Only the Fed Can Save Us

Jerome Powell and the Federal Reserve must stand up to Trump. If they don't, the American economy is heading for disaster.

By William D. Cohan

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Here's the moment I realized the next financial crisis is inevitable. It wasn't Aug. 23, when the president wondered who was our "bigger enemy," Jerome Powell, the chair of the Federal Reserve Board, or President Xi Jinping of China. It wasn't the week before those comments, when it looked as if the trade war would tip the world into recession. Rather, it was several months ago, at the end of November, when Mr. Powell was giving a speech at the Economic Club of New York.

By that point, the Federal Reserve had already raised short-term interest rates three times in 2018, and the crowd of economists, policy wonks and business journalists at the lunch were looking for any sign that he might do so again. Fed chairs rarely make their policy changes explicit, but it was clear from Mr. Powell's comments that he was putting on the brakes.

"Interest rates are still low by historical standards," Mr. Powell said, "and they remain just below the broad range of estimates of the level that would be neutral for the economy — that is, neither speeding up nor slowing down growth." His use of the word "neutral" at that moment was the key. While he was talking, the Dow Jones industrial average rocketed up 618 points, its biggest one-day gain in months.

But although a sense of euphoria spread through the room, as well as through debt and equity markets, I was overcome by a sense of dread. A decade of historically low interest rates has begun to warp our economy. As we learned to our collective horror during the 2008 financial crisis, a period of sustained low interest rates forces investors on a desperate search for higher yields, inflating asset prices and the risks of owning loans and debt of all kinds.

Jerome Powell, the Fed's chair. Al Drago for The New York Times

Instead of continuing to try to right the ship, by gradually raising interest rates, Mr. Powell, in that speech, seemed to be caving to political pressure — from the president and from Wall Street bankers and traders — to keep rates low. Indeed, that is what he has done. On July 31, for the first time in more than a decade, he lowered short-term interest rates.

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That was a mistake. Mr. Powell and his colleagues at the Fed need to stand up to Mr. Trump and do what's right for the economy. If they don't, the only question that remains is, when will it all blow up? When it does — and that day will be soon — we will be staring down yet another financial panic.

We're now more than a decade into an era of super-low interest rates. The Fed's decision to keep capital cheap and plentiful made sense after the financial crisis. It allowed companies and consumers to get the money they needed to rev up the economy after the recession choked the capital markets.

But the years of low interest rates have also caused debt investors — who couldn't get good returns on low-yielding Treasury securities pegged to the Fed rate — to start chasing higher yields. As a result, they've been taking on far too much risk, for far too low a return, for far too long.

All that risk is not hidden on the balance sheets of the big Wall Street banks, as it was during the 2008 financial crisis. But it doesn't just disappear into thin air. Like the oxygen we breathe but cannot see, it's all around us, in hedge funds, private equity firms, and pension funds and university endowments that have been investing in risky debt, in the form of corporate bonds and other securities, to the tune of trillions of dollars.

What do those securities look like? There is, first of all, a proliferation of dodgy bank loans, issued without the covenants that are designed to protect the lender in case of default. In typical Wall Street fashion, those loans are turned into securities and sold to investors around the world. (Japanese banks are among the largest investors in these securities, called "collateralized loan obligations.") It's the current version of the mortgage-backed securities phenomenon that helped to sink the economy in 2008.

There is also an eye-popping amount of risk propagated by some of the biggest names in American business. Bonds rated BBB — a notch above "junk" bonds — issued by big companies such as AT&T, Verizon, G.E., G.M. and Ford, represent more than half of the investment-grade corporate bond market. That raises the ugly specter of the "triple-B cliff," the losses bondholders will incur when the economy dips and some of those companies can't repay their debt.

Anne Walsh of Guggenheim Partners said at an investor conference in April that the risk in the BBB market reminded her of 2008. "The overleverage is in corporate America," she said. "This is where we feel the risk is, and right now you're not getting paid to take that risk."

