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MARKET SNAPSHOT

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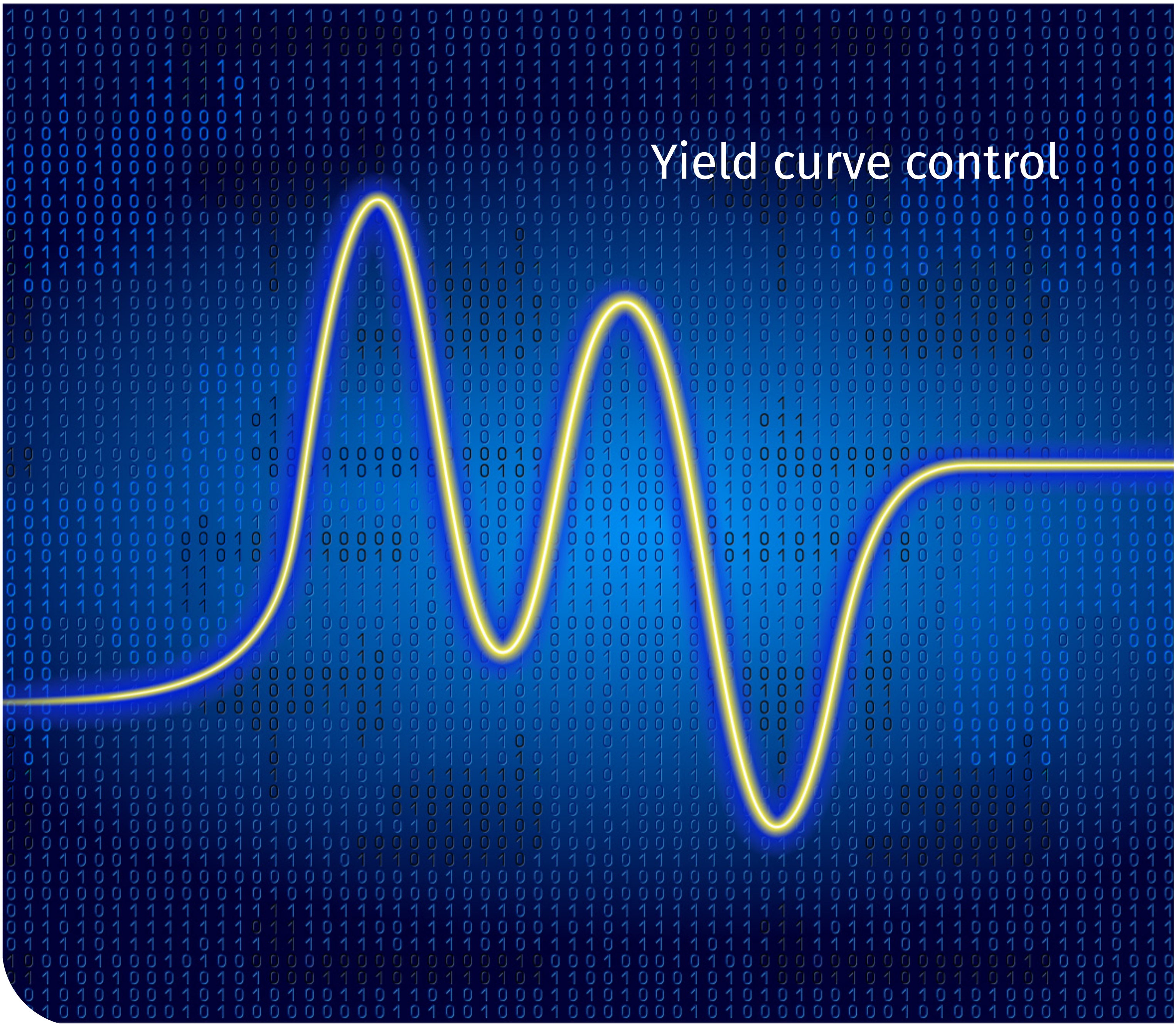

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GLOBAL STRATEGIC ASSET ALLOCATION

GLOBAL SECURITY SELECTION

REGIONAL ASSET ALLOCATION

REGIONAL PORTFOLIO CONSTRUCTION

What is yield curve control (YCC)? While the Federal Reserve has studied it closely – although appears to have lost any enthusiasm recently – this is a good time to ask what this policy tool is, and what its strengths and weaknesses might be. In this issue of *Infocus*, Stefan Gerlach looks at these and related questions.

What is YCC?

YCC is a policy through which the central bank seeks to influence the shape of the yield curve by promising to buy longer-term securities at preannounced prices/yields. For instance, it may announce that it will buy bonds with a maturity of 10 years so that the yield to maturity does not rise above some ceiling, such as 0% or 0.25%. Alternatively, it could introduce yield targets, such as promising to keep 10-year yields close to 0% or 0.25%.

