The MarketWatch

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Feldstein says Fed should let the market fall and keep hiking rates

Central bank should not pause due to stock market declines, Harvard economist says

Interview with MarketWatch and Martin Feldstein

WASHINGTON (MarketWatch) — Martin Feldstein, a prominent Harvard economist once on many people's short-list to lead the Federal Reserve, has a simple message for the U.S. central bank: ignore the stock market.

In an interview with MarketWatch, Feldstein said stocks are overvalued. Any signal from the U.S. central bank that it may pause from its plans to continue raising interest rates would only create the impression that there is a "Fed put" on the market. A put is an option that protects an investor from losses.

In the interview, Feldstein, now 76 and the president emeritus of the National Bureau of Economic Research, sees a risk of higher inflation going forward. He said growing talk of a recession in the U.S. is misguided.

MarketWatch: In a column in the Wall Street Journal in August, you said this about Fed policy: "It is time to escape the unprecedented monetary policy that for a while stimulated demand – but then distorted prices and brought about the current corrections." Can you unpack that? What is going on?

Feldstein: They introduced unconventional monetary policy, quantitative easing. It was successful in the way that the Fed and [former chairman] Ben Bernanke predicted, in that it raised household wealth by driving investors into equities and increased the value of homes. And in response to that increase in wealth, consumers went out and spent more and that got the economy going. I think it was as simple as that, and it was effective. But, at the same time, these super-low, sustained low interest rates have led to a variety of risk-taking that could cause significant problems going forward. So the stock market got pushed up to a point where the price-to-earnings ratio is about 30% higher than it's been historically and we're seeing what that's doing in terms of falling equity prices and similar things are happening on high-risk debt, and I could go on.

MarketWatch: You want them to tighten more?

Feldstein: I want them to do what the FOMC forecast in December, which is that they would take the rate up by 100 basis points in 2016 and continue to do more in 2017. And even that will still be very easy, accommodative, monetary conditions.

MarketWatch: Won't financial conditions tighten and the stock market decline?

Feldstein: That's right, the stock market might decline. But if the stock market is very overvalued we shouldn't be surprised that, at some point, it has to revert to a more normal level.

MarketWatch: Won't that damage the economy?

Feldstein: I'd rather it happen slowly, then build up the kind of problems we had in 2006, 2007 and 2008.

MarketWatch: So this is just an adjustment the economy has to make?

Feldstein: The danger, in my mind anyway, is if the Fed keeps interest rates extremely low, if they say, in reaction to the recent decline in equity prices, if they say: "Well maybe we shouldn't raise interest rates," that will just be a signal to buy more equities and to push up the price of equities even further and to get things further out of line so when the correction comes, it will be even bigger.

MarketWatch: So asset prices are now overvalued and that has to reverse?

Feldstein: Yes, and making it worse would not be a good thing.

MarketWatch: You've been worried about inflation for some time –even pressing Fed Chairwoman [Janet] Yellen when she first took office about it. Haven't you been wrong so far?

Feldstein: I think I have said it was important for the Fed to make it clear that they cared about inflation. I think I wrote that and I said that in the Economic Club of New York discussion with Janet Yellen [in April 2014]. I've also explained, in a Project Syndicate piece, that contrary to what a lot of people say, there hasn't been a big increase in the money supply, and therefore inflation is unlikely. People have said to me, 'since we've had this explosion of money, why didn't that create inflation?' And what I wrote that we haven't had that explosion of money, what happened was the commercial banks took the opportunity to just leave funds at the Federal Reserve. They didn't use those funds to expand their lending and to expand the money supply. But I think there is the danger going forward, that, starting where you are today, with an unemployment rate of 5%, if the Fed continues to have negative real short-term rates, that we could see the unemployment rate drifting down below 5% and, at some point, that would start to raise inflation.

MarketWatch: Larry Summers, and others, have argued that the neutral interest rate – the level of interest rates consistent with full employment – is lower now than it used to be. It sounds like you are not buying that.

Feldstein: Yes, I am not a big fan of those arguments. I think it is hard to know. What we know is that actual rates are very low, but we know the Fed has made that happen. So the neutral real rate is not a number you can see in the market, it is a number that economists can try to calculate but I am not persuaded that that number is a negative number or dramatically lower.

MarketWatch: You want the Fed to hike rates steadily, step-by-step toward something like a 3.5% terminal rate?

