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TWO NEW IDEAS, ONE INVOLVING A TWIST

The government still has some options to stimulate the economy.

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What can Washington do now to help consumers, housing and stocks? Options remain. The Obama administration and the Federal Reserve are reportedly considering two interesting tactics: one first employed 50 years ago, and another that could bloom into a multi-faceted effort to aid homeowners under pressure.

Is a great mass refinancing coming? The August 24 edition of the *New York Times* mentioned that the White House was mulling over three different proposals to aid the housing market.

- One plan would let homeowners with government-backed home loans refinance those mortgages at today's 4% interest rates. The potential economic stimulus could be profound: Columbia University professor Christopher Mayer, who first suggested the idea to the Obama administration, thinks it could save homeowners \$75 billion in interest a year. While that would be great for Main Street (and personal spending), it might rile the regulator supervising Fannie Mae and Freddie Mac and mortgage bond investors. Banks could applaud this program, which could start without Congressional approval and without drawing down the \$45.6 billion in Troubled Asset Relief funds earmarked for aiding homeowners. (Those billions could be redirected for deficit reduction.)
- A second proposal would change criteria for the federal refinancing programs already up and running so that more mortgageholders could become eligible for help.
- A third plan (actually the most developed of the three) would help troubled homeowners rent out their residences to avoid foreclosure. Houses owned by Fannie and Freddie could be converted to rentals or put to other uses. This plan may prove very attractive to investment firms, especially if the federal government lends them money to promote their involvement.^{1,2}

Could the Fed try a new variation on Operation Twist? In early 1961, we were facing a recession. Soon after taking office, President Kennedy convinced the Federal Reserve to sell short-term Treasuries and invest the proceeds into longer-term bonds. This program - known as Operation Twist - was kind of like a small-scale ancestor of QE2. It lengthened the average maturity of the Fed's holding of Treasuries and it was fairly successful; it had an impact roughly akin to a 1% cut in the federal funds rate.^{3,4}

Operation Twist had two objectives:

- To bump up the yields on shorter-term Treasuries, thereby making them more attractive to overseas investors while aiding the dollar.
- To reduce long-term Treasury yields and stimulate longer-term investments.

Operation Twist was also a weapon against cross-currency arbitrage. The U.S. was on the gold standard then; billions in gold were leaving our shores. Foreign investors were converting dollars to gold and using the gold to purchase higher-yielding assets in Europe.

Today, the playing field has changed - yet a sequel to Operation Twist could potentially increase appetite for risk. If an effort like this manages to reduce yields on “safe” assets, insurance companies, pension funds and other institutional investors could be convinced to put their money elsewhere (i.e., equities).

Lower long-term interest rates could also reduce the cost of capital for companies and encourage borrowing on Main Street: mortgages, auto financing and other consumer loans would be less expensive. JPMorgan economists think that a new Operation Twist could possibly lower mortgage interest rates by .1%. (This projection assumes the Fed passively buys \$20 billion in long-term Treasuries per month.)³

Of course, the stock market would prefer to see a full-blown QE3 rather than the comeback of Operation Twist. Yet with GDP so anemic and the stock market and housing sectors both needing boosts, any idea with merit is welcome - and these proposals may go from drawing board to reality this fall.



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Citations.

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