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Federal Reserve's Operation Twist Takes Wrong Turn

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Abstract

The Federal Reserve recently renewed efforts to strengthen the U.S. economy through Operation Twist, under which it sells short-term securities and buys long-term securities. The Fed is responding to weak U.S. jobs growth and the evident ineffectiveness of President Obama's economic policies. The "twist" policy has little prospect of helping the economy, while adding more harmful uncertainty to markets. Down the road, as interest rates rise again, the policy means the Fed will be at risk of losing significant sums on its investments, further burdening the federal budget and the taxpayer. Once a robust recovery is underway, the Fed may also find it hard to unwind its positions in long-term securities without seriously undercutting the recovery.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2710**

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At its meeting on June 20, 2012, 11 of 12 members of the Federal Open Market Committee (FOMC) voted to apply another $267 billion to continue Operation Twist through the end of this year. The "twist" is the Federal Reserve's latest effort to compensate, through monetary policy, for the failure of the Obama Administration's fiscal and regulatory policies to stimulate the economy. The Fed's policy is to push down long-term interest rates while pushing up short-term rates, hence twisting the maturity spread of interest rates. Jeffrey Lacker, president of the Richmond Federal Reserve Bank, was the lone vote against further twisting. Lacker was right.

Setting the Economic Scene

The days following the FOMC meeting were filled with bad economic omens validating the Fed's concerns over the economy and persistent high unemployment:

- The Philadelphia Federal Reserve bank index slipped to –16.6, and moved deeper into contraction territory;
- Consumer confidence fell for the fourth month in a row;

KEY POINTS

- U.S. job growth has nearly stalled and the unemployment rate is projected to remain above 8 percent at least through 2013.
- Operation Twist, the Federal Reserve's latest attempt to stimulate the economy, is unlikely to put appreciable downward pressure on long-term interest rates or to help the economy as intended. It will add unhelpful uncertainty to financial markets.
- As interest rates begin to rise in the future, the Federal Reserve is likely to lose significant sums on its long-term securities holdings, creating a new burden on the federal budget and the taxpayer.
- Though Operation Twist is unlikely to have much effect on long-term interest rates today, when a robust recovery does take hold the Fed is likely to find it difficult to unwind its enormous holdings of long-term securities without putting additional, upward pressure on long-term rates, thus prematurely weakening the recovery.

- The Census Bureau reported that monthly retail sales fell in April and May while June same-store sales were flat;
- The Institute for Supply Management (ISM) manufacturing index slid into contraction territory at 49.7; and
- The ISM non-manufacturing index slid 1.6 points to 52.1—its lowest level since early 2010.

Then, the Department of Labor reported the economy created a very modest 80,000 jobs in June, about on par with the prior two months, and consistent with the other data indicating an economy apparently stalling.[1] The key word in the Labor Department report was "unchanged": "the number of unemployed persons (12.7 million) was essentially unchanged"; "the number of long-term unemployed (those jobless for 27 weeks and over) was essentially unchanged"; and on and on. An economy that is essentially "unchanged" is not an economy that is growing.

Nor, judging by the actions of other central banks, is the slowdown limited to the United States. On July 5, in response to the developing recession in the United Kingdom, the Bank of England launched its third round of quantitative easing, adding another 50 billion pounds ($77 billion) to the 325 billion pounds ($504 billion) already pumped into the domestic money supply. On the same day, the European Central Bank cut its key lending rate by 25 basis points to a record low of 0.75 percent as recession envelopes the continent. Coincidentally, even the Bank of China cut rates for the first time in three years, cutting its benchmark one-year lending rate by 0.31 percent to 6 percent, and the rate on deposits by 25 basis points to 3 percent.

Of course, not all economic indicators are flashing red. The U.S. housing sector continues to stabilize; inflation remains tame while key prices like gasoline have fallen from recent highs; factory orders remain solid; and weekly new unemployment insurance claims, while elevated, remain just below the worry line of 400,000.

All in all, the economy grew at a limping 1.9 percent in the first quarter of 2012 and clearly appears to be slowing. With the U.S. economy languishing, the global economy struggling, and no help on the horizon from the President or Congress, Chairman Ben Bernanke understandably seeks to do something, indeed anything, to help. If nothing else, the Fed's actions should put to rest any doubt President Barack Obama's economic policies have failed. The Fed would not be driven to desperate measures if the President had pursued effective measures instead of a political agenda to grow the federal government and federal debt to European proportions.

