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On the September FOMC

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Donald Luskin

Another minimalist "do something" move, with three dissents -- against "significant" risks.

This is the first time in a very long while that the FOMC has surprised us. We didn't think that the Fed would do anything at all at this meeting, given that policy is about right relative to current levels of unemployment and inflation (see "Being Ben Bernanke" August 22, 2011). Perhaps the Fed is looking beyond *current* levels, and buying a hedge against what it characterized in today's statement as "significant downside risks to the economic outlook… including strains in global financial markets."

- The FOMC announced a new version of 1961's "Operation Twist," the lengthening of the maturity of the Fed's Treasury portfolio. The Fed will "purchase by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less."
- The object is to "put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative."
- Further, the Fed "will now reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities." Previously they had been invested in Treasuries.
- The object is to "help support conditions in mortgage markets."

Neither of these moves is "quantitative easing," because they do not increase the level of bank reserves. They both work through what Bernanke refers to as the "so-called portfolio balance channel," by taking onto the Fed's balance sheet maturity and credit risk now borne by the market, thus ameliorating the economy's extreme risk aversion.

- With three dissents from FOMC members who "did not support additional policy accommodation at this time" -- the same three who dissented at the previous meeting (see "On the August FOMC" August 9, 2011) -- it's not implausible to guess that this was all that Bernanke could get done.
- That said, we didn't even think he wanted to do *this* -- so it's hard for us to believe he wanted to do *more*.

Update to strategic view

US FED: The Fed announced a new version of 1961's Operation Twist, lengthening its portfolio's maturity. Bernanke himself has written that such maneuvers are not necessarily very effective, yet apparently he was sensitive to a demand effect by market expectations to be seen as "doing something," especially as he now feels downside risks to the economy are "significant."

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- Perhaps Bernanke was mindful of not disappointing market expectations. According to a CNBC poll, 69% of responding economists expected some version of Operation Twist, and of those, 78% expected it at today's meeting (and the amounts and maturities involved are eerily close to the average expectations in the poll). We know from the worst days of the banking crisis in 2008 that Bernanke is loath to not meet market expectations (see "Jump! How High? Cut! How Low?" January 31, 2008). Judging by the poor immediate reaction from growth-sensitive stocks and inflation-sensitive gold, perhaps Bernanke did not in fact meet expectations.
- It appears he has no great conviction that lengthening maturities of the Fed's portfolio ought to be especially effective. In a 2004 paper *Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment*, Bernanke wrote (with Reinhart and Sack) that "Operation Twist does not seem to provide strong evidence in either direction" for the efficacy of such policies. However examining other similar historical examples suggests that "targeted purchases of bonds at the zero bound could be effective at lowering the yields on longer-dated securities."
- At the same time, lengthening the maturity of the Fed's portfolio has significant costs, in that it makes it harder for the Fed to exit. Shorter-term securities can simply roll off -- longer-dated ones must be actively sold in the market (possibly at a loss, raising issues the Fed would rather not have raised).

Bottom line

The Fed announced a new version of 1961's Operation Twist, lengthening its portfolio's maturity. Bernanke himself has written that such maneuvers are not necessarily very effective, yet apparently he was sensitive to a demand effect by market expectations to be seen as "doing something," especially as he now feels downside risks to the economy are "significant."

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