

Operation Twist

Victor A. Canto, PhD | August 2026

KEY TAKEAWAYS

- **Operation Twist is not quantitative easing.** The policy alters the maturity structure of government debt but does not inherently increase the quantity of money circulating in the economy.
- **Its effectiveness depends on market structure.** For Operation Twist to materially affect the yield curve, investors must view securities of different maturities as imperfect substitutes. The greater the substitutability, the less powerful the policy is likely to be.
- **Real rates may be driven by the economy, not policymakers.** Real interest rates may ultimately reflect the economy's underlying balance between savings and investment rather than the composition of Treasury debt.
- **The yield curve also carries information.** If Operation Twist artificially compresses long-term yields, it may reduce the yield curve's usefulness as a signal of inflation expectations, recession risk, and future economic conditions.

In a recent article in The Wall Street Journal, "The Treasury Market's Coveted Status as a Safe Haven Is Fading," Greg Ip writes the following:

The U.S. Treasury's surprise announcement Wednesday that it would boost buybacks of less-liquid longer-term debt simply treats the symptoms rather than the underlying cause. The move, while reducing yields in the short run, might yet raise them in the long run by eroding the U.S.'s reputation for stability and predictability.

The paragraph describes a well-known policy that the Treasury has applied in the past, and it also takes as gospel that the policy will work as intended. Yet we contend that the policy will not necessarily work as conventional wisdom assumes. Before we get into that, it may be worthwhile to review the policy unveiled by the Treasury Secretary and discuss whether these actions make the Fed's job harder.

Operation Twist was originally attributed to Nobel Prize winner and Yale economist James Tobin and implemented during the Kennedy Administration. It is a maturity-extension policy in which the Treasury sells short-term Treasuries and buys long-term Treasuries. Another way to put it is that Operation Twist is essentially duration targeting: it changes the average maturity of its portfolio to influence the term premium, a key component of long-term interest rates. Operation Twist is nothing more than a policy that alters the composition of the public debt while leaving the total debt outstanding unchanged. It differs from Fed QE in a very significant way. Unlike QE, Operation Twist does not increase the size of the Fed's balance sheet, which potentially increases the quantity of money circulating in the economy.

Operation Twist vs. Quantitative Easing (QE)

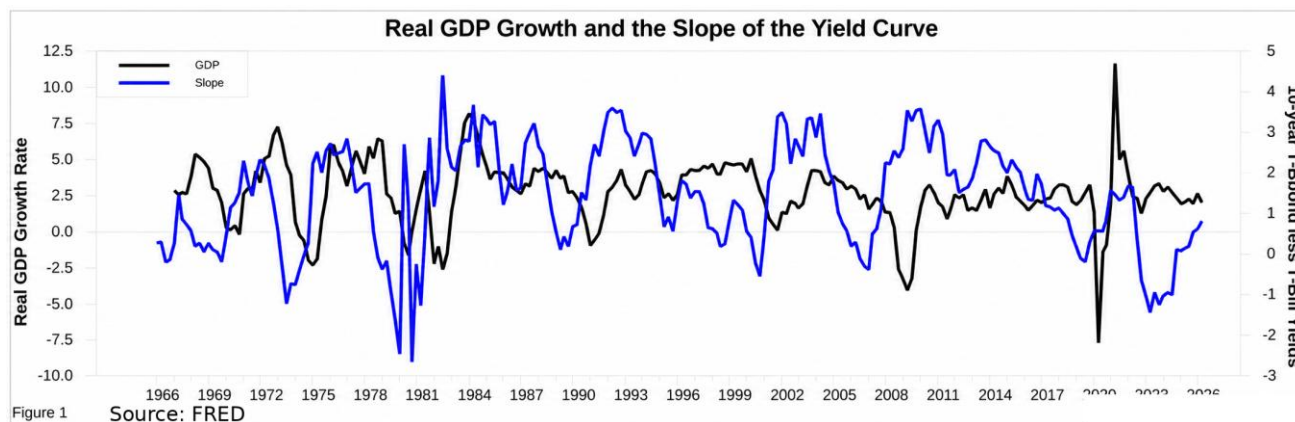
Other than the U.S. Treasury's ability to print coins, the Federal Reserve is the one institution that can alter the quantity of money circulating in the economy, while the U.S. Treasury is the only institution that can issue government debt. This division of labor, due to legal and institutional considerations, imposes restrictions on who has the ability to conduct Operation Twist and QE policies. Needless to say, since the Treasury does not print money, it cannot implement QE, QT, or any other form of monetary policy, while the Fed is in a different situation regarding Operation Twist. With Treasury acquiescence, it is possible for the Fed to alter the composition as well as the amount of public debt held by the private sector. Therefore, the Fed can implement a version of Operation Twist.

