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Why the Fed Should Raise Rates Now

Unemployment is low, inflation is on the rise and asset prices are through the roof.

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The Federal Reserve remains trapped in inaction by the success of its quantitative-easing strategy, despite increasing support among its 12 district-bank presidents for raising short-term interest rates. Its policy of buying long-term bonds and promising to keep short rates low has pushed asset prices to dangerously unsustainable levels. The time for debate has passed. With consumer prices on the rise and unemployment low, it's time for the Fed to normalize short-term rates.

Notwithstanding talk of a "nonrecovery," rising asset prices have lifted household wealth to an all-time high, leading to more consumer spending, faster GDP growth and lower unemployment. In 2013 household net worth increased by more than $10 trillion, according to Fed data, causing real GDP to rise by 3.5% in the second half of the year and by 2.5% in 2014.

Although GDP growth slowed to about 2% in 2015, the unemployment rate stood at 4.9% in August—essentially full employment. That is causing inflation to rise, with the core consumer-price index inflation rate at 2.3% between August 2015 and August 2016, up from 1.8% over the previous year. If the unemployment rate continues to decline, inflation is likely to accelerate further.

The Fed's policy of exceptionally low interest rates causes investors to reach for yield, continuing to raise the overvalued prices of equities, longer-term bonds, commercial real estate and other riskier assets. Consider:

• The price-earnings ratio of the Standard & Poor's 500 is now around 25, about 60% higher than its historic average.

• A 30-year Treasury bond now has a yield of 2.3%, about equal to the current core CPI inflation rate. Historically the 30-year bond yield has exceeded the inflation rate by about 2%. If the bond yield rose to 4.3% from 2.3%, the price of the 30-year bond would fall by more than 30%.

• Commercial real-estate prices have been rising at around 10% a year for the past five years, according to the Federal Reserve Bank of St. Louis, driving capitalization rates—the annual return of income-producing properties—down to less than 7%, from over 8% in 2011. Falling cap rates are considered a clear sign of rising prices.

• The prices of emerging-market bonds are up more than 40% since 2011, according to the Federal Reserve Bank of St. Louis, driven by the lower interest rates in the U.S. and other developed countries.

Fed Chair Janet Yellen and Fed board members are rightly concerned that normalizing interest rates would cause the prices of overvalued assets to decline, pulling the economy down. But the longer they wait, the worse the problem of asset inflation will be and the more damaging the decline in asset prices.

Abnormally low interest rates are also inducing banks and other lenders to reach for yield by lending to lower-quality borrowers and granting loans with fewer restrictions. If an asset-price correction causes an economic decline, these high-risk loans will suffer and the banks and other lenders will be in trouble.

The current low bond rates have also removed the usual pressure on the government to deal with budget deficits. The debt-to-GDP ratio has more than doubled over the past decade, rising from 35% to 75%. Recently the Congressional Budget Office forecast that the debt ratio will rise to 86% a decade from now, even if there is no increase in the planned historically low spending on defense and nondefense discretionary programs.

The high level of government debt means the tax burden will grow. Future bond rates will rise and the cost of servicing the debt, more than half of which is held by foreign investors, will become more expensive. The current high debt-to-GDP ratio will also make it hard to persuade Congress to provide a fiscal stimulus if economic growth declines. Raising military

spending in the face of an increased national-security threat will also become more difficult.

The Fed's reluctance to raise interest rates reflects not only the fear of destabilizing financial markets but also a desire to increase employment. Although there may be little room to lower the unemployment rate, total employment can be raised by inducing an increase in labor-force participation. Such gains in employment are clearly worth having, but the continued strategy of low interest rates may lead to a burst asset bubble, a sharp downturn and far higher unemployment rates.

I suspect that the Fed leadership would like to see the inflation rate rise above the target of 2%, reaching 3% or more. That would give the central bank the ability to raise the federal-funds rate to between 3% and 4%, putting it in a position to cut the rate if the economy softens.

The Fed could rationalize overshooting 2% by noting that its target is not a ceiling but a desired average over time. But if the bond markets reject that explanation, bond rates could rise rapidly, destabilizing financial markets.

Ms. Yellen, during a September press conference, said "We don't want the economy to overheat and significantly overshoot our 2% inflation objective." This points to a willingness to allow the inflation rate to rise above the 2% target. So too does the FOMC's median projection that the unemployment rate will fall to 4.6% in 2018, below the Fed's projected long-term sustainable rate of 4.8%.

All of this suggests a willingness to continue the current dangerous policy of low interest rates—regardless of its effect on asset prices, inflation and financial stability. It is past time for the Fed to shift gears and normalize interest rates more rapidly.

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