Explaining Dissent on the FOMC Vote for Operation Twist (With Reference to Jan Mayen Island, Paul Volcker and Thor's Hammer)

Remarks before the Dallas Assembly

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Thank you, Anne [Motsenbocker]. I was privileged to have been a member of the Dallas Assembly before I aged into being "mature." Being here today with you young folks brings back very fond memories and is wonderfully energizing. Thank you for inviting me to lunch today.

Jan Mayen Island

I am going to start by taking you far away from Dallas, near the Arctic Circle, where, were you to visit Jan Mayen Island, you would see this sign:

Jan Mayen is a desolate volcanic island located about 600 miles west of Norway's North Cape. It is the home of a meteorological and communications station manned in the harshest of winters by 17 hearty members of the Norwegian Armed Forces. If you read Tom Clancy's *Hunt for Red October*, you would know it as "Loran-C," a NATO tracking and transmissions station. In the video game Tomb Raider: Underworld, Lara Croft visits Jan Mayen in search of Thor's Hammer, considered the most awesome of weapons in Norse mythology, capable of leveling mountains and performing the most heroic feats.

My brother Mike recently visited this station on Jan Mayen. This is the sign that greeted him.

In norsk, it reads as follows:

"Theory is when you understand everything, but nothing works."

"Practice is when everything works, but nobody understands why."

"At this station, theory and practice are united, so nothing works and nobody understands why."

My wry brother implied that this about summed it up for monetary policy. Drawing on theory and practice, the 17 members of the Federal Open Market Committee (FOMC) have been working in the harshest economic environment to harness monetary theory and lessons learned from practice to revive the economy and job creation without forsaking our commitment to maintaining price stability. But the committee's policy has yet to show evidence of working and nobody seems to quite understand why.

Today, I am going to quickly summarize the action taken by the FOMC at our meeting last week. I am going to explain at greater length why I dissented from the consensus of the committee, incorporating why I believe the monetary accommodation we have thus far implemented has failed to deliver.

I remind you that conducting monetary policy in today's economy is not for the faint of heart. All 17 of us who have the privilege of serving on the FOMC are working toward the same end. We devote ourselves to crafting the right monetary policy for the nation. When we meet, each of us lays out our arguments calmly, with great respect for each other and without acrimony—an approach that is sadly rare elsewhere in government. As I represent the Dallas Fed at the FOMC table, I want you and others to know what my views are so that you might have a better understanding of the difficult trade-offs involved in our decisionmaking.

Last Week's FOMC Meeting

After meeting for two days last week, the committee announced that its outlook for the economy was less sanguine than it had previously anticipated. It foresaw "significant downside risks to the economic outlook, including strains in global financial markets." Realizing that resolution of the European situation depends on European authorities, we focused on policy alternatives that might bolster the U.S. economy. The committee decided that it would "purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and ... sell an equal amount of Treasury securities with remaining maturities of 3 years or less. This program," the committee stated, "should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative." In addition, the FOMC also reaffirmed the expectation it expressed at the August meeting, "that economic conditions … are likely to warrant exceptionally low levels for the federal funds rate"—the interest rate we set for overnight interbank lending—"at least through mid-2013."

Concurrently, the committee decided it would depart from its previous decision to invest the proceeds from the roll-offs from its substantial portfolio of mortgage-backed and agency—Fannie Mae and Freddie Mac—securities into Treasuries and would instead "reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities."[1]

In the interest of time, I will not dwell on the decision to reinvest proceeds in the agency and mortgage-backed markets. Since the beginning of this year, the spreads between mortgage-backs and Treasuries have been widening and have accelerated, especially lately, to levels last seen in early 2009. This decision, while not expected by the markets, was acceptable for me as a tactical way to provide limited assistance to the mortgage market at little cost. The decision to embark on an "Operation Twist," however, was a strategic decision where I did not feel the benefits outweighed what I perceived to be the costs. So, I will dwell on that difficult decision.

The Rationale Behind Operation Twist

As the minutes of last week's meeting will not be released until Oct. 12, it would be inappropriate for me to provide you a fulsome recital of the discussion that took place at the table. When you do read the minutes, however, it might help to recall a little history.

The original Operation Twist was announced by President Kennedy on Feb. 2, 1961. It was actually the idea of my mentor, Robert Roosa, who later hired me out of Stanford Business School in 1975 to be his assistant, following in the footsteps of other "Roosa Boys"—the first of whom was a fellow named Paul Volcker. In the original Operation Twist, the Federal Reserve sold a portion of the short-term Treasuries held in its System Open Market Account (SOMA) portfolio and invested the proceeds in longer-dated Treasuries. The goal was to decrease long-term rates and increase investment, while increasing short-term rates so as to prop up the dollar.

The purpose of Operation Twist II is similar: The FOMC seeks to drive down the cost of capital for businesses in order to induce them to invest more in expansion and create more jobs. Implicitly, the program may also lift short-term rates, albeit mildly given the expectation that rates at the short end will remain at "exceptionally low levels" through mid-2013, perhaps providing some relief to money market funds that, in searching for yields sufficient to cover their costs, have been invested in foreign bank paper now considered by many analysts to be somewhat toxic.