Unemployment in the United States is expected to remain at, or above, 8 percent, at least through 2013. Considering those who have dropped out of the labor force or are working part time because they cannot find full-time jobs, the full extent of labor market weakness is even greater. With inflation remaining subdued, indeed possibly threatening to slip into negative, or deflationary, territory, effective action is sorely needed—but at this point only President Obama, working with Congress, can take effective action.

The immediately needed action is not terribly sophisticated: President Obama should work with Congress to disarm "Taxmageddon" immediately.[2] Taxmageddon is the $496 billion tax hike ready to slam the economy on January 1, 2013. Knowing Taxmageddon is coming and watching the President's calls to raise taxes on small businesses, those businesses are already responding defensively.[3] They have no choice: They do not know how high their tax burden will be next year except that the President wants to raise it, and they do not know whether the President and Congress will wake up in time to disarm Taxmageddon's crushing blow.

The Fed Responds

Under the circumstances, the Federal Reserve should respond if a reasonable response is available, but unfortunately the Fed has already exhausted its traditional tools such as lowering short-term interest rates by buying short-term Treasury notes and similar securities. The mechanism is simple enough: Add to the supply of cash in the economy and the price—short-term interest

1. News release, "The Employment Situation–June 2012," Bureau of Labor Statistics, July 6, 2012, http://www.bls.gov/news.release/pdf/empsit.pdf (accessed July 9, 2012).
2. J. D. Foster, "Preventing Taxmageddon Is Congress's Summer Job," Heritage Foundation *Issue Brief* No. 3608, May 17, 2012, http://www.heritage.org/research/reports/2012/05/tax-increase-preventing-taxmageddon-is-congress-s-summer-job.
3. Curtis Dubay, "Taxmageddon is Slowing the Economy Now," The Heritage Foundation, The Foundry, June 20, 2012, http://blog.heritage.org/2012/06/20/taxmageddon-is-slowing-the-economy-now/.

rates—goes down. The federal funds rate, the traditional target for effecting monetary policy, already stands near zero, so that tool is spent.

With short-term interest rates near zero, to respond to economic weakness the Fed must move up the maturity ladder to longer maturities. But the Fed has already pursued two rounds of quantitative easing to no apparent effect.[4] Quantitative easing involves much the same mechanism as traditional monetary policy—buying securities to add liquidity to the market. The difference is that under quantitative easing the Fed attempts to push down long-term interest rates by buying longer-term securities rather than short-term interest rates by buying short-term securities. However, for little apparent effect on the economy, quantitative easing has led to a massive increase in the money base and in the Fed's balance sheet, both of which will create serious problems for monetary policy when the economy finally begins to recover and the inflation threat returns.

Thus the Fed has turned to Operation Twist: Rather than buying securities and adding liquidity to the market (as it did in the past and as the Bank of England is doing today with quantitative easing), the Fed sells short-term securities and buys long-term securities, generally Treasury securities with maturities of at least six years. The idea behind Operation Twist is to push down long-term interest rates, such as home mortgage rates, and thus stimulate the economy without increasing liquidity in financial markets and without expanding the Fed's balance sheet further. Reasonable in theory, in practice this policy is likely not only to prove ineffective, but counterproductive in the near term and harmful in the long run.

The Fed's Twist policy is likely to prove ineffective for three reasons:

- Applying $267 billion to the purchase of long-term securities over a period of months is likely to have an imperceptible effect on long-term interest rates. To put this figure in context, the domestic mortgage market had a total volume of $13.5 trillion at the end of 2011, nearly 50 times larger than the Fed's purchases, and this is only a portion of the global long-term market the Fed seeks to influence.

- Long-term interest rates are already astoundingly low. For example, the 10-year Treasury bond rate is around 1.5 percent—compared to 3.3 percent in 2010 and an average over the past 20 years of about 5 percent. Home mortgage rates have followed a similar track. If long-term rates this low cannot prop up the economy, the imperceptible interest rate effects of Operation Twist can have no appreciable economic effect.

- The flip side of Operation Twist is selling short-term securities. If twisting has a downward effect on long-term interest rates as the Fed hopes, it is also likely to have a roughly equivalent upward effect on short-term interest rates with an uncertain net effect, at best, on the economy.

What's the Harm in Trying?

Given the high unemployment rate and Operation Twist's likely negligible economic effect, the policy might still be worth pursuing were it not for the (likely substantial) downsides.

In the short run, the Fed's policy adds confusion and uncertainty to the market. No one can say on any given day whether the policy has an effect or not, and so it is more difficult to distinguish interest rate movements due to market forces from movements due to Fed intervention. This means by extension that asset values, all of which are tied to one extent or another to interest rates, are more in question. A prerequisite for economic healing is price discovery, especially for assets, which comes from and leads to clarity and certainty. Operation Twist adds to the uncertainty in markets.

