I have grown increasingly concerned about the risks posed by current monetary policy.

First, we are experiencing financial excess that is of our own making. There is a lot of talk about "macroprudential supervision" as a way to prevent financial excess from creating financial instability. But macroprudential supervision is something of a Maginot Line: It can be circumvented. Relying upon it to prevent financial instability provides an artificial sense of confidence.

Second, I believe we are at risk of doing what the Fed has too often done: overstaying our welcome by staying too loose, too long. We did a good job in staving off the deflationary and depression risks that were present in the aftermath of the 2007–09 financial crisis. But we now risk fighting the last war.

Given the rapidly improving employment picture, developments on the inflationary front and my own background as a banker and investment and hedge fund manager, I am increasingly at odds with some of my respected colleagues at the policy table of the Federal Reserve as well as with the thinking of many notable economists. The economy is reaching the desired destination faster than we imagined.

Third, should we overstay our welcome, we risk not only doing damage to the economy but also being viewed as politically pliant.

The Fed has been running a hyper-accommodative monetary policy to lift the economy out of the doldrums and counteract a possible deflationary spiral. Much of what we have paid out to purchase Treasurys and mortgage-backed securities has been put back to the Fed in the form of excess reserves deposited at the Federal Reserve banks. As of July 9, $2.517 trillion of excess reserves were parked on the 12 Fed banks' balance sheets, while depository institutions wait to find eager and worthy borrowers to lend to.

But with low interest rates and abundant availability of credit in the nondepository market, the bond markets and other trading markets have spawned an abundance of speculative activity.
There are some who believe that "macroprudential supervision" will safeguard us from financial instability. I am more skeptical. Such supervision entails the vigilant monitoring of capital and liquidity ratios, tighter restrictions on bank practices and subjecting banks to stress tests. All to the good. But whereas the Federal Reserve and banking supervisory authorities used to oversee the majority of the credit system by regulating depository institutions, depository institutions now account for no more than 20% of the credit markets.

I am not alone in worrying about this. In her recent lecture at the International Monetary Fund, Fed Chair Janet Yellen said, "I am also mindful of the potential for low interest rates to heighten the incentives of financial market participants to reach for yield and take on risk, and of the limits of macroprudential measures to address these and other financial stability concerns." She added that "[a]ccordingly, there may be times when an adjustment in monetary policy may be appropriate to ameliorate emerging risks to financial stability."

I believe that time is fast approaching.

Some are willing to tolerate the risk of financial instability because the Fed has yet to fulfill the central bank's mandate of "promot[ing] effectively the goals of maximum employment and stable prices." Where do we stand on those two fronts? Answer: closer than many think.

While it is difficult to define "maximum employment," labor-market conditions are improving smartly, quicker than the principals of the Federal Open Market Committee expected. The commonly cited household survey unemployment rate has arrived at 6.1% a full six months ahead of the schedule predicted only weeks ago by the central tendency of the forecasts of FOMC participants. The U.S. Bureau of Labor Statistics' so-called Jolts (Job Openings and Labor Turnover Survey) data indicate that job openings are trending sharply higher, while "quits" as a percentage of total separations continue to trend upward—a sign that workers are confident of finding new and better opportunities if they leave their current positions.

Wages are beginning to lift. Median usual weekly earnings collected as part of the Current Population Survey are now growing at a rate of 3%, roughly their pre-crisis average. In short, the key variable of the price of labor, which the FOMC feared was stagnant, is beginning to turn upward. It is not doing so dramatically, but wage growth is an important driver of inflation.

The FOMC has a medium-term inflation target of 2% as measured by the personal consumption expenditures (PCE) price index. The 12-month consumer-price index (CPI), the Cleveland Fed's median CPI, and the so-called sticky CPI calculated by the Atlanta Fed have all crossed 2%, and the Dallas Fed's Trimmed Mean PCE inflation rate has headline inflation averaging 1.7% on a 12-month basis, up from 1.3% a few months ago. PCE inflation is clearly rising toward our 2% goal more quickly than the FOMC imagined.

I do not believe there is reason to panic on the price front. But given that the inflation rate has been accelerating, this is no time for complacency either. Some economists have argued that we should accept overshooting our 2% inflation target if it results in a lower unemployment rate. But the notion that we can always tighten policy to bring down inflation after overshooting full employment is dangerous. Tightening monetary policy once we have pushed past sustainable capacity limits has almost always resulted in recession, the last thing we need.

So what to do? My sense is that ending our large-scale asset purchases this fall will not be enough. The FOMC should consider tapering the reinvestment of maturing securities and begin incrementally...
shrinking the Fed’s balance sheet. Some might worry that paring the Fed’s reinvestment in mortgage-backed securities might hurt the housing market. But I believe the demand for housing is sufficiently robust to continue improving despite a small rise in mortgage rates. Then early next year, or potentially sooner depending on the pace of economic improvement, the FOMC may well begin to raise interest rates in gradual increments.

Those of us who are the current trustees of the Fed’s reputation—the FOMC—must be especially careful that nothing we do appears to be politically motivated. In nourishing the growth of the economy and employment, we must avoid erring on the side of coddling inflation to compensate for the inability of fiscal and regulatory policy makers in the legislative and executive branches to do their job. We must continue to protect the independence of the Fed.

Mr. Fisher is president of the Federal Reserve Bank of Dallas. This article is excerpted from his speech on July 16 at the University of Southern California’s Annenberg School for Communication & Journalism.