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# For New Fed Chief, Stock Boom May Bring Bubble Déjà Vu

With stock and property prices once again setting records, Jerome Powell will likely face some agonizing trade-offs in the next year or two



Jerome Powell, nominated to succeed Janet Yellen as Fed chair, largely agrees with his predecessors that monetary policy should be a last resort for dealing with financial excess. Above, Mr. Powell speaks at a Senate Banking Committee confirmation hearing on Nov. 28. PHOTO: AARON P. BERNSTEIN/BLOOMBERG NEWS

*By Greg Ip*

Jan. 10, 2018 11:37 a.m. ET

Any central banker watching the stock market today should get a queasy sense of déjà vu.

A housing boom preceded the last recession. A tech stock bubble ushered in its forerunner.

Today, stock and property prices are once again setting records, in absolute terms and relative to household incomes. That may leave the Federal Reserve and Jerome Powell, nominated to succeed Janet Yellen as Fed chair next month, confronting some agonizing trade-offs in the next year or two: What if low inflation calls for low interest rates but those low interest rates make an eventual, destructive asset bust more likely? Should he lean against an incipient bubble by raising rates faster now, or plan to mop up the mess if assets collapse later?

Unfortunately, the past isn't much help as a guide to the present. The 2008 cataclysm resulted not just from falling housing prices, but the knock-on wave of mortgage defaults that then brought down the institutions that held the debt. Today, the financial system has much thicker buffers against loan losses and is more closely regulated. Credit growth isn't excessive.

Stock price-to-earnings ratios are by some measures the highest since 1999, but today's are more justifiable. In 1999, government bonds yielded 6%; today, they yield 2.6%, which makes them a less appealing alternative to stocks. Moreover, even if stocks fell, that wouldn't necessarily destabilize the financial system.

"When we look at other indicators of financial stability risks, there's nothing flashing red there, or possibly even orange," Ms. Yellen said in December.

Yet it doesn't take a crisis for an asset bust to hurt. The 1990s tech stock run-up fueled a surge in investment and spending via higher wealth and easier financing conditions. When the bubble burst in 2001, that surge reversed, dragging the economy down. The damage was contained because the Fed quickly slashed interest rates by nearly 5 percentage points. Today, it can at most cut them by 1.5 points.

The stock market's 23% rise since the end of 2016 has been a powerful economic tailwind. Increased wealth has encouraged consumers to spend more and save less of their paychecks, driving the personal saving rate below 3%, the lowest since 2007. Both spending and stocks have gotten an added kick from the recent tax cut.

It isn't a stretch to see all those factors switching into reverse within a year or two. And if dangerous excesses are simmering in the financial system, they may not appear until the boom goes bust.

In the old days, recessions occurred because an overheating economy led to higher inflation, then higher interest rates and a pullback in spending. In such a world, getting interest rates correct could achieve both low, stable inflation and sustainably low unemployment, which economists dubbed the "divine coincidence."

But, as Mr. Powell noted a year ago, no divine coincidence dictates that the same interest rate will achieve both 2% inflation and a stable financial system.

Whether that means the Fed should stop bubbles from forming in the first place has long vexed officials. Before the global financial crisis, they concluded no: pre-emptively pricking bubbles seemed much riskier than letting them burst of their own accord. They are less dogmatic now. Though officials' first choice is to use regulatory authority to ensure any such bust doesn't sink any financial institutions, Ms. Yellen said in 2010 she couldn't "unequivocally rule out" using higher interest rates to pre-empt a

bubble. But she set the bar quite high.

In actions, if not words, Fed monetary policy already does respond to financial stability concerns and asset prices. In a 2016 study, Federal Reserve Bank of Boston President Eric Rosengren and two co-authors counted how often words such as “bubble,” “bust,” “crisis” and “volatility” appeared in transcripts of monetary policy discussions at Fed meetings. They found that such worries tended to move interest rates more than mere considerations of inflation and unemployment could justify, although the influence was stronger when rates were falling than rising.

Mr. Powell largely agrees with his predecessors that monetary policy should be a last resort for dealing with financial excess. Yet his bar doesn’t appear to be as high. When Mr. Powell joined the Fed in 2012, he told colleagues he worried that the Fed’s bond-buying program could fuel risk-taking down the road, according to meeting transcripts released last week.

In a 2015 speech, he said: “Tighter monetary policy might eventually be necessary” if dangerous risk-taking reappeared. A year ago, he went further: “The current extended period of very low nominal rates calls for a high degree of vigilance.”

The case for vigilance has only grown since.

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*Appeared in the January 11, 2018, print edition as 'For Fed, Stock Boom Brings Bubble Déjà Vu.'*

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