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Opinion | CONTRIBUTING OP-ED WRITER

What Trump Can Do to Prevent the Next Crash

Ruchir Sharma SEPT. 14, 2017

The Federal Reserve arguably has more influence on the daily lives of Americans than any other government agency. In the coming year President Trump has a chance to appoint or replace five of the central bank's seven governors, including the vice chairman, Stanley Fischer, and possibly the chairwoman, Janet Yellen.

Few presidents have had so many seats to fill this quickly, and it's time to pay attention to how Mr. Trump will use the opportunity. The heavy hitters vying for seats are talking — often vaguely — about reforming the Fed, which has been praised for preventing a depression after the financial crisis of 2008, but questioned for failing to anticipate the crisis itself.

The Fed missed the crisis in part because it has a dual mandate to keep unemployment and consumer price inflation low — and both were low before 2008. Real reform would add a third mandate: maintaining financial stability, and in particular stabilizing prices for assets like houses and stocks, which are not counted as "consumer prices" but now have a bigger influence on the economy.

Consumer price inflation has largely disappeared, in part because central bankers have been fighting it effectively since the 1970s, and in part because heightened global competition began restraining prices for consumer goods from TVs to toys. Meanwhile, asset prices are getting pushed in the opposite direction.

To ease the Great Recession after 2008, central banks adopted zero to negative interest rates and provided huge amounts of cash, effectively giving investors free money. In a world with few barriers to the flow of capital across borders, this is spurring buying sprees, and thus bidding up prices for stocks, bonds and real estate in markets from New York to Shanghai.

Today, global financial assets (including just stocks and bonds) are worth over $250 trillion and amount to about 330 percent of global gross domestic product, up from $12 trillion and just 110 percent in 1980. Traditionally, economists have looked for trouble in the economy to cause trouble in the markets. But the ocean of money in financial markets is now so large, it's possible that ripples on its surface could trigger the next big downturn.

In the postwar era, finance has grown enormously as a share of the global economy, often feeding debt-fueled bubbles. In 2015, the economist Alan M. Taylor and his colleagues looked at data going back 140 years for 17 leading economies. Before World War II, there were 78 recessions — including only 19 that followed a bubble in stocks or housing or both. After the war, there were 88 recessions, a vast majority of which, 62, followed a stock or housing bubble or both.

Since 1990, every major economic shock has been preceded by a collapse in prices for houses, stocks or both, including Japan's crash in 1990, the Asian crisis of the late 1990s, the dot-com crash of 2000-01, and the global financial crisis of 2008.

The Fed has changed with the world before. After the Great Depression, it focused on fighting unemployment. Amid crippling consumer price inflation in the 1970s, it shifted its focus to fighting this scourge. Now, amid looming market bubbles from China to Norway, central bankers are tentatively starting to recognize that they can't ignore asset price inflation. At the Federal Open Market Committee, its key policy-making body, financial stability rarely came up before 2012 but has come up at 27 of 39 meetings since.

Of course, even market insiders can't spot when asset prices are ready to crash, so skeptics say the Fed can't be expected to either. Better to let bubbles pop and "mop up" after. However, the painfully slow recovery from 2008 shows how ineffective mess-mopping can be: Losses after the crash tend to be much bigger than gains on the way up. The Fed need not try to predict the market's peak; it needs only to identify signals of crises, so that it can act early to forestall them, controlling asset price inflation by raising rates or reducing cash infusions into the economy.

Thanks to post-mortem research done since 2008, we know much more about these signals. The key is to be on alert when markets are rising much faster than the underlying economy. Normally, for example, home prices rise around 5 percent a year; the International Monetary Fund has found that rate more than doubles in pre-crisis periods.

At least equally telling is the pace of increase in debt. When asset prices collapse, the owners suffer instant pain. But when debt used to buy those assets collapses, the resulting defaults ripple through banks and become a drag on the economy. The longest and deepest recessions tend to follow real estate busts, because homes are almost always purchased on credit, and during booms, so many buyers are tempted to borrow excessively for that dream house.

Nonetheless most economists — even conservative deficit hawks who worry about the Fed "blowing bubbles" — still look mainly for economic threats to the financial markets, rather than the threat that overgrown markets pose.

They thus don't recognize fully that the world has changed, and the tail now wags the dog. Many mainstream economists still argue that the economy can't be overheating if consumer price inflation is quiet, and they want to keep rates lower for longer, hoping that easy money will stoke growth in the economy, and jobs, for the poor and the working class.

However, since 2008, easy money has produced an unusually weak economic recovery alongside an unusually long and strong run-up in prices for stocks, bonds and housing. The rich own the fattest share of these assets, so wealth inequality is increasing. In addition, easy money is fueling monopoly power by helping entrenched companies borrow.

Liberals who question the value of promoting monopolies and the superrich might also question their fondness for easy money. Instead, to stabilize financial markets, most favor upholding tough post-2008 regulations — but regulation alone can't contain the ocean of money in financial assets. From Australia to Canada to

Sweden, central banks are keeping rates low because consumer price inflation is weak, thus fueling housing bubbles. Regulatory attempts to contain those bubbles are failing.

Central bankers are starting to recognize that when loose monetary policy is driving up asset prices to potentially unstable levels, it sows the seeds of a recession and hurts everyone. But only a minority are prepared to lean against the wind now. Asset prices from stocks to real estate have never been this expensive simultaneously.

In general, government agencies, including the Fed, change their ways only after crises. The big threat is that the Fed will fully commit to preserving financial stability only after instability in the markets has triggered the next crisis. Mr. Trump should be looking for governors who are willing to commit now.

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