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Save Low Interest for a Rainy Day

President Trump chided the Fed for raising rates, but the move creates space to spur the economy later on.

By MARTIN FELDSTEIN

President Trump told a national television audience last week that he disapproves of the Federal Reserve's decision to continue raising short-term interest rates. He later repeated his concern in a series of tweets. In complaining publicly about the Fed, Mr. Trump is breaking decades of presidential precedent, and he is wrong on the substance. The Fed actually is behind the curve in normalizing short-term interest rates, and it should now raise the federal-funds rate at least four times a year.

The president isn't alone in his opposition to the Fed's interest-rate policy. Narayana Kocherlakota, a former president of the Minneapolis Fed, recently published an article criticizing the interest-rate hikes. Critics of the Fed's policy point out that the inflation rate is neither high nor rising rapidly. The consumer-price index in June was only 2.9% higher than the previous year, pushed up by the recent jump in energy prices. The price index the Fed uses to calculate inflation, the personal-consumption expenditures index, was up only 2.3%.

But controlling inflation isn't the primary reason for the Fed to keep raising the short-term interest rate. Rather, raising the rate when the economy is strong will give the Fed room to respond to the next economic downturn with a significant reduction.

That downturn is almost surely on its way. The likeliest cause would be a collapse in the high asset prices that have been created by the exceptionally relaxed monetary policy of the past decade.

It's too late to avoid an asset bubble: Equity prices already have risen far above the historical trend. The price/earnings ratio of the S&P 500 is now more than 50% higher than the all-time average, sitting at a level reached only three times in the past century. Commercial real-estate prices also are extremely high by historical standards.

The inevitable return of these asset prices to their historical norms is likely to cause a sharp decline in household wealth and in the rate of investment in commercial real estate. If the P/E ratio returns to its historical average, the fall in share prices will amount to a $9 trillion loss across all U.S. households.

Large drops in household wealth are usually accompanied by declines in consumer spending equal to about 4% of the wealth drop. That rule of thumb implies that a $9 trillion drop in the value of equities would reduce consumer spending by about 2% of gross domestic product—enough to push the economy into recession. The fall in the value of commercial real estate would add to the decline of demand. And with consumer spending down sharply, businesses would cut back on their investment and hiring.

Recent recessions have generally been short and shallow, as a result of a rapid response of offsetting monetary and fiscal policy. The Fed typically cuts its short-term interest rate by several percentage points, and tax cuts and increased government spending help spur demand.

But significant monetary stimulus would be impossible to achieve if the short-term interest rate remains at the current 1.75%. And there is less room than ever for fiscal stimulus, as annual deficits will exceed $1 trillion by 2020 and federal debt will be greater than 100% of GDP by the end of the decade.

That's why it's important for the Fed to raise the federal-funds rate to 4% over the next two years, which would allow it to cut the rate by at least three points when the next recession begins. Such a rate reduction might not be enough to prevent a recession within the next two years, but it would maximize the Fed's positive influence on the economy.

Raising rates does increase the risk of bursting the asset bubble sooner than investors and consumers might hope. But the Fed has let the economy grow fragile by keeping short-term rates too low for too long. Now it must respond by raising rates enough to deal with the bubble burst when it inevitably comes.

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