buyers of U.S. government debt. They've been able to do that because they have had a large current account surplus. That surplus has come down from 10 percent a few years ago to less than 2 percent now. If they pursue the policies they say they're going to pursue, it could easily disappear in the next couple of years. How should we think about the implications of that for the US economy?

Volcker: I think that's good news from the standpoint of what I just mentioned. China is not the only other country in the world. But China was an important accumulator of US dollars. If they stop accumulating, the kind of worry I just expressed is somewhat alleviated. It's not gone, because our current account deficit continues.

Our current account deficit is smaller, too, and hopefully can remain small. I hate to see our deficit go back to where it was. I'd like to see it disappear, but it's hard to make it disappear. No question about that.

Feldstein: On that semi-optimistic note, let me thank you again for taking the time and giving us your views about all of this.

---

<sup>20</sup> Robert Triffin (1960) testified before the Joint Economic Committee of Congress that the economy with the world's reserve currency—then and now the US dollar—must be willing to run ongoing trade deficits so that the reserve currency will be available for the global economy, but this in turn means that foreign governments hold large quantities of dollar assets, which at some point as events change are likely to become a source of global financial instability. This situation became known as the “Triffin dilemma.”

## References

- Bernanke, Ben S. 2010. "Federal Reserve's Exit Strategy: Testimony Before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C." February 10. <http://www.federalreserve.gov/newsevents/testimony/bernanke20100210a.htm>.
- Burns, Arthur F. 1977. "The Need for Order in International Finance," Address at the Columbia University Graduate School of Business. April 12. [http://fraser.stlouisfed.org/docs/historical/burns/Burns\\_19770412.pdf](http://fraser.stlouisfed.org/docs/historical/burns/Burns_19770412.pdf).
- Burns, Arthur. 1979. "The Anguish of Central Banking: The 1979 Per Jacobsson Lecture." <http://www.perjacobsson.org/lectures/1979.pdf>.
- Carter, James Earl. 1980. "Anti-Inflation Program Remarks Announcing the Administration's Program." March 14. The American Presidency Project. <http://www.presidency.ucsb.edu/ws/?pid=33142>.
- Federal Deposit Insurance Corporation. 1997. "History of the Eighties: Lessons for the Future. Chapter 7 Continental Illinois and Too Big to Fail." <http://www.fdic.gov/bank/historical/history/>.
- Group of 30. 2009. Financial Reform: A Framework for Financial Stability. [http://www.group30.org/images/PDF/Financial\\_Reform-A\\_Framework\\_for\\_Financial\\_Stability.pdf](http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf).
- Ivry, Bob. 2009. "Reed Says 'I'm Sorry' for Role in Creating Citigroup." Bloomberg.com, November 6. <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a.z4KpD77s80&pos=6>.
- National Bureau of Economic Research. 1980. "Business cycle peaked in January." June 3. <http://www.nber.org/cycles/june1980.html>.
- Silber, William L. 2012. *Volcker: The Triumph of Persistence*. New York: Bloomsbury Press.
- Triffin, Robert. 1960. "Statement of Robert Triffin to the Joint Economic Committee of Congress," December 8. <http://babel.hathitrust.org/cgi/pt?id=mdp.39015081224407;view=1up;seq=234>.
- U.S. Senate, Committee on Homeland Security and Intergovernmental Affairs. 2013 "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses." March 15. <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses>.
- Volcker, Paul A. 2005. "An Economy On Thin Ice." Washington Post, April 10, p. B7. <http://www.washingtonpost.com/wp-dyn/articles/A38725-2005Apr8.html>.