M&B News Update

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Will the Fed Buy More Long-Term Securities?

At the December 2012 meeting of the Federal Open Market Committee (FOMC), the policymakers will consider several significant policy initiatives, one concerning Operation Twist and the other about communicating information about when they might stop their program of quantitative easing.

The Fed began what is commonly known as Operation Twist in September 2011, when it decided to sell short-term bonds from its portfolio and buy long-term bonds, with the idea of reducing long-term interest rates. That program expired in June 2012, at which time the Fed decided to continue it until the end of the year. Since it started the twist program, the 10-year U.S. Treasury bond interest rate has declined from 1.9 percent to 1.6 percent, but the decline occurred in fits and starts, and may be attributable to economic weakness rather than to the Fed's program.

So, now the Fed must decide if it wants to continue the program or not. That decision is complicated by the fact that the Fed is nearly out of short-term securities to sell. One possibility is that the Fed could simply do more quantitative easing, buying long-term bonds with newly created cash, rather than buying long-term bonds with the proceeds from selling short-term bonds.

In September 2012, the Fed decided on a third round of quantitative easing, known as QE3, in which it decided to increase the amount of assets in its portfolio by buying $45 billion per month in mortgage-backed securities. If the Fed wants to continue Operation Twist by buying as many long-term bonds in 2013 as it has done in 2012, it would need to engage in an additional $40 billion per month in bond purchases, for a total of $85 billion per month.

At the December FOMC meeting, the participants will also consider proposals to outline when they might stop quantitative easing. In a recent speech, Federal Reserve Bank of Chicago President Charles Evans, a leader among the proponents of quantitative easing, argued that the Fed should keep engaging in its easing program until the unemployment rate falls below 6.5% (it is currently 7.7%) or if the inflation rate forecast two or three years in the future rises above 2.5%. Both of those threshold levels are lower than he had previously proposed by 0.5 percentage points. But he thinks they would give the Fed good targets to aim at. The fact that the inflation rate threshold is a forecast, rather than a realized data value, is consistent with the fact that monetary policy affects inflation with a long lag, but is problematic if the forecasts for inflation are not very good, which tends to be the case.

The likelihood is that the Fed will increase its quantitative easing and keep buying long-term bonds to reduce long-term interest rates. Whether they will support President Evans's thresholds is a bit less certain.