What central banks have used YCC?

The Bank of Japan has employed YCC since 2016 and the Reserve Bank of Australia adopted it earlier this year. The Federal Reserve sought to prevent long bonds yields from rising above 2.5% between 1942 and 1951. (See the Appendix for more information.)

Why is there a need for YCC?

Historically, central banks cut interest rates to stimulate the economy. But with short term interest rates now so close to zero, central banks cannot cut the standard policy rate by enough to be sure that long interest rates fall sufficiently to stimulate the economy. (Of course, they could cut short rates below zero, but there seems to be increasing scepticism about negative interest rates among central banks.) YCC offers a way for central banks to influence long interest rates directly as a complement to traditional monetary policy.

What is required for YCC to work well?

It is crucial that the public believes that the central bank is fully committed to carry out its promises, that is, to buy bonds, potentially to an unlimited extent, if interest rates start to rise above the promised ceiling. If its commitment is credible, the central bank may be able to control long interest rates without buying any bonds – its promise to do so is all that is needed.

How does that work?

The reason YCC allows a central bank to control bond yields without purchasing bonds is that credibility engenders stabilising expectations. To see this, suppose that the bond yield rises to just below the announced ceiling. If the central bank is credible, it will not allow the yield to rise much further; the yield will either remain at about that level or decline.[1] Market participants thus expect the yield to fall and buy the bond to benefit from the expected capital gain. This is what prevents the interest rate from reaching the ceiling in the first instance and what obviates the need for the central bank to purchase the bond.

In practice, of course, a central bank is never perfectly credible and will have to remind the market from time-to-time of its commitment by buying bonds even if the interest rate ceiling has not been reached. But if the central bank is highly credible, it may need to do so only rarely. Thus, YCC allows a credible central bank to reduce the amount of bond purchases it has to conduct to prevent bond yields from rising.

What problems might arise?

One problem that might arise is that the central bank's credibility evaporates. To return to the earlier case, suppose that the relevant bond yield is just below the ceiling announced by the central bank and that bond holders for some reason start to doubt that the central bank will buy bonds if the yield continues to rise. Market participants will then no longer expect a capital gain if they buy the bond and will therefore be less inclined to hold it.

The demand for the bond and its price will therefore fall, leading to a rise in its yield. While the central bank can wait to purchase bonds until the yield has risen to the ceiling, in practice it will step in to buy the bond before the limit has been reached. In brief, poor credibility can force the central bank to engage in potentially very large bond purchases.

A similar problem arises if the economy recovers strongly and the central bank decides to abandon YCC. Without the existence of stabilising expectations, bond yields will rise and bond holders will experience a capital loss. With a large amount of government bonds being held by the financial system, such losses may trigger risks to the solvency and stability of financial intermediaries.

Given these problems, market participants may expect the central bank to abandon the policy "early", that is, before

[1] But not rise further since the central bank will then step in to prevent that from happening.

doing so will lead to such large capital losses among bond holders as to raise financial stability risk. But that means that the policy will lack credibility from the outset.

To limit this problem, the central bank may prefer to focus on bonds of short to intermediate maturity, say one to three years. It could for instance commit to maintaining a ceiling on the yields on two-year bonds that mature before a specific date, say 1 January 2022. This would let longer bond yields move freely in response to investors' expectations of the future path of monetary policy, at the potential cost of reducing the stimulatory effect of YCC.

How does YCC differ from QE?

Under QE, the central bank decides how many bonds it will buy and lets the yield be determined by market forces. Under YCC, it sets a ceiling or target for the yield and market dynamics decide how many bonds it has to buy to reach that target.

APPENDIX

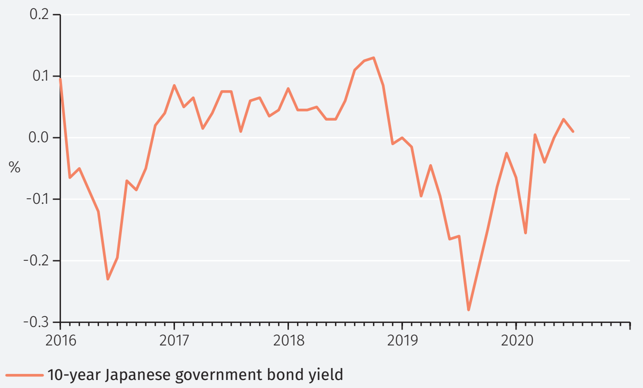
Experiences with YCC

The Bank of Japan introduced YCC in 2016 and the Reserve Bank of Australia in 2020. The Federal Reserve also sought to control US long bond yields between 1942 and 1951.

