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Is the Treasury undermining QE?

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QUANTITATIVE easing suffers its fair share of controversy, but not over this aspect: whether you like it or not, it's the central bank's job and no one else's. I've just read a paper that suggests otherwise: done right, the Treasury could achieve the same thing through debt-management policy. Better yet, the Treasury and Fed working together should be able to multiply the impact of QE.

The new paper (http://www.ericswanson.us/papers/lta.pdf) by Eric Swanson of the San Francisco Fed re-evaluates an early attempt at QE. In the early 1960s, the Treasury and Federal Reserve embarked on Operation Twist, under which the Fed would buy up long-term bonds in an effort to nudge down their yields. To finance those purchases, it, and Treasury, would sell short-term Treasury bills.

Operation Twist has long been considered a failure. Research in particular by Franco Modigliani and Richard Sutch found very little impact on long-term yields. This helped reinforce the orthodox academic view that efforts to influence security prices by altering their supply were doomed to failure. By this argument, bond yields were determined by investors' expectations of inflation, growth, fiscal and monetary policy. You could withdraw every dollar of Treasury debt from circulation if necessary and the yield on the last remaining dollar wouldn't change. This was one reason why so much scepticism greeted the Federal Reserve's latest round of QE.

Mr Swanson has re-examined the historical record and concluded that the early analysis was wrong: it examined yields at overly wide intervals, thus failing to isolate the impact of Operation Twist from other influences. Mr Swanson looked at bond-market responses within days of news on Operation Twist, and concluded that it lowered long-term bond yields by 15 basis points—the macroeconomic equivalent, he said, of lowering the federal funds rate by 100 basis points.

With Operation Twist only the maturity, not the amount, of outstanding Treasury debt changed. By contrast, with QE the amount of publicly held debt actually shrank. This, Mr Swanson argues, is a technical distinction: it does not matter whether the bond purchases are financed by Treasury issuing short-term bills or by the Fed creating bank reserves. I'm not sure I agree; newly created bank reserves would not crowd other investments out of investor portfolios, and are not seen as liabilities of the federal government even if they technically are.

But let's say Mr Swanson is right and that it doesn't matter whether bond purchases are financed by issuing Treasury bills or by printing money. If so, then everything the Fed is now doing could be accomplished by Treasury simply altering the structure of the debt by halting bond issuance and financing the entire federal deficit by issuing Treasury bills. When the deficit skyrocketed at the onset of crisis and recession, Treasury financed it by issuing bills since it does not like to alter its bond auction schedule. As a result, the average maturity of its debt plummeted. It has, in the last year, been trying to rectify this by upping issuance of long-term bonds, and the average maturity of the debt has been rising.

Lou Crandall of Wrightson, my go-to man on these matters, tells me that since QE2 began on November 12, the Fed has bought $440 billion of Treasury notes and bonds. Since November 1, however, Treasury's total issuance of such paper has been $533 billion, so the public's holdings of long-term debt have on net risen. Mr Swanson's findings suggest that Treasury's debt managers are working at cross purposes to QE.

When I put this to Mr Crandall, his response was: "[T]hank God they are. The worst thing they could do would be to further undermine confidence by allowing their rollover risk to rise. Showing a commitment to prudent finance is part of what you need to do if you are going to run a deficit of 10% of GDP." Rollover risk refers to the threat that a spike in interest rates would sharply elevate debt-service costs as short-term debt matured, or worse, that the government could be locked out of the markets (Greek style) if no buyers showed up.

But I suspect this is a narrow view. The rollover risk the Treasury sheds by issuing more long-term bonds is absorbed by the Fed as it buys those bonds. Should short-term rates rise suddenly, the Fed will absorb market losses on its bond holdings, and future interest income (which it repays to Treasury as seigniorage) will be lower since it will have fewer maturing short-term holdings to reinvest at higher rates. Moreover, the presence of the Fed as the buyer of last resort of Treasury debt makes a Greek-style lock-out of financial markets pretty unlikely. The best argument in favour of keeping Treasury out of the QE business is that it avoids commingling the responsibilities of the fiscal and monetary authorities. On the other hand, that didn't seem to bother anyone during Operation Twist.

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