Originally published in **The Wall Street Journal**

Raise Rates Today to Fight a Recession Tomorrow

November 27, 2018

A downturn is inevitable as asset prices fall. The Fed can prepare by continuing to raise rates now.

By MARTIN FELDSTEIN

Federal Reserve Chairman Jerome Powell will lay out a vision Wednesday for the course the Fed will steer through coming economic turbulence. So far, the Fed's governors have appeared committed to their plan to continue raising interest rates, which they began in late 2015 after nearly a decade of holding them near zero. The federal-funds rate has jumped from 0.3% in January 2016 to 2.2% today, and the median forecast of the Federal Open Market Committee is that it will reach 3.4% by the end of 2021.

Some observers worry that higher short-term rates will push the economy into recession and wonder why the Fed is continuing to raise rates despite already having achieved its explicit monetary-policy goals. Yet that view overlooks the role that higher interest rates today must play in enabling the recovery from an inevitable future downturn. It is in the interest of the next recovery, I believe, that the Fed will continue its steady rate increases.

To be sure, the Fed has currently achieved its two explicit goals: price stability and full employment. In recent years, it has set an inflation rate of 2% and a low unemployment rate that amounts to full employment as markers of success in these areas. And behold, the inflation rate has now reached 2%, as calculated by the Fed's preferred measure of inflation, the rate of increase of the price index for personal-consumption expenditures. The unemployment rate has dropped to a remarkably low 3.7%—lower than the Fed and most economists previously thought possible.

Most watchers of U.S. monetary policy assume that the Fed is increasing the short-term rate to prevent or limit a rise in inflation. History does suggest that the current very low unemployment rate will cause inflation to rise. But during the recent unemployment dip, inflation has crept up surprisingly little. The core consumer-price index, which excludes the prices of food and energy, has accelerated from a 1.8% rate of increase five years ago to 2.1% today. The PCE inflation rate, the Fed's preferred measure, increased to only 2.2% from 1.1% over the same period. And even the FOMC's own forecast is that inflation will hardly rise above the current rate in the next three years.

As I have argued in these pages since 2013, the Fed should have begun raising the fed-funds rate several years earlier. Doing so would have prevented the recent sharp increases in the prices of equities and other assets, which will collapse when long-term interest rates rise. Declining asset prices could destroy a substantial amount of household wealth and push the economy into recession. Unfortunately it is not possible to turn back the clock and prevent the overvaluation of assets and the resulting risk of recession. But I believe that the Fed is raising rates today so that it will be in a better position to offset a future economic decline.

The U.S. has experienced 11 recessions since 1945. Unlike the recession that began in 2007, most have been relatively short and shallow. The average time from the beginning of a downturn to the start of the recovery is just 11 months. That's because the Federal Reserve historically has responded to downturns by sharply reducing the fed-funds rate. Lower rates stimulate spending by households and businesses and weaken the dollar, spurring foreigners and Americans alike to buy more U.S. goods and services.

Looking ahead, there is a significant risk that the U.S. economy will slide into recession in the next few years. Though gross domestic product has grown robustly of late, bloated asset prices will likely collapse, dragging industry down with them. The price-earnings ratio of the S&P 500 is nearly 40% above its historic average. As long-term interest rates return to normal levels, demand for equities and other assets will decline rapidly. A return of share prices today to their historic price-earnings ratios would wipe out nearly $8 trillion of household wealth. The resulting decline in consumer spending and the related fall in business activity would be enough to push the economy into recession.

If that scenario plays out in the next few years, the Fed won't be able to achieve a large rate reduction. Even if the Fed raises the fed-funds rate to 3.4% by the end of 2021, as it currently plans to do, that will not be high enough to allow a substantial rate reduction. And the consequence would be a deeper and longer recession than usual.

Though it would have been better for the Fed to start raising rates earlier, the Fed is right to increase the short-term rate now so that it will have as much ammunition as possible when the next downturn comes.

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