Bank of Japan

The Bank of Japan expanded its set of monetary policy tools by adopting YCC in September 2016.[2] At that time, it reaffirmed that asset purchases would continue until inflation had risen above 2% but also set a target for 10-year JGB yields of "around" 0%. Apparently, market participants interpreted this as a band of ±0.1%. The band was widened to ±0.2% in June 2018. As Figure 1 shows, the Bank of Japan has been successful in keeping long bond yields close to zero and has managed to do so while reducing bond purchases.

1. 10-year Japanese governmentbond yield

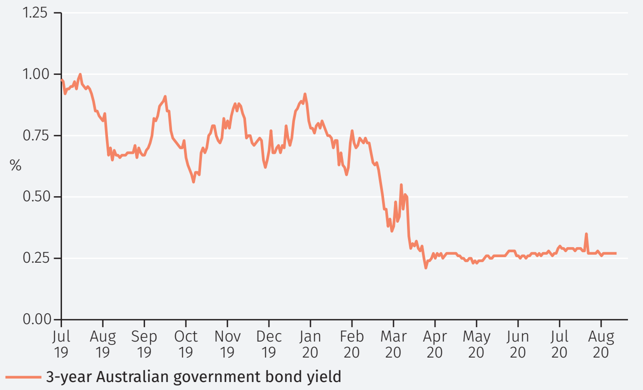


Source: Federal Reserve Bank of St. Louis (FRED). Data as at 7 September 2020.

The Reserve Bank of Australia

The RBA introduced YCC in March 2020 as part of a package of policy measures that were designed to prevent long-term yields from rising.[3] Thus, the RBA cut the cash rate target to 0.25%, stated that it would not raise interest rates "until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band," and introduced "a target for three-year Australian Government bonds of around 0.25%." Three-year yields have stayed very close to the target since then.

2. Three-year Australian governmentbond yield



Source: RBA. Data as at 7 September 2020.

Cont.

[2] See *Japan's Experience with Yield Curve Control*, by Matthew Higgins and Thomas Klitgaard at https://libertystreeteconomics.newyorkfed.org/2020/06/japans-experience-with-yield-curve-control.html

[3] See Statement by Philip Lowe, Monetary policy issues, 19 March 2020 at https://www.rba.gov.au/media-releases/2020/mr-20-08.html

Appendix *(.cont)*

The Federal Reserve

Much attention has recently focused on the Fed's attempt to target the yield curve between 1942 and 1951.[4] However, the objective of that policy was to allow the US Treasury to finance wartime spending at a low interest rate and not to provide macroeconomic stimulus.

Thus, in March 1942, the Fed and the US Treasury agreed to introduce a ceiling on long-term Treasury yields of 2.5% and set a 3/8% interest rate on short-term T-bills. The 2.5% target was apparently not announced, implying that the expectations based stabilizing mechanism discussed above was not necessarily effective.

While interest rates were kept at the agreed levels until the end of the war, as inflation started to rise in 1947 the Fed and the Treasury agreed to raise the T-bill rate. As Figure 3 shows, the T-bill rate started an upward trend that only ended in 1953. With short term rates rising, market participants deemed the 2.5% yield on long bonds as too low, forcing the Fed to purchase large quantities of bonds to enforce the ceiling.

The 2.5% ceiling on long yields was abandoned in March 1951 as rising inflation pressures associated with the outbreak of the Korean war made it clear that the ceiling on bond yields prevented the Fed from achieving its mandate.[5]

While proponents of YCC may argue that the 1942-51 episode of interest rate pegging in the US demonstrates that fixing yields at too low a level does generate inflation, the US economy experienced huge fluctuations in government spending resulting from the start and end of World War 2 and the start of the Korean War. As the yield curve control in this period is best seen as a fiscal tool to facilitate the financing of the quickly growing public debt, the episode may contain few lessons about the effectiveness of YCC relevant to the modern era.[6]

3. T-bill and long bond yields in the US

Source: Federal Reserve Bank of St. Louis (FRED). Data as at 7 September 2020.

[4] For an excellent discussion of this episode, see *Targeting the Yield Curve: The Experience of the Federal Reserve, 1942-51*, by Radha Chaurushiya and Ken Kuttner at https://www.federalreserve.gov/monetarypolicy/files/FOMC20030618memo01.pdf
[5] Thus, inflation rose from -3.0% in August 1949 to a peak of 9.5% in February 1951.
[6] That said, quickly rising public debts as a consequence of the Covid-19 slowdown may raise the attractiveness of YCC to some policymakers.

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