Is it Volcker Time?

Those who consciously experienced the 1970s and 80s remember well the turning point in history that was heralded in 1979 with the appointment of Paul Volcker as Chairman of the US Federal Reserve. The USA had hit bottom: an ignominious retreat from the ill-fated Vietnam War, an expulsion from Tehran in embarrassing circumstances, weak growth as a result of overly active monetary and fiscal policies, and annual inflation that intermittently peaked just below 15% in early 1980. The country began to straighten up under the new president Ronald Reagan; needful structural reforms were addressed and the fatalistic mentality of the 1970s was banished from people's minds. However, it took nearly ten years to force the poison of overly loose monetary policy out of the financial system. Above all, though, it needed a Fed Chairman who, regardless of accusations from virtually all sides and with admirable strength of purpose, pushed through his new monetary policy based on monetarist principles. High interest rates – the benchmark rate was at times 20% – initially strangled the economy, only to put it on a healthier footing after years of bitter disillusionment. For the economy, «Volcker time» meant blood, sweat and tears.

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Given the overheating of the US economy following the pandemic and the decades-long practice of accommodating the financial markets with cheap and even cheaper money («don't worry, the Fed will fix it»), the question is now whether current Fed Chairman Powell will follow in Volcker's footsteps and continue to implement his restrictive monetary policy. Political augurs and financial analysts, and presumably also a substantial share of market participants, do not believe this will be the case. They assume that Powell would capitulate at the first real opposition from Washington or Wall Street and quickly cut interest rates again. They would say he does not have Volcker's character, is not a real expert, and on top of all that, the Fed is dependent upon the financial markets because of its high bond holdings. Nor can Powell rely on any political force because both parties have long succumbed to the sweet poison of low interest rates.

After careful consideration, I have come to a different conclusion: Chairman Powell and the Fed will continue and prevail with their new monetary policy, even in the medium and long term. For this is the last chance to save the US dollar as a global currency and to preserve the unique attractiveness of the American capital market (and thus the American economy). Otherwise, the dollar is fated to become a «me-too currency» à la euro or Brazilian real – with incalculable consequences for the financing of the US government and economy.

Events in the USA are being shaped by three predominant forces: Washington, Wall Street and a group of «sages» in the Treasury department, IRS, a few banks, industrial companies, the military and security authorities. This «invisible backbone» is overlooked by most observers, but it has survived every administration and generally preserved order, albeit often at the last minute. Washington's current weakness and the foreseeable stalemate after the upcoming midterm elections suggest that such a time is at hand, especially since the USA also needs to find a path to a more powerful geopolitical position vis-à-vis China and Russia. The «invisible backbone» will strengthen Powell's position, no matter how loudly Wall Street howls.

One more thing: if I am right, the ECB will have to prepare itself for the worst. The collapse of the euro system could be the price for the resurgence of the US dollar as a global currency.

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