I
n June, the Federal Open Market Committee voted to extend “Operation Twist,” its program of selling short-term Treasury securities and purchasing long-term Treasuries, through the end of 2012. The Fed will sell a total of $667 billion of short-term bonds (nearly all of its short-term holdings) and purchase an equivalent amount of Treasuries with maturities of between six and 30 years with the goal of lowering long-term interest rates. (In December 2012, the FOMC voted to purchase long-term Treasuries at a pace of $45 billion per month and continue purchasing $40 billion of mortgaged-backed securities a month to further drive down long-term interest rates.)

The Fed is able to influence short-term interest rates by changing its target for the federal funds rate, the interest rate that banks charge one another to borrow money overnight. Other short-term interest rates tend to track the federal funds rate. The Fed has targeted a federal funds rate of near zero percent since December 2008 in an effort to boost recovery from the recent recession. It does not have a way of directly targeting long-term interest rates, however, which is why it has employed Operation Twist.

By buying long-term Treasuries, the Fed can reduce their supply in the market, raising their price. The interest rate of a security has an inverse relationship to its price. If you purchase a Treasury for $100 today and you receive $105 when you redeem it in one year, then the interest rate on the investment is 5 percent. If the price today goes up to $102 because supply is low, then the interest rate falls to about 3 percent.

Operation Twist would ordinarily have the opposite effect on short-term interest rates. By selling its holdings of short-term Treasuries, the Fed increases their supply, lowering their price today and raising their interest rates. If you plot the interest rates according to the bond’s time to maturity — the so-called “yield curve” — you get a curve that slopes up quickly, then flattens out. The hoped-for effect of Operation Twist on this curve is how the operation got its name: The yield curve is “twisted” when short-term rates are pushed up and long-term rates are pushed down. Since the Fed has committed to keeping the federal funds rate near zero until labor market conditions improve, however, it is unlikely that short-term rates will rise in response to this action, allowing the Fed to target lower long-term rates while maintaining short-term rates.

But “Operation Twist” is also a double entendre; it owes its name in part to the era in which it was first employed. In 1961, the twist dance craze was sweeping America at the same time that the incoming Kennedy administration was facing a weak economy. At the time, the dollar was still tied to gold, and President Kennedy’s administration was worried about gold outflows. Kennedy wanted a way to promote growth through monetary policy without lowering short-term interest rates, which would have encouraged investors to convert more dollars into gold rather than hold them in short-term bonds.

The Fed announced a plan to sell short-term Treasuries and buy long-term bonds; at the same time, the Treasury reduced its issuance of long-term securities and increased the number of short-term securities. Originally referred to as Operation Nudge because of its intended goal of nudging long-term rates lower while maintaining or elevating short-term rates, it was renamed Operation Twist in homage to the song Chubby Checker popularized.

Today, the Fed finds itself in a somewhat similar position. It wants to stimulate growth but is constrained from lowering short-term rates because, in this case, they cannot go any lower. Through its quantitative easing operations, the Fed seeks to lower long-term rates by purchasing long-term securities with newly created reserves. This effectively increases the money supply and has led some critics to voice concerns that such actions could lead to inflation in the future. In contrast, Operation Twist is balance sheet neutral, as the Fed pays for the long-term bonds by selling its holdings of short-term bonds.

Early research on the 1961 Operation Twist suggested that it had minimal impact. More recently, however, a 2011 study by Eric Swanson at the San Francisco Fed found that the move caused long-term interest rates to fall by about 0.15 percentage point, equivalent to the expected response to a surprise 1-percentage-point cut in short-term rates.

It’s possible that today’s Operation Twist will have similar results, though there is at least one reason it may not. James Hamilton of the University of California, San Diego, noted on the Econbrowser blog that while the Treasury Department in 1961 reinforced the supply actions the Fed was trying to achieve, today’s Treasury has increased its issuance of long-term securities. This may partly offset the current Operation Twist, leading Hamilton to be pessimistic about its lasting effects. Long-term yields on Treasuries have fallen since the start of Operation Twist, but it is difficult to separate the impact of the Fed’s actions from other market influences.