One concern occasionally raised with Operation Twist is that it adds to the risk of higher inflation down the road. This concern is likely misplaced. Unlike traditional Federal Reserve operations or even quantitative easing, which seek to push down short-term or long-term interest rates by expanding the money base and the Fed's balance sheet, Operation Twist alters the mix of securities in the marketplace and on the Fed's balance sheet, but does not alter the amount of money in the economy and so it does not add to the existing future inflation threat.

The good news ends with inflation, however. The long-term threat from Operation Twist is that it may make the Federal Reserve's job of unwinding all the monetary stimulus of recent years much more difficult. At some point, just as the economy is beginning to strengthen and unemployment to fall, the Fed will have to

4. J. D. Foster, "The Fed's QE2 and the Economy: Sailing to Safety or a Ship of Fools?," Heritage Foundation *Backgrounder* No. 2481, October 25, 2010, http://www.heritage.org/research/reports/2010/10/the-feds-qe2-and-the-economy-sailing-to-safety-or-a-ship-of-fools.

reverse its positions, shift toward a more conservative, anti-inflationary posture, and dramatically shrink its holdings of long-term securities.

What this means in practice is that, just as the economy is finally recovering and interest rates begin to rise toward more normal levels, the Fed will push up interest rates even faster than market pressures would indicate, especially long-term rates, substantially dampening the recovery. William McChesney Martin, the longest-serving chairman of the Federal Reserve Bank, famously quipped it is the Fed's job "to take away the punch bowl just as the party is getting going." The consequence of recent Fed policy will likely be that the Fed will have to take away the punch bowl just as the first guests arrive, which will make for a very dreary party.

Herein lies a sad irony surrounding Operation Twist. Though it likely will have an imperceptible effect on long-term interest rates this year because it is essentially "pushing on a string," unwinding the twist while the economy is recovering smartly will be like yanking on a taut string and is likely to have a much stronger effect in terms of upward pressure on interest rates.

A Fed Stress Test?

A final danger associated with Operation Twist concerns the Federal Reserve itself. The simple fact is long-term interest rates in the United States are very low. The Fed is adding to its already enormous position in long-term assets. When interest rates rise, which they will inevitably do (and likely rapidly and to much higher levels than normal), the value of the Fed's long-term assets will plummet. For example, if long-term interest rates rose to just 4 percent, the Fed's $267 billion Twist investment could drop in value by as much as $50 billion. If long-term rates rose to 6 percent, the Fed would lose as much as $80 billion. Even with today's massive budget deficits, that is real money.

The Fed is supposed to be a central bank, not a hedge fund. When it loses money, it loses taxpayer money. It would be worthwhile, then, for the Fed to consider a stress test of its own. Unlike stress tests performed on private financial institutions, the Fed's stress test would not explore its financial soundness. After all, the Fed can create its own assets by printing money, so financial soundness is not the issue. Taxpayer losses are the issue. When, not if, interest rates rise, the question will be how much money taxpayers stand to lose.

This is a reasonable question for taxpayers to ask and demand that Chairman Bernanke answer—especially when the Fed's holdings of long-term securities appear to have little beneficial effect and in fact may impede near-term recovery while posing a long-term economic risk. It is also a reasonable question for the Fed to ask itself, as the Fed may be creating a real threat to its own future political independence. The Fed's history of yielding back earnings to the federal Treasury has long been a bulwark against political incursions on the Fed's independence. If the Fed suddenly becomes a drain on the Treasury, Congress may see an opportunity to press the Fed more fully on other matters such as interest rate policy.

Return to Basics: Do Less Harm

The economy's prospects, which are today far from encouraging, would brighten if the Fed, the President, and Congress each adopted a do-less-harm approach to economic policy. For the President and Congress, that starts with disarming Taxmageddon. For the Fed, a do-less-harm approach involves three simple steps:

- **Suspend Operation Twist and thereby remove this one source of confusion and uncertainty in the marketplace.**

- **Acknowledge there is little monetary policy can do at this juncture to support today's economy.** This acknowledgement would have the dual benefit of placing the onus to act back on President Obama and Congress, and would further reduce market uncertainty by eliminating the suggestion of future Fed meddling.

- **Assure market participants that, in the event of another financial crisis, the Fed is ready, willing, and able to respond in its role as lender of last resort to provide liquidity where and when it is needed.** In light of recent economic developments in Europe, markets are likely to value this assurance highly.

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