As background to my take on this newer version of Operation Twist, I want to make it crystal clear that I am as eager as anyone on the committee to see greater job creation. It is true that I am an inflation hawk: I believe the foremost duty of any central banker is to ensure price stability. Indeed, I believe that the Fed cannot deliver on its congressionally mandated task of seeking full employment unless it delivers first on its mandated duty of warding off both inflation and deflation.

The Dallas Fed tracks 178 items in the consumer basket through a constantly updated series dating back to 1977. Using this data, we calculate what we call a "trimmed mean" analysis of personal consumption expenditures (PCE) in order to ascertain the level of inflation affecting real consumers.[2] This is my preferred compass for charting the direction of inflation. It presently suggests that headline inflation will decline from its current level—just shy of 3 percent as measured by the PCE and 3.75 percent as measured by the Consumer Price Index—to 2 percent, a level that the majority of the committee believes a tolerable target. Thus, while I remain on constant watch for signs of inflationary impulses, I believe the most urgent issue is job creation and the reduction of the scourge of unemployment.

I believe, however, that there is significant risk that the policies recently undertaken by the FOMC are likely to prove ineffective and might well be working against job creation.

Previous Dissents

In the interest of time, I will neither repeat the reason for my opposition to the round of accommodation known as QE2 nor discuss my dissenting vote in August, when the committee indicated its expectation that rates would remain exceptionally low through mid-2013. I have explained my logic in previous speeches, which are located on our website.[3]

I'll focus here on Operation Twist and the decisions announced last Wednesday. There is a common theme running through my dissenting views on Operation Twist, QE2 and what has come to be viewed as a commitment by the market that we will hold the fed funds rate "extremely low" for the next two years. My fundamental concern is about the efficacy of these initiatives.

Efficacy Questions

The efficacy of the original Operation Twist has been vigorously debated through time. Bob Roosa once confided in me that he considered it "too clever by half" and "not (his) brightest brainchild." Bob's self-deprecation was recently quantified in a study by Eric Swanson of the San Francisco Fed. Swanson estimated that the impact of the 1961 program resulted in a 15-basis-point reduction—remember, 15 basis points is 15 one-hundredths of 1 percent—in long-term Treasury yields and a 2- to 4-basis-point—2 to 4 one-hundredths of 1 percent—reduction in corporate bond yields.[4] Swanson's paper follows upon an insightful study by two top economists at Northwestern University who estimated that QE2—the previous round of accommodation—lowered Treasury yields by roughly 20 basis points and investment grade corporate bond yields by about 7 to 12 basis points.[5]

To nonfinancial market types, this may seem a tad bit esoteric. The point is that the direct benefit of QE2 seemed small relative to the cost, including the complications arising from the expansion of our balance sheet and the stirring of suspicions among our critics that the FOMC is influenced too heavily by the financial interests that make more money from trading than from lending to job-creating businesses.

For me, Swanson's study begged questions about the cost/benefit trade-offs of a modern Operation Twist from a theoretical perspective. From a practical perspective, I had other concerns.

Before every FOMC meeting, I survey a select group of 30 or so private business and banking operators, imparting no information about monetary policy but listening carefully to their perspectives on developments in the economy as seen at the ground level. For weeks leading up to the meeting, there was speculation in the financial markets and in the press that an Operation Twist was being contemplated. I received an earful of opinions on these rumors. What I gleaned from those conversations was as follows:

1.) Embarking on an Operation Twist would provide an even greater incentive for the average citizen with savings to further hoard those savings for fear that the FOMC would be signaling the economy is in worse shape than they thought. They might view an Operation Twist as setting the stage for a new round of monetary accommodation—a QE3, if you will. Such a program was considered redundant by business operators given their surplus of undeployed cash holdings and bankers' already plentiful excess reserves. In addition, such a program might frighten consumers by further driving down the yields they earn on their savings and/or lead to long-term inflation that would erode the value of those savings;

2.) The earning power of banks, both large and small, would come under additional pressure by suppressing the spread between what they can earn by lending at longer-term tenors and what they pay on the shorter-term deposits they take in;

3.) Pension funds would have to reassess their potential returns, with the consequence that public and private direct-benefit plans would have to set aside greater reserves that might otherwise have gone to investments stimulating job creation;

4.) Expanding the holdings of the Fed's book of longer-term debt would likely compound the complexity of future policy decisions. Perversely, the stronger the economy, the greater the losses the Fed would incur as interest rates rise in response and the prices of those longer-term holdings depreciate. The political incentive to hold rates down might then become stronger precisely when we want to initiate tighter monetary policy. This concern, of course, would be a good news/bad news issue: The good news is that it would stem from a stronger economy; the bad is that might hurt our maneuverability and, in doing so, might undermine confidence in the Fed to conduct policy independently.

