JFK and quantitative easing

Twisted thinking

Government debt-managers may be undermining quantitative easing

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QUANTITATIVE easing (QE) is an ugly name for a simple idea. Central banks buy long-term government bonds with newly printed money. This raises the bonds' prices, lowers their yields and provides a helpful boost to growth when central banks' main tool, the short-term interest rate, is close to zero.

QE in Camelot

There is plenty of dispute over whether QE works, but not over who should be doing it: the central bank, obviously. Yet is it so clear-cut? A new paper has found that a finance ministry can accomplish the same outcome simply by altering the maturity structure of its debt.

America tried precisely that in 1961. To lower long-term rates the administration of John Kennedy persuaded the Federal Reserve to co-operate with the Treasury in selling (shorter-term) bills and using the proceeds to purchase (longer-term) bonds. By altering the supply of different types of debt, the idea was to "twist" the yield curve. This came to be known as Operation Twist after the early 1960s dance craze sparked by Chubby Checker, a singer whose views on QE are not known.

Operation Twist has long been considered a failure. Early studies found little impact on yields, vindicating those who argued that the price of a security depends only on expectations—of inflation, for example, or monetary policy—not its relative supply. Eric Swanson, an economist at the Federal Reserve Bank of San Francisco, disagrees. Previous studies, he reckons, didn't properly isolate the influence of Operation Twist from countervailing factors. By studying the behaviour of bonds right around announcements related to Operation Twist, he concludes the programme lowered yields by 15 basis points in total. Since the Fed's current QE programme is comparable in size, at around 4% of total Treasury and agency-backed debt, he reckons it should have the same sort of impact. (The actual effect is difficult to discern; yields have actually risen since QE began, but that is mostly because the economy has improved.)

What that implies is that finance ministries could conduct their own QE by issuing less long-term debt, reducing its supply and driving up prices. In fact, governments have done exactly the opposite. Since mid-November America's Treasury has issued some $589 billion in extra long-term debt, of which the Fed has bought $514 billion. From early 2009 through to March 2010 Britain's Treasury issued £247 billion ($396 billion) of extra long-term gilts, of which the Bank of England bought £199 billion. In effect, QE in both countries has been undermined by debt-management policy.

Finance ministries and central banks have different goals, of course. The government wants to minimise the risk that short-term interest rates spike and lenders flee just when lots of debt must be refinanced. Such "rollover risk" is the reason why America's Treasury has lengthened the average maturity of its debt since mid-2009, and its British counterpart has kept average maturities at a rich-world high of 14 years. For their part, central banks prefer the fiscal authorities to steer clear of monetary policy, even the unconventional sort. But in times like these a bit more co-ordination might be constructive.

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