The Fed can also alter the total amount of debt held by the private sector. However, as it attempts to do so, the Fed's actions affect the quantity of high-powered money, or the monetary base, circulating in the economy. The reason is simple: in order to be a net buyer of government securities, the Fed has to print high-powered money. Everything else being equal, the increase in the monetary base results in an increase in the quantity of money circulating in the economy. Again, if inflation is a monetary phenomenon, the money printing used to finance the bond purchases will fuel an incipient increase in the price level.

To prevent this from happening, the Fed has to convince the banking sector not to deploy the excess monetary base it has printed. All of this means the following: the Fed retires long bonds from the private sector, and the private sector uses the excess monetary base to buy repos, or "short-term government securities." To induce this behavior, the Fed has to pay a high enough interest rate on the repos to drain enough base money and prevent the banking system from increasing the quantity of money. Under these conditions, the Fed is able to attempt to implement Operation Twist without affecting the quantity of money circulating in the economy. Like the U.S. Treasury, the Fed can pursue an Operation Twist policy. Unlike the Fed, the U.S. Treasury cannot implement QE or any form of monetary policy. Operation Twist, in principle, solely affects term premiums, while QE can affect the term premium as well as liquidity or inflation conditions. Operation Twist is a narrower, or more surgical, policy than QE.

Will Operation Twist succeed?

A successful Operation Twist will push down long-term interest rates, flatten the yield curve, lower long-term borrowing costs, and stimulate investment. More importantly, the policy will do all this without expanding the balance sheet. Figure 1, below, shows an interesting relationship between the slope of the yield curve, defined as the 10-year bond yield less the T-bill yield, and the real GDP growth rate.



One cannot help but notice that during the periods surrounding major disturbances - the 1974 oil shock, the Volcker change in operating procedures in 1979, the phase-in of the Reagan tax-rate cuts, the George H. W. Bush recession, the dot-com crash, the Financial Crisis, and COVID - the slope of the yield curve precedes the economic slowdown. If we are willing to equate temporal precedence with a causal relationship, then a strong case can be made that interest rates "cause" economic activity. If one is willing to assume that the U.S. Treasury can control the slope of the yield curve through Operation Twist, then one must also conclude that the U.S. Treasury can control the pace of economic activity. This also raises the question: How quickly should the Fed react to an economic slowdown?

But what if the causality goes the other way? Then the real economy, not the U.S. Treasury, determines real rates of return based on the economy's aggregate demand and supply conditions. If that is the case, the real interest rate will be driven by the real economy, and the U.S. Treasury will be unable to alter the term structure. It behooves investors and policymakers to determine the conditions under which the causal direction can be established, at which point the appropriate policy may be designed.

However, to control the slope of the yield curve, several conditions must be satisfied. One of them is that the different maturities are not imperfect substitutes for each other. Under Operation Twist, the Treasury controls not

only the total but also the composition of the public debt. All of this, combined with the assumption that the different maturities are imperfect substitutes for each other, yields the implication that, by changing the composition of the debt, the authorities can alter their relative attractiveness and thus the price that the private sector is willing to pay for these securities.

Needless to say, under these assumptions, the magnitude of the relative yields depends in part not only on the relative supply of the different maturities but also on the degree of demand substitutability among the different maturities. The greater the degree of substitutability, the smaller the changes in relative returns and the effectiveness of the policy in altering the term structure and average yield of the public debt. Under the conditions outlined here, the U.S. Treasury may be able to control the shape of the yield curve, and in doing so it may also control or drive the U.S. economy.

Beware the Substitution Effects

Is the previous analysis missing something? It is. Extending the substitution effects to incorporate corporate securities weakens the argument in favor of Operation Twist because there is a source of securities that the U.S. Treasury does not control. Furthermore, the inclusion of these potential substitutes means that a much larger Operation Twist will be required in order to achieve the desired composition of the distribution of different maturities, including corporate bonds. But that is not all. The issue of control and causality regarding nominal interest rates, their components, and the economy must also be addressed.

