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The Fed Surprises

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The August 9th meeting of the Federal Open Market Committee -- the policymaking arm of the Fed -- was widely expected to be largely uneventful. It was anything but.

Instead, the Fed issued a [press release](#) in the aftermath of the meeting that caught even its closest watchers off-guard, and is indicative of the state of turmoil in the U.S. economy and financial markets.

The Fed left the "federal funds" interest rate at 0 to .25 percent. That in itself is not a shock. The Fed surprised markets, however, by specifying for how long it will hold interest rates at this low level: through mid-2013. It is unprecedented for the Fed to specify so precisely for how long it will maintain a given policy.

The committee meeting must have been a brouhaha, because 3 of the 10 voting members dissented. In recent years, dissents have been

infrequent and typically just one vote. (Outgoing Kansas City Fed president Thomas Hoenig dissented at every meeting for one year.) The dissenters were the presidents of the Dallas, Minneapolis and Philadelphia Fed banks. Goldman Sachs reported that the last time there were 3 dissents was 1992.

What is the meaning of this?

Promising not to raise rates until mid-2013 means the Fed will not need to make a policy change in a presidential election year. That could be interpreted as an attempt to be non-political; that is, not to be a topic for campaign debate. It could equally be interpreted as an overtly political move to aid President Obama's re-election. In years past, the Fed had a certain independence from politics and would have been insulated from the suspicion of partisanship. But the current Fed chairman, Ben Bernanke, has politicized the Fed and invited suspicions about its motives.

Promising to hold interest rates down for two years ties the FOMC's hands. A great deal can happen in two years, and the committee may come to regret the decision.

The FOMC decision also signals the Fed has thrown in the towel on the recovery. Its economic forecasts have been consistently too rosy. It has explained weakness in economic growth in the first half of 2011 on special factors like disruptions in industrial production caused by events in Japan. It forecasted a stronger second-half growth as these transient factors passed from the scene. Now it is effectively admitting that something structural is wrong with the economy. It was late to that realization, as many forecasters and now the financial markets have been signaling.

Given its more pessimistic view of the economic future, one might wonder why the FOMC didn't adopt a still more aggressive stance. Why not announce a new round of purchases of financial assets as it has done twice before. Why not QE3 (quantitative easing, 3rd round)? Though I expect no such admission, I suspect that even Chairman Bernanke has come to the realization that prior monetary stimulus has failed. As it has. Additionally, if there were three dissents on lukewarm easing, he might have lost the vote for an even more aggressive policy.

What about financial markets? For the near term, Treasury obligations are the only financial safe haven. (Gold is a commodity safe-haven.) The stock market has been trying to run on monetary and fiscal fuel. The room for further federal spending has been circumscribed. Now the prospects for additional monetary stimulus have dimmed. Markets are going to trade on economic fundamentals. Those are not strong, and hence the volatility witnessed in the last three days.

There are two clear losers with today's decision: the dollar and savers. The promise to keep interest rates low for two more years ensures continued weakness of the dollar against strong foreign currencies and gold. I watched the value of the Swiss franc and gold rise as the timing of announcement approached.

Savers lose because of low returns. If the Fed were trying to destroy the middle class on the installment plan, it could hardly have devised a better policy than one of continued low interest rates.

Mr. O'Driscoll is a senior fellow at the Cato Institute and was formerly vice president at the Federal Reserve Bank of Dallas.

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NASDAQ	2472.86	+91.81	+3.86%
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Gainers	Losers	Most Active
AONE	\$4.44	+1.27 +40.06%
IL	\$8.20	+1.56 +23.49%
SOL	\$3.98	+0.75 +23.22%
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