The Logic Of The Twist

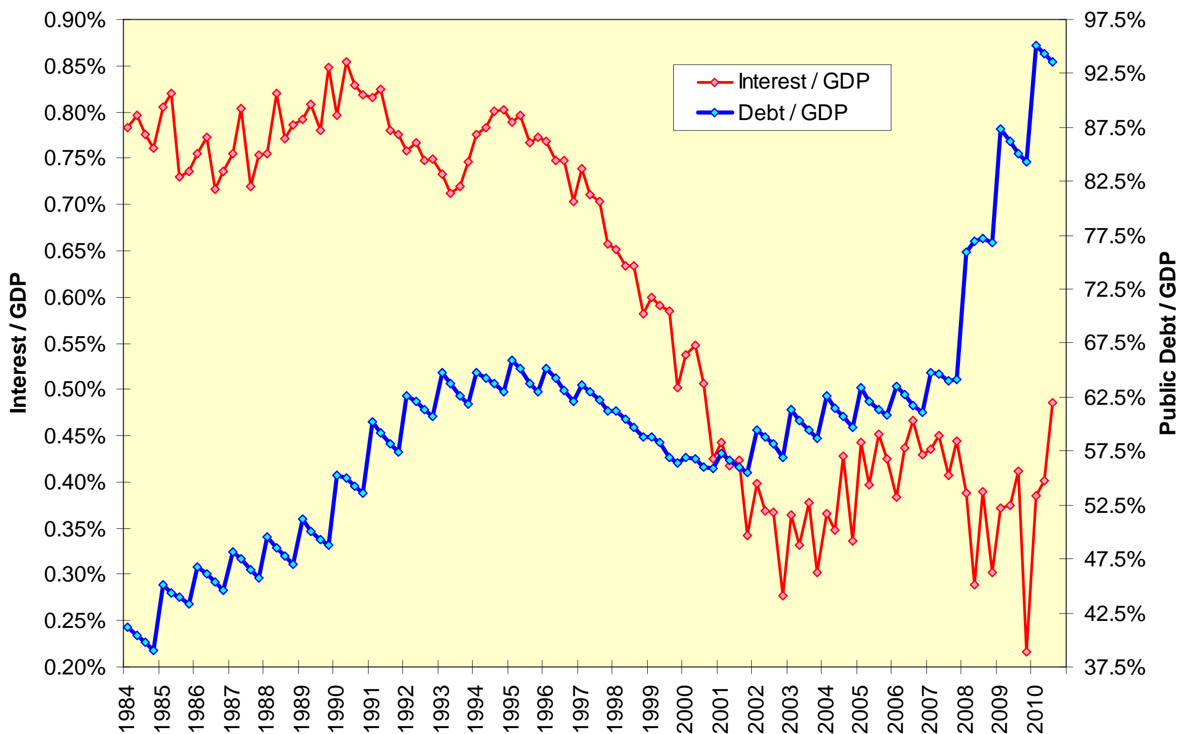
Most stuff coming out of Washington think-tanks is tax-exempt blather whose thesis is so closely and readily identifiable with the sponsor's interests it quickly gets all of the attention it deserves, which is none. A true exception was a late Vietnam-era Brookings Institution book, since updated, by Morton Halperin and Priscilla Clapp, Bureaucratic Politics and Foreign Policy. It tells the tale of how decisions are made on the basis of something other than national interest, however defined.

This avenue of thought is most useful when contemplating last week's re-opening of the Kennedy era's Operation Twist. Realistically, no one should hold out any hope for this latest foray into monetary tinkering to affect output and employment. It will keep rolling coupon payments into mortgage securities; $1.25 trillion hurled at this market during QE1 between March 2009 and March 2010 served to signal prospective buyers housing was overpriced; once this "stimulus" was removed, housing resumed its torpor. As the Twist involves selling the short end and buying the back end of the yield curve, it will not expand the Federal Reserve's balance sheet; that got a bad odor during both QE episodes. The desired wealth effect from QE2 never materialized.

