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Unintended results

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Last August, sensing potential contraction in the economy, Fed Chairman Ben Bernanke used an annual retreat of Federal Reserve bankers in Jackson Hole, Wyo., to introduce unprecedented monetary stimulus from our nation's central bank. What ensued was the purchase by the Federal Reserve of $600 billion in U.S. Treasuries between November 2010 and June 2011. This increased the money supply and grew the Fed's total portfolio of treasuries and mortgage securities to more than $2.5 trillion. That effort, formally understood as a second round of "quantitative easing," has been dubbed QE2. Given how tenuous economic growth continues to be, many market watchers wondered whether last week's Jackson Hole retreat would produce a similar announcement from Bernanke.

Thankfully, his remarks this year suggest that the Fed is content to stand still for the foreseeable future. Perhaps the only thing proven by QE2 was the law of unintended consequences. When Bernanke announced QE2 he said that it would help lower the cost of borrowing. Instead, the cost of borrowing increased. There seemed to have been some hope that QE2 would help inflate a deflated housing market. It didn't. The only asset class that inflated was precious metals. What is clear is that QE2 knocked the wind out of the dollar. Some economists, curiously, rejoiced in the the weaker dollar. Why? Because a weaker dollar would, in theory, reduce the cost of U.S. exports in foreign markets, increasing demand for U.S. products, thereby increasing domestic manufacturing. Nice theory. But according to **Cato Institute** economist Alan Reynolds, net exports actually decreased under QE2. What we do know is that the weaker dollar under QE2 significantly increased the cost of oil and other industrial commodities. Those increased costs probably account for the net decline in domestic manufacturing because of how they affected production and distribution. Some claim that QE2 was a blessing to the stock market, pointing to the rise in stock prices last year. But that rise had at least as much to do with record earnings as it did with monetary accommodation, and those record earnings for U.S. companies are increasingly coming from overseas operations. The Federal Reserve's announcement earlier this month that it will keep the discount rate near zero for the next two years provides extraordinarily easy money for as far as the eye can see. Easy money policies, like these, are fraught with unintended results. Intended to spur consumption, they might actually dampen it. A recent study by the American Institute for Economic research shows how low interest rates have decimated the incomes of savers, depriving them of anywhere from $256 billion to $587 billion in job-creating consumption. Given how hard it is for the best and the brightest to predict how a novel approach to monetary policy will actually play out, we're grateful that there is no QE3 to worry about. All that we ask of the Fed now is to keep the dollar strong and inflation low.