Feldstein: Assuming that inflation does increase, as the Fed itself predicts, remember that core CPI is at 2.1% relative to 12 months ago, so if someday the price of oil stops falling, we will see actual inflation catch up with the core, so when the inflation rate gets into the 1.5%-2% range, then I think normalization of interest rates means getting interest rates back to, as you say, 3.5% to 4%.

MarketWatch: Do you want them to go steadily, go in March?

Feldstein: I hate to use their expression but it's data dependent. So it depends on what is happening in the economy. But I wouldn't take the fall in the equity market as a reason not to stick to their interest rate expansion path because I think that would send a very bad signal to investors that there is a kind of Fed put there and that they don't have to worry because the stock market only goes up, because that will get it further out of line with reality.

MarketWatch: There has been growing talk about a recession. You don't sound so worried.

Feldstein: I'm not. We've had a weak [fourth] quarter, basically we had a very weak October. We don't have December numbers yet. If you look at the various forecasts that you and I probably both look at, for the first quarter, there are numbers in the 2.5% range for real GDP, so I don't see any serious problem. And even the fourth-quarter numbers, which are just estimates at this point, are primarily driven by reductions in inventories and weaker exports. So it is not domestic demand that is doing this.

MarketWatch: If the Fed keep raising rates, won't the dollar continue to strengthen and hurt manufacturing?

Feldstein: If we look at the impact of the exchange rate on the cost of imports and competitiveness on exports, there is very little in it from the exchange rate. The main thing that has driven the cost of imports has been the energy price, and the government breaks out those two components of what drives the import price index. The competition that supposedly comes from abroad because of the exchange rate is very small relative to the part of the import price index that is driven by energy.

MarketWatch: So commercial real estate is another example of a bubble?

Feldstein: Overvalued. The number I hear is cap rates of around 3%, that is not sustainable.

MarketWatch: Part of your concern is the Fed doesn’t have good tools to combat asset bubbles.

Feldstein: They perhaps could have them if they wanted them, but they certainly don’t use them. They have said that we should have macroprudential policies other than interest rates as a way of dealing with these kinds of risks. But when you look around, it is hard to see what those are, other than building up the capital requirements for commercial banks, which, in itself is a macroprudential policy, does reduce the risk of the banks getting into the kind of trouble that they did before. On the other hand, we have to remember that the banks are just one-third of total capital raising in the United States.

MarketWatch: It seems you were never a big fan of quantitative easing. You don’t want it in the tool kit for the next downturn?

Feldstein: I suppose it comes down to what’s the alternative. If you had said to me before the economic downturn: “What do you think about fiscal policy as a tool for fighting downturns,” I would say that is not a very good tool, we have learned from experience that trying to use discretionary fiscal policy is likely to get us in trouble because we can’t move fast enough. But when this downturn happened, I felt that this is different from previous ones. It was deeper and more importantly, longer, and therefore there was room to do fiscal policy, but the fiscal policy that the administration did in 2009 was just very badly designed and really didn’t do much to stimulate demand.

MarketWatch: And that forced the Fed.

Feldstein: And the Fed came along and said: “Well, if conventional monetary policy won’t do it, and fiscal policy they tried and failed, so it’s up to us now.” And I don’t disagree with that.

MarketWatch: What about other tools to combat downturns — negative rates and raising the 2% inflation target to 4% — you are not a fan?

Feldstein: I am not a fan.

MarketWatch: Let’s take those one at a time — negative rates

Feldstein: Negative rates just provide even more incentive for excessive risk taking. People saying: “Well I can’t get a decent return on a relatively safe asset, so I will take duration risk, I will take credit risk, I will invest in real assets like commercial real estate with exceptionally high prices.” So I think that is not a good thing. And of course in Europe, it is not doing much for them.

MarketWatch: And moving the inflation rate higher?

Feldstein: I am old enough to remember the pain of the inflation in the late 1970s and the early 1980s before Paul Volcker came around and fixed that problem. We paid a high price for getting back to a world where people believe inflation is going to stay low, and if we now come along and say: “Well instead of 2% , let’s go for 4% or 5% because that has certain technical advantages,” then people are going to say: “Oops, what are they going to do next.”

MarketWatch: I hear what you’re saying but maybe I’m not as sanguine as you are. With growth around 2%, couldn’t we end up in a ditch if the Fed does too much?

Feldstein: That’s why, when you asked would I commit to that or would I see how it plays out, I said I must see how it plays out. That’s data-dependent movement.