OPINION

Bessent's revisit of 'Operation Twist' will be a failure

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SAM WOLFE/REUTERS

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U.S. Treasury Secretary Scott Bessent surprised financial markets on Aug. 19 by announcing that the Treasury would double the size of its bond buyback program starting next month to US$4-billion an operation from US$2-billion. These long-bond purchases will be financed by issuing short-term bonds and T-bills.

The Treasury's buyback program is not equivalent to quantitative easing (QE) by the Federal Reserve. Quantitative easing refers to a monetary policy move whereby the Fed boosts liquidity in the financial system by essentially printing money to buy government bonds, swapping interest-bearing securities for cash in an attempt to lower interest rates.

What Mr. Bessent announced was a classic "Operation Twist."

Do you remember the last one? Most investors don't, but this nearly forgotten piece of history holds important lessons for anyone trying to forecast what 2026 will hold for the U.S. economy.

What to know about the sell-off in world bond markets

The John F. Kennedy administration launched the operation in February, 1961, (when "the Twist" was the latest dance sensation) and continued it until 1965.

Operation Twist involved buying Treasury bonds while simultaneously selling T-bills. By creating demand for long-term bonds while at the same time increasing the supply of T-bills (which mature in less than a year), the Treasury hoped to push up government bond prices while pulling down T-bill prices.

Interest rates move in the opposite direction to bond prices, so in theory all this buying and selling should reduce longer-term interest rates while boosting short-term interest rates.

The U.S. Treasury hoped that twisting interest rates in this fashion would support the U.S. dollar by attracting capital from abroad with higher short-term interest rates. It also expected the operation would stimulate investments and the economy through lower long-term interest rates. Since mortgages are tied to long-term interest rates, the Treasury hoped that Operation Twist would help lower consumer interest rates and increase demand for mortgages and housing.

But Operation Twist failed, according to research that was done by prominent MIT economists Franco Modigliani and Richard Sutch. Long-term yields rose instead of falling – perhaps because the entire operation was relatively small. In all, the Treasury bought US$9-billion in Treasury bonds, amounting to just 1.64 per cent of GDP at the time.

Opinion: Bond market unease poses greatest risk for next financial crisis

Flash forward to 2026, when the Treasury is once again attempting to affect interest rates. A rally in bond prices followed this announcement, but the rally fizzled out by the next day and stocks fell on bets that the Treasury's plan to curb the massive cost of government debt servicing is just a short-term fix – bringing to mind the Kennedy years. Moreover, this time government finances are in much worse shape, which will hinder any future similar moves by Mr. Bessent. Investors are worried about burgeoning government debt, government spending that has ballooned to between 23 per cent and 25 per cent of GDP, heavy borrowing by tech firms, and the Federal Reserve's commitment to fighting inflation.

Moreover, this time around, the Treasury market is so large that even purchases made at the scale of last month's announcement may not have much impact. Analysts at Macquarie, an investment bank, estimate that the U.S. government will need to issue nearly US$550-billion in bonds this quarter to finance its operations.

A few questions emerge. Since Operation Twist didn't work before, does it have any hope now? What other tools could Mr. Bessent reach for if yields start heading higher? Will limits to the Treasury's firepower mean the Federal Reserve might need to step in and support it with new QE, triggering fears of higher inflation? What will be Fed chair Kevin Warsh's response to those fears?

Operation Twist, along with an increase in quantitative easing, may tilt interest rates to a lower level. Rather than twisting the yield curve (the differential between long- and short-term interest rates), such a combination should shift both long- and short-term interest rates to a lower level.

The Treasury operations supplemented by QE may actually increase long-term interest rates if markets expect the added liquidity to help the economy. But this could have benefits: Even though the Fed may fail in lowering interest rates, it may succeed in creating an expectation of a better economy.

Bessent to meet with Canadian counterpart at G20 finance chiefs meeting

But what about inflation? The amount of money to be pumped into the economy through QE will increase inflation, which is already elevated above the Fed's desired level.

A look at nominal and real bond yields since Aug. 19, the day the Treasury announced the latest round of Operation Twist, shows that both yields have risen in the United States. Real bond yields are a good guide to how quickly the market expects the economy to grow in real, inflation-adjusted terms, while nominal bond yields indicate expectations for both real growth and inflation.

VIDEO 2:04

Global bond yields hit major new highs on Tuesday as renewed fighting in the Middle East lifted oil prices and traders braced for interest rate hikes, putting pressure on stock markets around the world.

REUTERS

While the behaviour of real interest rates suggests that the economic outlook may be fine in the U.S., my view is that it will not be characterized by vigour and much of the growth will be inflationary. Operation Twist disappointed; QE is not likely to do much better in the current environment to bring interest rates down.

Comments