Repeating the interest rate mistakes of the past

United States was facing two serious economic problems: It had been in recession since April 1960, and it had a persistent international balance-of-payments deficit. In fact, the U.S. balance of payments had been in deficit since 1951. Under the Bretton Woods agreements of 1944, the currencies of the industrialized world were pegged to the U.S. dollar, and the U.S. dollar was fixed in its value to gold. Essentially, the world was on a dollar standard, while the United States was on a gold standard. Thus any country that ran a balance-of-payments deficit with the United States could pay off the debt in U.S. dollars. The United States, on the other hand, had to exchange dollars for gold, if requested, to pay off a creditor country. Central banks in creditor countries began converting accruals of dollars into gold and threatened to convert their reserve balances as well. As a result, gold was leaving the United States at what was considered an alarming rate, with even greater losses foreseen.

Under this fixed exchange rate regime, policymakers believed that managing the recession and the balance-of-payments deficit required two, very different, governmental actions: an expansionary policy aimed at increasing aggregate demand for the recession; and a contractionary policy aimed at reducing aggregate demand (thereby reducing the demand for imports) for the balance-of-payments deficit. The Fed, having control of monetary policy, had to choose which need—the recession or the balance-of-payments deficit—was more pressing. After all, it could not correct both at the same time. Or could it?

Which Front to Attack, the Domestic or the International?

The Fed decided to attack on both fronts by engaging in a swapping operation—purchasing long-term bonds while simultaneously selling short-term bills. This operation was intended to fight the recession by lowering long-term interest rates to stimulate domestic investment, and the balance-of-payments deficit by raising short-term interest rates to attract foreign investment to the United States through a relatively higher rate of return. This swapping policy became known as Operation Twist because the Fed attempted to artificially flatten or twist the typically upward-sloping yield curve.

The policy, begun in February 1961, moved the Fed away from its March 1953 “bills only” policy that restricted open market operations to the short end of the market, especially Treasury bills. The February 20 directive of the Federal Open Market Committee (FOMC), the Fed’s main policy arm, authorized the Federal Reserve Bank of New York to purchase intermediate- or long-term U.S. government securities of up to 10 years in maturity, in an amount not to exceed $500 million. The plan initially limited acquisitions to securities in the range of one to five and one-half years, allowing the market time to adjust to the new policy. Afterwards, securities in the range of five and one-half to 10 years would be purchased. These purchases were to occur before the March 7 meeting of the FOMC.

This directive also included a clause requiring that purchases of intermediate- or long-term securities be offset by sales of short-term securities, thereby having the effect of altering the maturity pattern but not the dollar holdings of the Fed’s portfolio. The purchases were thus “designed
which allowed commercial banks, because of the greater availability of deposits, to take advantage of the arbitrage opportunities present in the market. Modigliani and Sutch argued that, if Operation Twist did contribute to a narrowing in the spread, it was unlikely to have exceeded 0.1 or 0.2 percentage points— a modest reduction at best. As they also pointed out, it is common for the spread to narrow as the economy recovers. (The trough of the business cycle was in February 1961; its subsequent peak was in December 1969.)

From this episode, many policymakers and analysts should have recognized, according to Benjamin H. Beckhart, that "long-term interest rates cannot be substantially reduced by money market gimmicks." It is doubtful, therefore, that the Fed would be more successful today than it was 30 years ago in attempting to twist the yield curve. Indeed, now that interest rate ceilings on deposit accounts are no longer in effect, there are no artificial forces holding these rates at any particular level. What's more, if expectations have a role in determining long-term interest rates, then the interest rate spread includes an inflation component that will not disappear simply because fewer long-term bonds are circulating in the market. As long as the swapping operation leaves inflationary expectations unchanged, no lasting narrowing of the interest rates spread can occur. In Beckhart's words, "A lasting decline will be achieved only if people gain confidence in the long-term purchasing power of the dollar."

Looking at the chart above, it appears so. The spread between the three-month Treasury bill and the 10-year Treasury bond declined steadily from 1.53 percentage points in 1961 to 0.06 percentage points in 1966. Increases in the short-term interest rate were primarily responsible for closing the gap. Closer examination, however, reveals that factors other than Operation Twist were responsible for this narrowing interest rate spread.

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FOR FURTHER READING