It's Operation Twist as Fed cranks up printing press

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The Federal Reserve last night flashed back almost 50 years to a campaign code-named "Operation Twist", as it announced the purchase of longer-dated Treasury securities to help end a deepening US recession.

In a decisive escalation in its campaign to restore growth, the Fed said it would buy up to $US300 billion ($440 billion) of longer-dated Treasuries over the next six months and buy another $US850 billion of mortgage securities.

Economists said the bold move was warranted by a worsening economic outlook, but also carried the risk of inflation in the future, unless the Fed was very careful.

Either way, the news got a very good bang for its buck. Benchmark Treasury yields notched the steepest one-day fall since the stock market crisis of 1987, while 30-year mortgage rates dropped to almost record lows of 5.0%.

Economists said this added Japan-style quantitative easing to reinforce Fed support of specific private credit markets, after it had already lowered interest rates almost to zero.

"The Fed has signalled the initiation of the third powerful leg of central bank policy: independent quantitative easing," said Marvin Goodfriend, a former senior economist at the Richmond Federal Reserve Bank.

Quantitative easing refers to the deliberate creation of money by a central bank to encourage spending. It was used as a tactic by Japan in the 1990s to confront a decade of stagnation, and by the Bank of England in recent weeks via the purchase of government debt.

"Monetary policy at zero on interest rates plausibly needs to be more aggressive in the current moment," said Goodfriend, an economics professor at Carnegie Mellon University in Rochester, New York.

The Fed also said on Wednesday that it would more than double an existing effort to boost the market for mortgage securities and debt, to the tune of $US1.45 trillion.

It has aggressively supported selected private credit markets since the global credit crisis flared last year, and this week launched a program to boost consumer and small business lending which could grow to $US1 trillion in size.

Twist again

The move to purchase longer-dated US government debt, on top of regular purchases of short-term Treasury bills, marked the first time it has done so since Operation Twist, which ran from 1961 until 1965. But that is where the similarities end.

In the 1960s, in an effort to flatten the yield curve to simultaneously tackle a recession and a lingering trade deficit, the Fed bought long-term bonds and sold short-term bills.

As a result, the operation was sterilized in terms of its impact on the money supply and was not an expansion of monetary policy. This time, the intervention will not be sterilized and should help ease monetary conditions.

"We see this as equivalent to a 75 basis point cut in the (fed) funds rate," said Ethan Harris, co chief US economist at Barclays Capital in New York. A basis point is one one-hundredth of a percentage point.

"A combination of monetary, credit and fiscal easing will slow the recession in the second quarter and spark a modest recovery by year-end," he said.

To reinforce aggressive Fed action, President Barack Obama has won $US787 billion in emergency fiscal spending, and has drafted a multi-trillion dollar budget to aid the economy.

All this stimulus comes with risks.

"It will raise inflation uncertainty," said Gregory Hess, an economics professor at Claremont McKenna College in Claremont, California.

The Fed has deliberately pumped up the money supply to encourage spending and beat back the risk that deflation, or a prolonged, broad-based decline in prices, might set in. However, the money-supply surge could spark inflation when growth resumes, unless the Fed can bleed off the heavy support.

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