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The Fed Needs to Step Up Its Pace of Rate Increases

Unemployment is now 5.5%, historically the lowest rate that can be sustained without starting an inflation spiral.

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The Federal Reserve now faces the tough task of unwinding the easy-money policy that has helped bring about the current solid economic upturn. But its projected path for increasing the short-term federal-funds rate over the next few years is dangerously slow. Most members of the Federal Open Market Committee want the real interest rate to be negative at the end of 2015 and approximately zero at the end of 2016. Only in 2017 would the real fed-funds rate even exceed 1%.

The justification, according to the Fed, is to achieve its statutory goals of “maximum employment and price stability.” Neither goal justifies such a slow normalization of interest rates. The Fed is aiming for an unsustainably low unemployment rate, and there is no indication it is considering the adverse effects its interest-rate path might have on financial stability.

Overall unemployment now is 5.5%. This has historically been regarded as about the lowest rate that can be sustained without starting an inflation spiral. The Fed is nevertheless projecting that its policies will cause unemployment to decline to 5% by the end of 2015 and even lower in the next two years. Historical experience suggests that means inflation would eventually increase year after year.

Yet this historical experience may understate the danger. Recent academic research, and a study at the San Francisco Federal Reserve Bank, implies that what matters for accelerating inflation is not overall unemployment but unemployment among those who have been out of work for less than six months. For this group of short-term unemployed, the inflation threshold is estimated to be between 4% and 4.5%. The latest count by the Bureau of Labor Statistics puts the unemployment rate for that group at less than 3.9%. This could mean inflation will soon begin to rise year after year without any further decline in overall unemployment.

The Fed nevertheless wants to bring the overall unemployment rate substantially below 5.5% because of concern about part-time workers, or those too discouraged even to look for work—a group not traditionally counted as unemployed. There is no doubt real hardship among this group—but it is wrong to think that this group can be helped by monetary policy without triggering an inflationary spiral.

The Fed also justifies its slow path to normal interest rates by a desire to raise the inflation rate, currently 1.3% over the past 12 months, to 2%. But who cares if the inflation rate is a bit below an arbitrary 2% target? The Fed’s goal of price stability should really mean avoiding the double-digit inflation rates experienced in 1979-81.

Finally there is the important issue of financial stability. When Ben Bernanke was Federal Reserve chairman, he correctly stressed the need to balance the risk to financial stability from excessively low interest rates against the favorable effects of low rates on aggregate demand.

Unfortunately, there is no indication the Fed is currently thinking about the need for balance. Financial stability received no mention in the FOMC’s official statement following its March meeting, nor did Fed Chair Janet Yellen refer to it in the opening remarks of her press conference on March 18.

The Fed’s policies of holding short-term rates near zero for six years and making large-scale asset purchases have pushed the yield on 10-year government bonds below 2%. Given the low yields, investors have been taking on more risks to obtain current income. The process of reaching for yield has increased bond prices, narrowed credit spreads, and pushed the stock market’s price-earnings ratio to 19, 25% above its historic average.

To achieve profits, banks and other lenders also have taken on extra risks by lending to less-creditworthy borrowers and by imposing fewer conditions in their loan covenants.

Extremely low interest rates have also encouraged corporations to issue an enormous amount of new debt. These bonds are now held by various mutual funds and exchange-traded funds. Investors believe they have complete liquidity because they can redeem their investments at any time. But if many of them tried to do so, the bond funds and ETFs would have to sell the underlying corporate bonds. It is not clear who the buyers would be, especially since Dodd-Frank has restricted what banks can do.

The Fed's current slow path to more normal interest rates is not justified by its employment and inflation mandates. The Fed should accelerate its projected rate increases and communicate the new projections explicitly to markets. Unless this is done, the combination of rising inflation and increasing real interest rates may expose the economy to an unnecessary risk of financial instability.

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