America’s Risky Recovery

By Martin Feldstein *Thu, Apr 30, 2015*

'My own best guess is that [the Fed] will start to raise rates in September, and that the federal funds rate will reach 3% by some point in 2017,' writes Martin Feldstein, the Harvard economist and former presidential adviser.

The United States’ economy is approaching full employment and may already be there. But America’s favorable employment trend is accompanied by a substantial increase in financial-sector risks, owing to the excessively easy monetary policy that was used to achieve the current economic recovery.

The overall unemployment rate is down to just 5.5%, and the unemployment rate among college graduates is just 2.5%. The increase in inflation that usually occurs when the economy reaches such employment levels has been temporarily postponed by the decline in the price of oil and by the 20% rise in the value of the dollar. The stronger dollar not only lowers the cost of imports, but also puts downward pressure on the prices of domestic products that compete with imports. Inflation is likely to begin rising in the year ahead.

The return to full employment reflects the Federal Reserve’s strategy of “unconventional monetary policy”—the combination of massive purchases of long-term assets known as quantitative easing and its promise to keep short-term interest rates close to zero. The low level of all interest rates that resulted from this policy drove investors to buy equities and to increase the prices of owner-occupied homes. As a result, the net worth of American households rose by $10 trillion in 2013, leading to increases in consumer spending and business investment.

After a very slow initial recovery, real GDP began growing at annual rates of more than 4% in the second half of 2013. Consumer spending and business investment continued at that rate in 2014 (except for the first quarter, owing to the weather-related effects of an exceptionally harsh winter). That strong growth raised employment and brought the economy to full employment.

But the Fed’s unconventional monetary policies have also created dangerous risks to the financial sector and the economy as a whole. The very low interest rates that now prevail have driven investors to take excessive risks in order to achieve a higher current yield on their portfolios, often to meet return obligations set by pension and insurance contracts.

This reaching for yield has driven up the prices of all long-term bonds to unsustainable levels, narrowed credit spreads on corporate bonds and emerging-market debt, raised the relative prices of commercial real estate, and pushed up the stock market’s price-earnings ratio to more than 25% higher than its historic average.

The low-interest-rate environment has also caused lenders to take extra risks in order to sustain profits. Banks and other lenders are extending credit to lower-quality borrowers, to borrowers with large quantities of existing debt, and as loans with fewer conditions on borrowers (so-called “covenant-lite loans”).

Moreover, low interest rates have created a new problem: liquidity mismatch. Favorable borrowing costs have fueled an enormous increase in the issuance of corporate bonds, many of which are held in bond mutual funds or exchange-traded funds (ETFs). These funds’ investors believe – correctly – that they have complete liquidity. They can demand cash on a day’s notice. But, in that case, the mutual funds and ETFs have to sell those corporate bonds. It is not clear who the buyers will be, especially since the 2010 Dodd-Frank financial-reform legislation restricted what banks can do and increased their capital requirements, which has raised the cost of holding bonds.

Although there is talk about offsetting these risks with macroprudential policies, no such policies exist in the US, except for the increased capital requirements that have been imposed on commercial banks. There are no policies to reduce risks in shadow banks, insurance companies, or mutual funds.

So that is the situation that the Fed now faces as it considers “normalizing” monetary policy. Some members of the Federal Open Market Committee (FOMC, the Fed’s policymaking body) therefore fear that raising the short-term federal funds rate will trigger a substantial rise in longer-term rates, creating losses for investors and lenders, with adverse effects on the economy. Others fear that, even without such financial shocks, the economy’s current strong performance will not continue when interest rates are raised. And still other FOMC members want to hold down interest rates in order to drive the unemployment rate even lower, despite the prospects of accelerating inflation and further financial-sector risks.

But, in the end, the FOMC members must recognize that they cannot postpone the increase in interest rates indefinitely, and that once they begin to raise the rates, they must get the real (inflation-adjusted) federal funds rate to 2% relatively quickly. My own best guess is that they will start to raise rates in September, and that the federal funds rate will reach 3% by some point in 2017.

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