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DJ FED WATCH: Operaton Twist Points To QE2 Potency - SF Fed

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NEW YORK (Dow Jones)--The end of Federal Reserve bond buying may be looming into view, but that doesn't mean the central bank has stopped trying to make sense of and justify the potency of the effort.

In a paper published Monday, researchers at the Federal Reserve Bank of San Francisco have gone back and looked at the last time the central bank attempted to buy long-dated Treasury debt in a bid to stimulate growth, and have concluded the purchases can lower long term borrowing costs.

The research, written by Titan Alon and Eric Swanson, of the San Francisco Fed, based its findings on the experience of the early 1960s' 'Operation Twist.' That episode saw the Fed and Treasury work together in a bid to force down longer run borrowing costs, in what they hoped was an effort that would stimulate growth.

Operation Twist, despite being of a half century old vintage, is an important point of reference. That's because it is the only other time in the Fed's history where officials can search for lessons to apply to the bond buying efforts undertaken over the last few years. In two separate occasions starting in 2008, the Fed has bought massive amounts of Treasury, agency and mortgage debt, in a bid to spur growth and restore financial market functionality. The latest round, widely referred to as **QE2**, started late last year and is slate to end in June, totaling $600 billion in Treasury purchases.

Both forays have been controversial, but the second one has been even more so. The Fed has justified the current spate of Treasury buying as important in helping the economy grow more strongly, which should help the unemployment rate fall faster. Officials like Chairman Ben Bernanke have deemed **QE2** a success, citing an improved economy, easier financial conditions and rising stock prices.

Critics, however, have noted that unlike the first effort where long term yields fell, **QE2**'s essential failure can be seen in the rise in bond yields that's attended the program. Some see that as a core failing of the program, aside from other questions about whether it was even needed in the first place.

The San Francisco Fed paper doesn't address questions of the appropriateness of **QE2**. It only delves into whether or not this sort of thing can work.

'An analysis finds that four of six potentially market-moving Operation Twist announcements had statistically significant effects and that the program cumulatively caused a significant but moderate 0.15 percentage point reduction in longer-term Treasury yields,' wrote Alon and Swanson.

'These results can be used to estimate **QE2**'s effects' because in relative terms, what the Fed did at the start of the Kennedy Administration was not all that dissimilar in size, at least in relative terms. If one looks at all government guaranteed debt Operation Twist was actually a touch larger than the **QE2** program, adjusted for size, the paper notes.

The paper stops short in evaluating the impact of **QE2**, noting only that the effort is comparable to Operation Twist because both came in calmer markets, unlike what the Fed faced in 2008 and 2009.

Whatever the impact of **QE2**, its days are growing short. The Fed will meet this week in a meeting that's almost certain to let the program continue. But all signs suggest an improving economy, rising inflation and internal discomfort within the central bank will see **QE2** end in the summer, as planned.

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