

## Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

SEPTEMBER 28, 2011

### OUR VIEW ON THE FEDERAL RESERVE: IT'S ABOUT MONEY, NOT INTEREST RATES

**What Is "Operation Twist"?** The Federal Open Market Committee (FOMC) unveiled a new plan to shift \$400 billion of its portfolio from shorter-maturity bonds (3 months to 3 years) out to longer-maturity bonds (6 years to 30 years). The marketplace labeled this plan "Operation Twist"—a throwback to a plan carried out by the Fed/Treasury in the early 1960s. In addition, the FOMC announced plans to reinvest proceeds from maturing mortgage-backed securities (MBS) back into MBS rather than into Treasuries.

**What's Really Going On?** Short answer: the Fed is trying to lower longer-term interest rates. Long answer: we think it is useful to think of the Fed as a large bond dealer or the "dealer of last resort" to the bond market instead of simply the "lender of last resort" to the banking system as portrayed by textbooks. The Fed holds a portfolio of \$2.9 trillion in assets. In effect, by selling shorter-term Treasuries and buying longer-term Treasuries and MBS, the Fed is removing bonds from circulation in the marketplace. In theory, this could force investors to seek out investment opportunities elsewhere (for investors: other parts of the bond market; for banks: new lending), which policymakers think will lower longer-term interest rates and promote a "stronger economic recovery".

**Is This QE3?** No. QE, or quantitative easing, means an *expansion* of the central bank's balance sheet by creating new bank reserves to finance securities purchases. "Operation Twist" represents a shift in the *composition* of the Fed's balance sheet in terms of maturity and securities

holdings. In other words, the Fed is reshuffling its holdings. By contrast, under QE2, the Fed expanded its balance sheet by creating new bank reserves. The difference is critical for investors since Operation Twist may not spark the same fears of inflation caused by money supply increases that followed QE2.

**Will "It" Work?** No. First, interest rates are already at historic lows and Operation Twist is likely to have only a marginal, additional impact on rates. Second, **the problem with QE2, Operation Twist, QE3 or other policies aimed at "keeping interest rates lower" is that the real problem is not interest rates, it is the flow of money and credit.** The credit system is like the circulatory system for a modern, complex monetary economy, connecting savers with borrowers and allowing economic activity to flourish. Since 2007, the money and credit system, which includes both the traditional commercial banking system and the so-called shadow banking system, has been severely impaired. Pushing down interest rates sounds nice in theory, but means little if a borrower cannot get a loan (or does not want a loan) at any rate. In fact, one of the reasons interest rates are at historic lows is because the flow of money and credit is clogged. Consider this: while US households continue to reduce their debt burden, savers, investors and even banks overwhelmingly prefer "risk-free" assets like US Treasuries over many other investment options. This lack of demand for new borrowing combined with an excess demand for "safe assets" keeps interest rates low. "Operation Twist" will likely do little to fix this log jam. As a result, while the bond market will be impacted by the Fed's actions, this does not mean the money and credit tap is freely flowing.

In short: it's about money (and credit), not interest rates!

TOOLS	FEDSPEAK	ENGLISH TRANSLATION
<b>Communication</b>	"Reinforcing the Committee's forward guidance about the likely path of monetary policy was seen as a possible way to reduce interest rates and provide greater support to the economic expansion."	Tell us how long rates will be low.
<b>Conditional Guidance</b>	"...a few participants emphasized that guidance focusing solely on the state of the economy would be preferable to guidance that named specific spans of time or calendar dates."	Tell us what their goals are.
<b>Large-Scale Asset Purchases</b>	"Some participants noted that additional asset purchases could be used to provide more accommodation by lowering longer-term interest rates."	Buy more bonds or other assets.
<b>Operation Twist</b>	"Others suggested that increasing the average maturity of the System's portfolio — perhaps by selling securities with relatively short remaining maturities and purchasing securities with relatively long remaining maturities — could have a similar effect on longer-term interest rates. Such an approach would not boost the size of the Federal Reserve's balance sheet and the quantity of reserve balances."	Sell short-term bonds and buy long-term bonds.
<b>Lower Interest on Excess Reserves</b>	"A few participants noted that a reduction in the interest rate paid on excess reserve balances could also be helpful in easing financial conditions."	Stop paying banks to park money at the Fed.