One other factor gave me pause and that was, and remains, the moral hazard of being too accommodative. For years, I have been arguing that monetary policy cannot solve the problem of substandard economic performance unless it is complemented by fiscal policy and regulatory reform that encourages the private sector to put to work the affordable and abundant liquidity we are able to create as the nation's monetary authority. These actions are not within the Fed's purview; they are the business of Congress and the president. Chairman (Ben) Bernanke said it well in his recent speech at Jackson Hole (Wyo.): "Most of the economic policies that support robust economic growth in the long run are outside the province of the central bank."[6] Both within the FOMC and in public speeches, I have argued that until our fiscal authorities get their act together, further monetary accommodation—be it in the form of quantitative easing or performing "jujitsu" on the yield curve through efforts such as Operation Twist—will represent nothing more than pushing on a string.

Of course, I am only a single voice at the FOMC table. I presented my views, as did other participants. All views were given a fair hearing. In the end, the decision taken by the FOMC is that of the majority, and the majority supported the initiatives that were announced. We must now hope that they will work.

The Siren Call of Inflation

I might conclude by sharing my concerns about the prospect of temporarily allowing more inflation as a means of unlocking expansion in final demand.

I understand the theoretical basis for entertaining that thesis: If businesses and consumers believe prices will rise, they will rush out to invest and consume now. But the practical aspects of this approach appear to counter the theoretical.

Paul Volcker, who has the scars on his back from his Herculean effort to rein in inflation in the 1980s, wrote of this in the *New York Times* on Sept. 18.[7] He reminded us that once unleashed, inflation combines with stagnation to make stagflation, the most painful of all combinations for the poor, for workers, for job seekers, for bond and stock holders and for businesses trying to navigate the economy.

His words from that article should be engraved on the foreheads of every central banker: "The siren song [of inflation] is both alluring and predictable. … After all, if 1 or 2 percent inflation is O.K. and has not raised inflationary expectations—as the Fed and most central banks believe—why not 3 or 4 or even more? Let's try to get business to jump the gun and invest now in the expectation of higher prices later … and maybe wages will follow. … Well, good luck. Some mathematical models spawned in academic seminars might support this scenario. But all of our economic history says it won't work that way. I thought we learned that lesson in the 1970s. … What we know, or should know, from the past is that once inflation becomes anticipated and ingrained—as it eventually would—then the stimulating effects are lost. Once an independent central bank does not simply tolerate a low level of inflation as consistent with 'stability,' but invokes inflation as a policy, it becomes difficult to eliminate."

To that I say, "Amen."

Thor's Hammer

I return to where I began—Jan Mayen Island. Paul Volcker understands better than most the limitations of theory and the harsh lessons of practice. I have nowhere near the wisdom or the experience of Volcker. But as the son of a Norwegian mother, I do know a little about Norse mythology. The legend holds that with his hammer in hand, Thor "would be able to strike as firmly as he wanted … and the hammer would never fail … and never fly so far from his hand that it could not find its way back."[8] Monetary policy is not Thor's hammer. It is an awesome weapon. But it has limitations. We must carefully harbor its power. If we deploy it incorrectly, we might level more than interest rates and destroy that which we seek to create. And if we let it fly too far from our grasp, we may never get it back. In conducting policy going forward, we must constantly bear this in mind.

Notes

[1] See Federal Open Market Committee statement, Sept. 21, 2011, www.federalreserve.gov/newsevents/press/monetary/20110921a.htm.

[2] The Trimmed Mean Personal Consumption Expenditure Index, complete with an analysis by Senior Economist Jim Dolmas, is available on the Federal Reserve Bank of Dallas' website at www.dallasfed.org/data/pce/index.html.

[3] See "Recent Decisions of the Federal Open Market Committee: A Bridge to Fiscal Sanity?" speech by Richard W. Fisher before the Association for Financial Professionals, Nov. 8, 2010,

www.dallasfed.org/news/speeches/fisher/2010/fs101108.cfm, and “Connecting the Dots: Texas Employment Growth; a Dissenting Vote; and the Ugly Truth,” speech by Richard W. Fisher at the Midland Community Forum, Aug. 17, 2011, www.dallasfed.org/news/speeches/fisher/2011/fs110817.cfm.

[4] See “Let’s Twist Again: A High-Frequency Event-Study Analysis of Operation Twist and Its Implications for QE2,” by Eric T. Swanson, Brookings Papers on Economic Activity, Spring 2011.

[5] See, “The Effects of Quantitative Easing on Interest Rates: Channels and Implications for Policy,” by Arvind Krishnamurthy and Annette Vissing-Jorgensen, Brookings Papers on Economic Activity, Fall 2011.

[6] See “The Near- and Longer-Term Prospects for the U.S. Economy,” address by Chairman Ben S. Bernanke at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyo., Aug. 26, 2011.

[7] See “A Little Inflation Can Be a Dangerous Thing,” by Paul A. Volcker, *New York Times*, Sept. 18, 2011.

[8] See “The Prose Edda: Tales from Norse Mythology,” by Snorri Sturluson, Oxford, U.K.: Oxford University Press, 1916.