ChartsandMarkets.com
Timely technical analysis
Insightful market commentary

BOB HOYE

NOVEMBER 27, 2018

Debunking the Volcker Myth

Former Fed Chairman, Paul Volcker, has now published a book which title includes *The Quest for Sound Money and Good Governance*. He is well known as the Fed chief that "ended inflation". His fame rests entirely upon the world of economics and policymaking, which is mainly theoretical. And when the world of theory intersects with financial volatility, the results can be ironical. Volcker's career in public affairs provides exquisite irony. The main thing is that neither he nor his policies "ended inflation". As in "No", "Nada" and "Unlikely". With ample evidence, market forces ended intense speculation in tangible assets and inflation in 1980. It was yet another transition from run-away speculation in things to run-away inflation in financial assets.

There is a tradition that goes with a fabulous bull market. The important agent in office is celebrated. During the "Roaring Twenties" Treasury Secretary, Andrew Mellon, was celebrated as the "greatest since Alexander Hamilton". Then during the Dot-Com Bubble, Treasury Secretary Robert Rubin enjoyed the identical accolade.

One of the most remarkable transitions in financial history has been from the intolerable condition of "inflation" to inflation in financial assets, which becomes a popular party.

The world of modern finance had evolved in London by 1700, with enough publicly-traded companies, to be called a stock market. A central bank with the privilege of issue was chartered in 1694. London's first advisory letter began in 1692.

Every example of relentless inflation has been accompanied by social distress and all have ended in speculative exhaustion. A key example, with a nasty war, ran until 1711 and collapsed. Out of that sudden contraction the first great financial mania developed. As it grew it was widely celebrated, as "everyone" was enjoying the prosperity. What's more, government extravagance was rescued by soaring tax revenues. Until the mania climaxed in 1720. It was called, in real time, the South Sea Bubble. The important thing was the transition from intolerable inflation to fun and games in financial assets.

The 1763 example provides a report in real time linking the transition with its commodity hit to the ultimate hit to the financial bubble. All of the great bubbles crashed in the fall and the Dutch publication *De Koopman* in December 1772 reported: ***"The dreadful year 1763 has returned – but the causes are different from those of 1763 and take root in England: the East India Company is the cause … our diseased credit is dead, discounting has gone wholly out of fashion, a loan cannot be had except on double security."***

It is an astute observation that this researcher has not seen with any of the other transitions. The Dutch understanding that "easy" credit is followed by "diseased" credit is a remarkable use of words.

The next fascinating transition was in 1816 with the 1825 Bubble completing nine years later.

By the time for the next set, New York had become a big enough to join financial history and a long run of inflation drove the US CPI up to 27 percent. That was in 1864 and nine years later the 1873 Bubble completed.

On the next example, inflation soared to 22 percent in 1920 and the natural run to financial ecstasy completed in 1929.

Of course, the most fascinating transition was set up by another great global speculation in commodities that drove the US CPI up to 14 percent in 1980. That one was riveting. Academics had a theory that artificial expansion of credit would drive economic expansion. Sadly another example of a primitive syllogism. Beyond that it forced depreciation of the dollar, which drove the CPI up. Because such inflation has always been distressful academics avoided blame by crafting the nonsense that the public's "inflation expectations" drove prices up. Tautology at its finest.

With this history, this writer's presentations to institutions in 1982 included a distinctive conclusion: ***"No matter how much the Fed prints, stocks and bonds will outperform commodities."*** It was controversial then and it is controversial now.

Paul Volcker was not in office at previous transitions from CPI inflation to financial manias. At extremes, Mother Nature and Mister Market rule.

Nor was he in office in 2008, when international speculation drove commodity indexes to the most powerful rally since 1920. Crude oil soared to 147. And what happened? Another wonderful example of inflation in financial assets that appears to have completed 9 years and 7 months later. This compares to the interval of 9 years and 5 months to the 1929 climax.

While Volcker was at the Fed in 1980, it was the public that forced the transition to the wonders of financial speculation. However, in 1971 he was instrumental in Nixon's decision to end gold convertibility. Which was the fateful step to reckless central banking and the world of unstable bubbles.

With remarkable irony, he now calls for ***"Sound Money and Good Governance"***.