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New Priorities for a New Fed Regime

Incoming leadership should make maintaining financial stability one of the central bank's goals.

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Now is a good time for those who hope to see new thinking at the Federal Reserve. There will soon be a new Fed chairman and vice chairman. The president of the Federal Reserve Bank of New York, who serves as vice chairman of the Federal Open Market Committee, will also be replaced in the coming months. And a majority of the Fed's Board of Governors will be new next year. What should this leadership emphasize?

Financial stability must become one of the leading objectives of monetary policy. The Fed now uses monetary policy to achieve its congressionally mandated goals of price stability and maximum employment. Although it relies on regulation and supervision to reduce the risks to the banking sector, the broader risks to the financial sector reflect the effects of monetary policy on asset prices.

The Fed has kept the short-term federal-funds interest rate at less than the rate of inflation for nearly a decade. Meantime, it has exploded its balance sheet, to $4.5 trillion today from $870 billion in 2007. Low interest rates have caused investors and lenders to reach for yield, pushing up asset prices and making high-risk investments and loans.

The most obvious increase in financial risk has been the rapid rise in share prices. The price/earnings ratio of the S&P 500 index rose from an average of 18.5 in the three years before the downturn of 2007 to 25.2 now, an increase of 37%. The current P/E ratio is 63% higher than its historic average and higher than all but three years in the 20th century.

If the P/E ratio declines to its historic average, the implied fall would reduce the value of household equities by $9.5 trillion. If every dollar of decline in wealth reduces spending by the historic average of 4 cents, the level of household spending would fall by $475 billion, or more than 2% of gross domestic product. The lower equity prices and the decline in household spending would also cause business investment to fall, further reducing economic activity.

Bond prices are also out of line with historic experience. With inflation at around 2%, the long-term 10-year Treasury yield should be at about 4.5%. Instead it is only about 2.5%. If the yield on long-term bonds returns to normal historic levels, there will be substantial losses of value for current bondholders.

Commercial real estate is overpriced because investors compare the yield on real estate with the interest rate on long-term bonds. Since real estate is often held in highly leveraged investments, falling prices could lead to an even greater decline in the net value of real-estate assets.

The combination of overpriced real estate and equities has left the financial sector fragile and has put the entire economy at risk. The Fed has so far chosen not to address this fragility.

Fed Chair Janet Yellen, during a July 2014 speech, acknowledged that certain conditions could prompt the Fed to deal with the risks of overpriced assets. Since 2014, the S&P 500 P/E ratio has risen to 25.17 from 18.96—more than 30%. Yet at no time in the past four years has the Fed explicitly allowed the increasing asset prices and resulting financial sector risks to influence monetary policy.

Ms. Yellen noted in her 2014 remarks that low interest rates can create incentives for participants in financial markets to take on excessive risk while reaching for more yield. But she also emphasized her skepticism of monetary policy's ability to deal with financial vulnerabilities. She added "the potential cost, in terms of diminished macroeconomic performance, is likely to be too great to give financial stability risks a central role in monetary policy decisions, at least most of the time." Looking at the conditions in mid-2014, she concluded that there was then no need "for monetary policy to deviate from a primary focus on attaining price stability and maximum employment in order to address financial stability concerns."

She concluded her speech stressing the importance of considering “adjustments in the stance of monetary policy, as conditions change in potentially unexpected ways.” Yet the departing Fed chair clearly prefers regulatory and supervisory policies that focus on banks over monetary policy when dealing with the risks of financial instability. Let’s hope her successor disagrees and incorporates financial stability as a key goal of monetary policy.

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