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The Fed's Stock-Price Correction

The equity-market downturn is the inevitable result of the central bank's policies. The unwinding will likely continue for months.

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The unfolding stock-market collapse–the Dow Jones Industrial Average plummeted more than 1,000 points on Monday morning, rebounding later to nearly 600 points down, following several days of decline last week–is the inevitable result of the Federal Reserve's policies, namely quantitative easing that produced abnormally low interest rates. The decline on Wall Street has spread to every stock market on the globe, many of which were also weakened by their own policies of excessively easy money.

When the Obama administration's poorly designed 2009 stimulus legislation failed to produce a strong economic turnaround, then-Fed Chairman Ben Bernanke announced that the central bank would pursue an "unconventional monetary policy" by purchasing immense amounts of long-term bonds and promising to hold short-term interest rates near zero for an extended period.

Mr. Bernanke explained that the Fed's policy was designed to drive down long-term interest rates, inducing portfolio investors to shift from bonds to stocks. This "portfolio substitution" strategy, as he labeled it, would increase share prices, raising household wealth and therefore consumer spending.

The Fed's strategy worked, causing household net worth to increase by $10 trillion in 2013. Households responded by spending more, leading to an accelerated rise in gross domestic product and a decline in unemployment.

The increase in share prices took the price-earnings ratio of the S&P index to about 30% above its historic average before the market downturn began last week. An alternative measure of the price-earnings ratio that looks at inflation-adjusted earnings over the past decade was even higher, at more than 50% over its historic average.

With virtually no yield available on government bonds and other low-risk fixed-income securities, investors were tempted to climb on the bandwagon of rising share prices. Some sophisticated investors realized that the rapid increase of share prices was a bubble that would end when interest rates returned to normal. They invested on the mistaken theory that they would know when to pull out.

Though the recent decision to start selling was triggered by a variety of events, including the collapse of oil prices world-wide and financial chaos in China, the high price-earnings ratios were enough to make the downturn inevitable. All that was needed was a spark to start the process, just as the increased defaults of subprime mortgages did in 2007.

The excess price of equities was not the only mispricing caused by the Fed's unconventional monetary policy. As investors reached for yield in a very low-yield environment, they depressed the spreads between Treasury rates and the yields on high-risk bonds and emerging market debt. The prices of commercial real estate have also been pushed to extremely high levels, driving down yields to unsustainably low levels. Banks and other lenders have boosted their short-term earnings by lending to lower-quality buyers and making loans with fewer conditions.

Much of this mispricing will likely unwind in the months ahead. What isn't clear is whether the fall of equity prices and other corrections will have adverse systemic effects as they did in 2007-08, bringing down consumer spending and business investment and thereby reversing the recent labor-market improvement. Only time will tell.

The market decline will no doubt lead some members of the Fed's Open Market Committee to argue against beginning the rise in short-term rates in September. But postponing a 25-basis-point rise from September to December or even March would not have any significant effect on aggregate demand and employment.

Market participants know that the economy is now essentially at full employment, that the consumer-price index is close to 2% and that there is little risk of deflation. They know therefore that interest rates must rise, and that a return to normal levels will reverse the mispricing of assets. The Fed cannot hide that realization by postponing rate hikes for a few months. And so the Fed should get on with the task of normalizing rates, particularly so that investors and lenders are no longer tempted to sink deeper into mispriced assets.

But if the asset-price corrections have serious adverse macroeconomic effects, the task of stimulating the economy should shift from the Federal Reserve to the Obama administration and Congress. There is no shortage of tax and budget policy prescriptions that could stimulate output without increasing national debt.

It's time to escape the unprecedented monetary policy that for a while stimulated demand–but then distorted prices and brought about the current corrections.

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