Federal Reserve Chairman Ben S. Bernanke has found in Operation Twist a way to expand his record monetary stimulus without provoking his critics.

Through Twist, the Fed sells short-term holdings and buys longer-term debt to spur the economy by cutting borrowing costs without increasing its balance sheet. The June 20 decision to extend the program hasn't generated much controversy so far, unlike the Fed's second round of asset purchases, announced in 2010, which sparked the worst political backlash in three decades as Republicans warned it risked accelerating inflation.

Avoiding political "heat" was one reason policy makers opted at last month's meeting to prolong Twist through the end of the year by $267 billion before starting a third round of so- called quantitative easing, said Stephen Stanley, chief economist at Pierpont Securities LLC. The central bank is under scrutiny not only for its monetary policies but also for its governance after a trading loss of more than $2 billion at JPMorgan Chase & Co. (JPM) revived concern it is too close to the banks it oversees.

"The institutional standing of the Fed is shakier today than it's been at any point certainly in my career, and doing QE3 in election season would be taking an unnecessary risk unless the case is blatantly obvious," Stanley, a former researcher at the Federal Reserve Bank of Richmond who has followed the Fed for 18 years, said in an interview from his Stamford, Connecticut, office.

'Sustained Improvement'

Bernanke hasn't ruled out QE3 and said June 20 that more easing probably will be needed unless there's "sustained improvement in the labor market." The economy added 80,000 jobs in June, missing the 100,000 median estimate of economists in a Bloomberg News survey. The unemployment rate, at 8.2 percent, remained above 8 percent for a 41st consecutive month.

Ward McCarthy, chief financial economist at Jefferies & Co. in New York, predicts the Fed will announce QE3 at its December meeting, unless the sovereign-debt crisis in Europe or political wrangling over the budget deficit in the U.S. curtails growth and prompts action sooner.

"They're not even forecasting sustained improvement in the labor market, so my interpretation of that is that they expect to do more," McCarthy said. "There's no reason to do it now that they've already put something else in place."

Fed officials see unemployment of 8 percent to 8.2 percent at year-end, compared with an April projection of 7.8 percent to 8 percent, according to their so-called central-tendency estimate. For 2013, they predict 7.5 percent to 8 percent, up from their previous forecast of 7.3 percent to 7.7 percent.

'Deep Concerns'

After the Fed said in November 2010 that it would buy $600 billion of bonds, House Speaker John Boehner of Ohio and three other Republicans sent Bernanke a letter expressing "deep concerns." Sarah Palin, the 2008 vice-presidential candidate, accused the Fed of a "dangerous experiment in printing $600 billion out of thin air."

Mitt Romney, the presumptive Republican presidential nominee, has said he won't keep Bernanke -- whose second four- year term expires on Jan. 31, 2014 -- as Fed chairman. QE2 "did not have the desired effect" and a potential QE3 wouldn't fare better, he said in an interview with CBS's "Face the Nation" taped June 16. QE2 risks devaluing the dollar and accelerating prices, he added.

Lawmakers also have expressed concern about the Fed's closeness to Wall Street ever since the taxpayer-funded bailouts of 2008 -- criticism that was rekindled by the May 10 announcement of JPMorgan's trading loss. Jamie Dimon, chief executive officer of the largest and most profitable U.S. bank, serves as a director of the Federal Reserve Bank of New York.

Tarullo Testimony

Three senators, including Bernie Sanders, a Vermont independent, introduced legislation in

May that would remove bankers from the boards of the regional Fed banks. Fed Governor Daniel Tarullo also was called to testify before Congress last month on JPMorgan's loss.

Operation Twist hasn't met with the same level of criticism from politicians as quantitative easing.

"Twist is better and has been much better received because you're not printing money; you're rearranging your balance sheet but you're not adding to it," Republican Representative Michael Grimm of New York said in an interview. "It's still not perfect, but it's better than QE2."

"Operation Twist is viewed as a more subtle, less disruptive intervention," Texas Representative Kevin Brady, the top Republican on the Joint Economic Committee, agreed in an interview. "Quantitative easing has so much more of a direct impact on the purchasing power of the dollar."

Creating Reserves

Under QE, policy makers direct the markets desk at the New York Fed to buy securities from primary dealers, or brokers who are authorized to trade directly with the central bank, adding funds to the dealers' accounts and creating reserves at their clearing banks.

After two rounds of bond purchases totaling $2.3 trillion, the Fed's balance sheet has more than tripled to $2.87 trillion since August 2008, the month before Lehman Brothers Holdings Inc. went bankrupt.

Operation Twist **"actually has some fiscal benefit,"** said **John Campbell, a Republican representative from California** . **"From the standpoint of managing the debt and the deficit, it appears to be a smart move." He added that "if the QE3 trigger is pulled, there will be more criticism, and it will be a little louder."**

Inflation Concerns

Despite Republicans' concern about inflation in 2010, prices are rising faster now than they were when QE2 was announced. The personal-consumption-expenditures price index climbed 1.5 percent for the 12 months through May, compared with a 1.2 percent pace in November 2010. Both are below the Fed's inflation target of 2 percent.

Bernanke has focused on stimulus options relating to the central bank's balance sheet after lowering the target for the benchmark federal funds rate to near zero in December 2008. In addition to the two rounds of bond buying, the Fed last September began extending the maturity of its portfolio.

The Fed chairman has said that both QE and Twist work by lowering interest rates and removing Treasuries from the market, which encourages investors to replace those holdings with other assets, such as equities or corporate bonds. The Fed chairman on June 20 called the extension of Operation Twist a "substantive step" and said the Fed is "very serious" about making policy decisions "on purely economic grounds, without political considerations."

Low Yields

The central bank's bond buying has helped drive down borrowing costs, with the yield on the benchmark 10-year Treasury note touching an all-time low of 1.44 percent on June 1. It was 1.55 percent on July 6.

Both programs have costs and benefits, prompting criticism from within the Fed. Jeffrey Lacker, president of the Richmond district bank, dissented on the extension of Operation Twist, asserting it won't significantly boost growth and will spur inflation.

Twist increases the interest-rate sensitivity of the Fed's holdings while also complicating its eventual exit strategy because it won't hold as many short-term securities that will mature, said Robert Eisenbeis, chief monetary economist at Sarasota, Florida-based Cumberland Advisors. That will make it more difficult to shrink the central bank's portfolio without dumping assets on the market, he added.

Not Textbook

“None of this is textbook, so I don’t think there’s a real definitive view on how it all works, and so reasonable people can disagree,” McCarthy said. “The ultimate objective of either type of operation is to get the economy going.”

Fed officials predict inflation will fall short of their goal this year, with prices accelerating between 1.2 percent and 1.7 percent. Their estimate for 2013 is for 1.5 percent to 2 percent.

The break-even rate for five-year Treasury Inflation Protected Securities, the yield difference between the inflation-linked debt and comparable maturity Treasuries, was 1.77 percentage points on July 6. The rate, a measure of the outlook for consumer prices over the life of the securities, has fallen from 2.19 points on March 14.

“Notwithstanding claims the Fed has been printing money like crazy, one indicator of inflationary pressures is actually significantly lower,” said John Lonski, chief economist at Moody’s Capital Markets Group in New York. Fed officials are “trying to basically amplify the kick that they get out of their current balance sheet.”