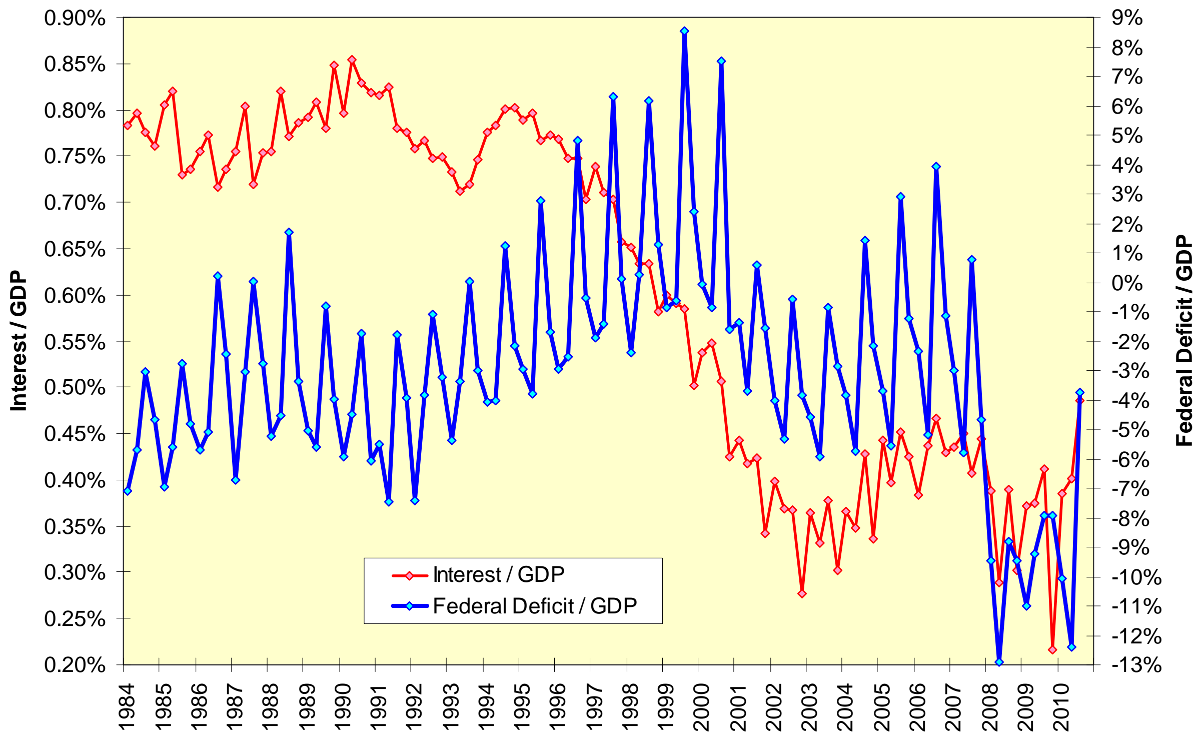
Follow The Money

As Vietnam was followed by Watergate and its famous "follow the money" dictum, let's see who is winning and who is losing by all this twisting. At the time of this writing, the yield to maturity on Treasuries maturing in more than ten years is 2.73%; the yield on Treasuries maturing in less than one year is 0.077%. If the Federal Reserve buys the longer-dated Treasuries, many of them now off-the-run or less liquid than normal, it will take the Treasury's coupon payments and reinvest them in housing. Any profits on the deal go back to the Treasury at the end of the fiscal year.

This is all in keeping with the undeniable trend in federal debt service payments. The ratio of interest to GDP had been declining for the better part of two decades before ticking higher in the second quarter. This trend has been the mirror opposite of the ratio of public debt to GDP; that number has exploded higher and neither Congress nor the administration appears to have any clue how to reverse the trend.



We get a similar result when we map the interest/GDP ratio against the federal deficit ratio to GDP. Here again, Uncle Sam has found it can service its debt more easily by driving interest rates lower and even to negative levels in the case of some recent Treasury bill rates.



This is part of the grand "financial repression" trade wherein risk-averse investors are being forced into paying a positive real interest rate to lend to Uncle Sam; I am so old-fashioned I continue to believe the borrower should pay the lender.

It also explains Operation Twist nicely: Take a policy with no discernible macroeconomic benefits, tell people you are being stimulative by driving long-term interest rates down, toss in some malarkey about housing or truth, justice and the American Way for all I care, scare them away from risky assets and turn right around and present the federal government with lower borrowing costs on its bloated and unmanageable debt.

Charles Ponzi got a scheme named after him even though he could not have been the first one in human history to try it. What will we call this?