We have already established that the U.S. Treasury does not control the quantity of money. If inflation is a monetary phenomenon, then inflation is too much money chasing too few goods. Furthermore, if money is a veil, as the monetarists argue, then monetary policy will have no long-run effect on the real economy. Under these conditions, we can safely argue that the underlying inflation rate, in addition to being outside the control of the U.S. Treasury, will have no long-run effect on the real economy. Therefore, if Operation Twist is to have any impact on the term structure, it will have to be through its effect on real interest rates.

This leads us to search for the determinants of real interest rates. The simple answer is that the real interest-rate structure depends on the economy's demand for and supply of funds—the overall investment and savings rates for different horizons. The real interest rate is the market-clearing rate for each of the investment/savings horizons. So far, so good. But this does not answer the question of who controls or drives real interest rates.

If the U.S. Treasury, through its Operation Twist, can control the price of the different securities, it will be able to control or drive the real economy. That is not the only possible direction of causality. In conclusion, the success of Operation Twist depends on the ability of the U.S. Treasury to control the term structure of real interest rates. If the Treasury does, which we doubt, it will succeed. But then that raises an interesting issue: if the U.S. Treasury can control the real yield curve and, through that, the pace of economic activity, shouldn't it be doing so all the time in order to ensure a prosperous economy?

Does Operation Twist make the Fed's job more difficult?

An unfettered yield curve provides the market with important signals regarding the economy. It incorporates the market's inflation expectations, estimates of recession risk, and the future path of the economy and policy rates. Operation Twist, if successful, will flatten the yield curve artificially by lowering long-term yields while short-term yields remain tied to the policy rate. In doing so, according to some critics, Operation Twist reduces the informational value of the yield curve.

Then there is the argument that Twist-like buybacks are nothing more than a soft form of financial repression - manipulating long-term yields to keep government borrowing costs down. The financial press has argued that Operation Twist makes the Fed's job harder because it distorts the yield curve in ways that undermine the Fed's ability to signal policy, anchor expectations, and manage inflation credibility. Although the Fed Chair has not addressed this topic directly, Mr. Warsh did address the issue of forward guidance. His position is simple: the

markets should be playing the ball rather than the referee. To us, the extrapolation of his conclusion is clear and straightforward.

Earlier, we argued that the likelihood that Operation Twist will be ineffective is not negligible. Regarding the issue of how Operation Twist could impact monetary policy, the answer depends on the operating procedures utilized by the Fed. If, as we believe, inflation is too much money chasing too few goods and money is a veil, the ability of the Fed to influence the real economy is fairly limited or nonexistent. Under these conditions, all the Fed can do is alter the quantity of money relative to the goods produced in the economy—i.e., the price level or inflation rate. Mr. Warsh was clear on this when he said that his monetary focus is to deliver a 2% inflation rate. Viewed from this perspective, Operation Twist, whether successful or not, is essentially irrelevant to the conduct of monetary policy.

Conclusion

Operation Twist appears straightforward in theory: alter the maturity composition of government debt, reduce the supply of longer-term securities held by the public, lower the term premium, and thereby reduce long-term borrowing costs. But its effectiveness ultimately depends on a much stronger assumption—that the Treasury can meaningfully control the real yield curve.

That assumption is far from certain. If real interest rates are primarily determined by the economy's underlying supply of savings, demand for investment capital, and expectations for future economic activity, changing the maturity structure of Treasury debt may have only a limited or temporary effect. The existence of corporate bonds and other substitutes further weakens the Treasury's ability to control relative yields.

Operation Twist may also reduce the informational value of the yield curve by artificially influencing long-term rates. Yet from a monetary-policy perspective, this need not fundamentally change the Federal Reserve's task. If monetary policy's primary responsibility is price stability, the Fed should remain focused on controlling inflation rather than attempting to manage real economic activity through the yield curve. The experience highlighted in the article suggests that credible control of inflation can itself reduce the inflation premium embedded in nominal interest rates over time.

The central question, therefore, is not whether policymakers can conduct Operation Twist—they clearly can—but whether changing the composition of government debt can overpower the fundamental economic forces that determine real interest rates. We remain skeptical that it can.

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