

OPINION

The Fed 'Twist' That Won't Dance

By David Malpass

With unemployment high and President Obama locked into antigrowth tax increases, the Federal Reserve is again being called on to intervene in financial markets. The latest bad idea is for the Fed to try to lower long-term interest rates (or "flatten the yield curve") by lengthening the maturity of its \$2.6 trillion bond portfolio.

The Fed should instead be using its considerable energy and expertise to provide sound money, and using its bully pulpit to encourage federal spending restraint and regulatory reform in line with its full-employment mandate.

Bond-buying creates an obvious conflict of interest because the Fed's portfolio loses value if it raises interest rates.

To try to flatten the yield curve, the Fed would buy more long-maturity bonds and finance them by selling some of its shorter-term bonds (dubbed Operation Twist) or by further increasing the \$1.6 trillion in short-term deposits it holds for commercial banks (in other words, more quantitative easing).

Either way, borrowing short and lending long is risky financial behavior. It exposes the taxpayer to interest rate risk—since the Fed's bond holdings will lose value if interest rates go up.

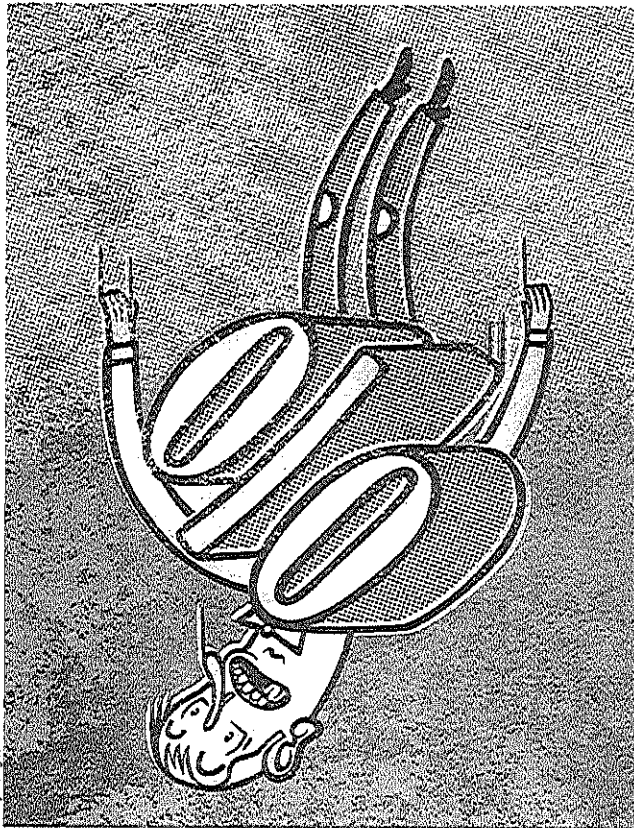
Just as worrisome, Fed bond purchases shorten the maturity of the

national debt. When it buys bonds, the Fed negates the Treasury Department's bond issuance, the goal of which should be to put longer-maturity debt into the global private sector while bond yields are low.

Long-maturity Treasury bonds protect taxpayers from higher interest costs in the event that interest rates have to rise in the future. But this won't happen if the Fed just buys the bonds back and holds them on its own balance sheet. By my estimates, the Fed's Treasury bond purchases in 2008-2011 shortened the average maturity of the national debt to four years from five, not counting the further shortening from the Fed's purchases of mortgage bonds.

The Fed will get attaboys from markets if it buys more bonds. The bond market loves a whale, a big buyer who doesn't care about price. It's even better when the purchases are announced in advance, giving markets an opportunity to buy first. When the Fed signaled it would buy mortgage bonds in 2008, markets bought them heavily before the Fed, locking in huge profits.

Similarly, markets bought Treasury bonds in September 2010 after the Fed signaled it would be a buyer. This drove yields down and prices up before the Fed began its purchases.



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Most of Washington wants the Fed to buy more bonds too. With the deficit running over \$1 trillion per year, Treasury has to move a lot of them. The Fed can't buy them all, though—the White House budget calls for the national debt to increase by another \$10 trillion, pushing the debt limit to \$24 trillion in 2021 according to the Office of Management and Budget's mid-session review.

Applause doesn't mean it's right for the Fed to keep buying. After all,

Wall Street and Washington gave the Fed hurrahs for its low interest rate bubble policy in 2004-2006. The motto was "dance till the music stops." More Fed purchases would hurt savers by lowering, for example, CD yields, add to market uncertainty, further distort short-term credit markets, and worsen the Fed's conflict of interest in setting interest rates, because its bond portfolio will lose value if it raises rates.

More fundamentally, the Fed should not be in the business of dangling bond purchases in front of world markets. Since the financial crisis, the Fed has been transforming itself from a monetary policy agency into a market-intervention shop, helping explain the thirst for gold, which has shot up to more than \$1,800 per ounce.

Operation Twist (named in honor of the 1960s dance craze) was first tried in the Kennedy administration. It consisted of Treasury issuing extra 18-month debt while the Fed bought back longer-term debt. In a study published in April, the San Francisco Fed said the operation, which caught markets by surprise, may have reduced bond yields by 0.15%—but only for a short period.

The modern version would probably be even less effective since markets are expecting it. The Fed's idea

is that the private sector will go looking for riskier and longer duration assets to make up for the bonds the Fed bought. But the evidence is clear that this isn't working: The Fed's near-zero interest rate policy and its huge overhang of bonds create uncertainty. This hurts small-business confidence and discourages job growth.

The twist from the second round of quantitative easing (QE2) contributed to the sharp economic slowdown in the first half of 2011 when the Fed was buying \$70 billion in bonds per month. The more it bought, the slower the economy grew as the twist sucked capital from savers and small businesses to the government.

The Fed has conducted a controversial experiment with near-zero interest rates and massive bond purchases. These policies have hurt growth and added to unemployment by distorting financial markets.

The Fed should be directing calls for action to the administration for tax reform, spending restraint and bank regulatory reform—each a proven job creator. The central bank has already bought nearly \$2 trillion in longer-term bonds, a massive intervention in markets, with no constructive results. It's time to move on.

Wall Street will threaten a tantrum if the Fed doesn't buy more long bonds. But most of the private sector would welcome a respite from constant government intervention. And the dollar might stop its slide, slowing the hemorrhage of growth capital from the United States.

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