The troubling size of this debt is not news — not even to the Fed or to the Treasury. "Business debt has clearly reached a level that should give businesses and investors reason to pause and reflect," Mr. Powell said on May 20. "If financial and economic conditions were to deteriorate, overly indebted firms could well face severe strains." Mr. Powell was careful to note that "the parallels to the mortgage boom that led to the global financial crisis are not fully convincing." But without capital, layoffs and recession are inevitable, which could bring to an abrupt end a decade of prosperity.

Ten days after Mr. Powell made those comments, Steven Mnuchin, the Treasury secretary, held an executive session of the Financial Stability Oversight Council in part focused on the topic of "corporate credit and leveraged lending."

No one knows exactly how much of the trillions of debt that's out there is at risk of default. We do know that since 2008, the dollar amount of American corporate bonds outstanding has increased to more than $9 trillion, from around $5 trillion. Companies, universities, municipalities and governments globally have never been more indebted, with a record of $237 trillion reached at the end of 2017, 40 percent more debt than a decade ago.

In large part, the explosion of debt issuance has been driven by central-bank policies that have kept interest rates at historically low levels, in effect rewarding entities for issuing more and more debt. Interest payments on corporate debt are tax deductible, in most jurisdictions.

We live in a world awash in debt.

But that's the risk we can see. There is plenty of additional risk hiding in the undisclosed obligations of private companies and in the "shadow banking system," nonbank financial institutions that have sprung up in the past decade to hold the risk that the Federal Reserve insisted, after the 2008 financial crisis, that Wall Street avoid.

So what would happen if interest rates did increase slightly, or if the economy dipped into a recession, and some of those overleveraged companies could no longer meet their interest payments? It wouldn't be pretty.

We got a taste of that, briefly, last December, when interest rates ticked up just a bit, and there were suddenly no buyers for high-yield debt. Not a single high-yield debt deal got done in that month. When companies with the poorest credit can't get financing, it sends a chill throughout the credit markets, but it also means that hiring slows, factories don't get built and innovation stalls.

It's easy to dismiss those fears. After that December freeze, the Fed again moved to keep interest rates low. And the capital markets revived. The party resumed. Many other economic indicators look stable — G.D.P. growth, unemployment, wages — and the Dow, while volatile, remains just 1,000 points below the high it reached in July.

But while we look to the stock market as a barometer of our economic health, it's increasingly less relevant. In the late 1990s, the number of publicly traded companies peaked at around 7,300; today there are around 3,600. With more companies in private hands, and the market for private finance growing, we know less and less about the hidden risks these companies pose to the economy.

For calm to return to the capital markets, we must pop the debt bubble, the sooner the better.

Mr. Powell could pivot back to a posture of raising short-term interest rates. He's been trying to hang tough. He has publicly defended the Fed from meddling by the president, who continues to pressure Mr. Powell to lower interest rates, believing incorrectly that it will accelerate economic growth.

Mr. Powell does have other tools. He could direct the Fed to sell some of the $3.7 trillion in assets on its balance sheet. That would, in effect, lower demand for and the price of bonds, and increase their yields. He most definitely should not lower rates again, as that would further inflate the gigantic bubble in the bond market. But he must do something to signal that interest rates will no longer be manipulated downward.

Investors could also consider tightening their credit standards or withholding their money until they get higher yields, and more protective covenants.

Barring these logical measures, we can just wait for the inevitable explosion. But one step the Fed can take now is to allow interest rates, the price of money, to find their own level.

In a talk before a financial reform conference on May 21, Daniel K. Tarullo, a former governor of the Fed who led the board's financial regulatory reforms, reminded the audience that the 2008 financial crisis hit households and smaller businesses especially hard — even those that were uninvolved in risky mortgages or the housing bubble. As a result, he noted, "it's a really good idea" to reduce the severity and frequency of financial crises.

"One might have hoped that, barely a decade removed from a major, global financial crisis, and the worst recession in three quarters of a century, it would not be necessary to make these points," Mr. Tarullo said. "Unfortunately, it is."

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