



## FEATURE ARTICLE

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### **Twist, Stick or Fire?**

I read a great quote recently from Stephanie Flanders, the economics editor of the BBC who said, "If you are not sure of the quality of your ammunition it is best to fire first." Well in response to the current economic situation the UK has returned to the same ammunition in the form of further quantitative easing (in effect printing or creating money) while in the USA we have Operation Twist.

#### **Operation Twist**

"Operation Twist" was announced by the US Federal Reserve (Ben Bernanke) on the 21st September and it is hoped this will stimulate growth in the USA - when Operation Twist was announced it was accompanied by an explanation from the Fed of "significant downside risks" to an already-muted economic recovery.

The plan is to extend the average length of US bonds held on the Fed's \$2.85 trillion balance sheet with a deadline for completing this of June 2012. This will be achieved by the Fed selling \$400 billion (£260 billion) of shorter-dated US Treasury bonds, those maturing in between three months and three years and using the proceeds to buy longer-dated bonds, those maturing in 6 to 30 years.

By doing this the Fed's expectation is that it will, as the economists say, "flatten the yield curve" i.e. reduce long-term bond yields. (Operation Twist will actually mean that the Fed will be buying around 90% of all 30-year bonds issued for the next nine months. By increasing demand in this way and soaking up supply, the Fed hopes to push up 30-year bond prices and bring down their yields.)

This in turn is expected to help growth because as most American homeowners have 30-year, fixed-rate mortgages, flattening the yield curve should lower mortgage interest rates and encourage borrowers to switch to cheaper deals. In theory, this should stimulate borrowing (since rates are lower), which should eventually lead to spending and growth down the line.



In addition as a further part of Operation Twist, in order to boost the ailing US mortgage market, the Fed will also invest the proceeds of maturing housing debt into mortgage-backed securities, instead of Treasury bonds.

### **Market reaction:**

Immediately after the announcement by the Fed of this new policy 30-year Treasury yields dropped sharply and the yield curve between two-year and 10-year Treasuries flattened markedly, but both have subsequently retraced much of those movements and at the end of September the net decline in 30-year yields was only approximately 20bps.

### **Negative Effects?**

Unfortunately if Operation Twist is ultimately successful one result will be that it will push up shortfalls in US final-salary pension schemes. This is because lowering long-term rates reduces the discount rate at which pension funds calculate their liabilities. Hence, pension liabilities will rise faster than asset values will, producing bigger deficits in US company pension plans which employers and/or members may be asked to plug with greater contributions?

In addition there is a concern over the potential impact on banks' earnings. Earnings are expected to drop as the tightening of the spread between short-term and long-term rates will have a negative affect on bank's bottom line profitability.

Then there is the fact that Operation Twist may limit the Fed's flexibility down the line. If the economy were to recover, the Fed would experience huge losses. The reason is that interest rates and bond prices have an inverse relationship. So if in the future the Fed raises rates to tighten monetary policy and prevent the economy from overheating, long-term assets prices would drop, hurting the Fed's balance sheet.

### **Historical Context?**

Of course, Operation Twist isn't the first time that the Federal Reserve has tried to give the US economy a boost by changing the shape of the yield curve. Something similar was tried fifty years ago, during the Kennedy era. In 1961, the operation was deemed a success as it caused long-term rates to fall while leaving short-term rates largely unchanged, although historical analysis indicates that the fall in long term rates was only approximately 15bps.

### **Conclusion**

Monetary policy without the aid of fiscal policy has been described as like pushing on a string. The goals of monetary policy should also be in line with that of the government's fiscal measures to make sure that the programmes do not clash. For instance, lower borrowing costs that encourage spending



shouldn't be met with higher taxes on goods that discourage purchases. This would just eliminate the positive effects of lower borrowing costs.

For now, it seems that the odds are stacked against the success of Operation Twist. Interest rates are already at record lows and pushing long term borrowing costs a little lower probably won't make much of a difference on its own especially, for example, for homeowners who have lost too much equity in their homes to refinance.

In terms of the ammunition available to them however for Central Banks initiatives such as Operation Twist, Quantitative Easing, Credit Easing and whatever else the central bankers come up with are better than nothing.

As Stephanie Flanders so rightly said, "If you are not sure of the quality of your ammunition it is best to fire first" but in my opinion it is ultimately psychological fear of a double-dip recession which is preventing businesses from investing and expanding while at the same time consumers are afraid to spend and take advantage of cheaper interest/loan rates because of fear of unemployment. In addition markets generally are concerned that in Europe policy makers are simply "kicking the can" down the road but the problem with this is that they are fast approaching a brick wall!

Of course confidence is a fickle beast and can change extremely quickly and in this respect it is better, I think, to focus on the long rather than the short term because when confidence changes it can happen in a flash.

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