YIELD CURVE CONTROL: AN EXPERIMENT IN REAL TIME

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WE BELIEVE THIS IS AN EXCEPTIONAL PERIOD IN GLOBAL MARKET MONETARY POLICY. IN REAL TIME WE ARE WITNESSING SEVERAL COUNTRIES USING YIELD CURVE CONTROL (YCC) POLICIES IN VARYING FORMS—DESPITE MANY UNKNOWN FACTORS AND POTENTIAL REPERCUSSIONS.

These YCC policies target a given yield through a mix of communications and asset purchases. This is a key distinction compared to the quantitative easing (QE) approaches implemented after the global financial crisis (GFC), which set out to buy a pre-determined amount of bonds. As a result, YCC has the potential to be more balance sheet efficient.

RESEARCH & PERSPECTIVES

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YCC is not a new tool. For example, during and after World War II, the Federal Reserve (Fed) set yield caps. But in our view, the dramatic evolution of global financial markets makes decades-old examples of YCC policies of limited use in terms of implementation and implications. When you couple this with the fact that *none* of the countries currently implementing YCC have attempted to exit the policy, it becomes clear that the experiment continues without exit implications being known.

Who to Watch

The Reserve Bank of Australia (RBA) and the Bank of Japan (BoJ) have adopted formal YCC policies. The European Central Bank (ECB) is using aspects of the tool as it targets financial conditions. The Bank of England (BOE) is expressing wariness about balance sheet size, which could be a precursor to YCC. The Bank of Canada and the Fed have discussed the tool, but seem unlikely to use it at this stage.

Observations from Australia, Japan and Europe

Financial market structure, broader policy mix and previous use of QE appear to influence a central bank's choice of which sector of the curve to target.

TARGETING THE FRONT END OF THE YIELD CURVE

AUSTRALIA:

The RBA announced in March 2020 that it would buy bonds in unlimited quantities in order to cap the three-year yield at the overnight cash rate.[1] The central bank targeted the three-year point on the yield curve because most financial instruments in Australia are priced off of that tenor of the market.

EURO ZONE:

The ECB has put in place forward guidance on rates. It views its targeted longer-term refinancing operations (TLTROs), which offer fixed-rate funds, as reinforcing that guidance. We believe this acts as a form of front-end control, but with less explicit impact on sovereign rates than that of the RBA model.

Both Australia and the euro area are incorporating a rate-signaling aspect in their approaches. In these cases, the banks intend for YCC and fixed-rate term lending to reinforce that the key policy rate will remain at its current level for an extended period. The RBA and ECB approaches are also aimed squarely at improving the pass-through of policy rates to borrowing rates.

[1] *Reserve Bank of Australia: https://rba.gov.au/media-releases/2020/mr-20-08.html*

TARGETING THE LONG END

JAPAN:

The BoJ's policy controls its 10-year rate. It actively seeks to allow yield curve steepening beyond that point, which in turn helps alleviate pressure on pension investors and insurers relying on returns at the longer end of the curve.

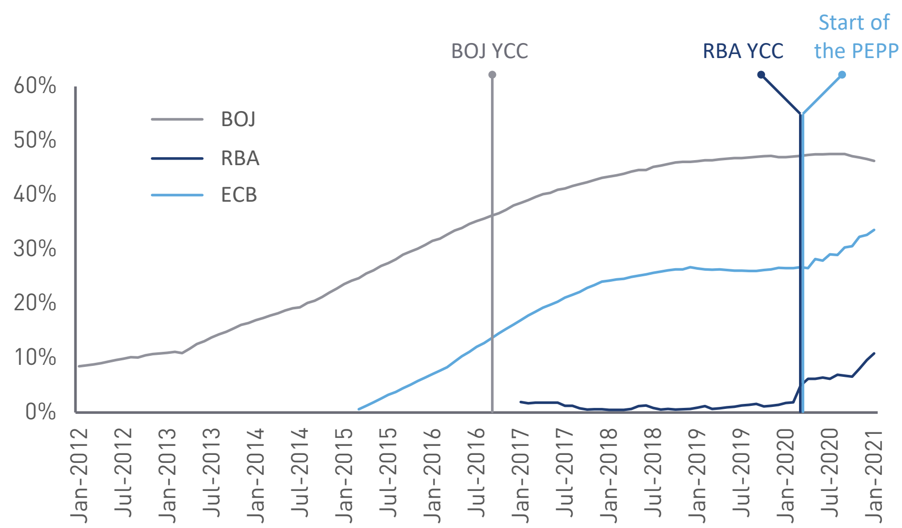
The BoJ implemented a traditional QE program in April 2013. The central bank evolved to YCC in September 2016 after running out of bonds to buy as part of QE and in response to yield curve distortions from the implementation of negative rates.[2] In our view, the perceived credibility of the central bank's 10-year bond YCC price target allows it to effectively anchor shorter maturities below that level without having to buy additional bonds.

EURO ZONE:

Turning to the ECB's focus on the long end, it has spoken about preventing an "unwarranted" steepening of the yield curve. In our view, it could use a mix of communications and asset purchases under its Pandemic Emergency Purchase Programme (PEPP). These could suggest its control preferences in terms of maturities and rate level even without an explicit target. In effect, the ECB is giving the market a sense of what it considers an appropriate level of rates, and pointing the market toward the indicators it is watching.

GOVERNMENT DEBT OWNED BY CENTRAL BANK

Sources: Bank of Japan, Reserve Bank of Australia, European Central Bank, as of 26 February 2021.



[2] *Bank of Japan: https://www.boj.or.jp/en/announcements/release_2016/k160921a.pdf*

One Tool Among Many

YCC can be used as a complement to negative rates, forward guidance and traditional QE. Or it can be an alternative to these.

For example, the BoJ started with QE, added negative rates and then fine-tuned both with YCC. With the introduction of YCC, the BOJ's QE purchase targets ceased to be binding—the bank implicitly chose to target bond price versus bond quantity.

In the RBA's case, YCC (three-year maturities) and QE (maturities around five to ten years) can coexist. The respective programs target different parts of the curve.

The ECB started with negative rates, added traditional QE and then flexible QE with aspects of YCC. The bank's TLTROs apply negative rates across the term of the facility, in effect merging these two tools in a form of YCC that also enhances forward guidance.

We believe the RBA may serve as a test case for using front-end YCC instead of negative rates. Perhaps it can be a precedent for economies with more stable inflation conditions that also wish to strengthen guidance and/or complement QE measures. We believe this seems most relevant to the BOE and Reserve Bank of New Zealand, which are considering adding negative rates as a policy option.

Exit Considerations and Policy Fine-Tuning

The only rate adjustment to date under YCC has been the BoJ's decision to widen the control band (from +/- 10 basis points to +/- 20 basis points) in July 2018.[3] This sort of managed float may be a precedent for exiting the YCC policy, although the BoJ has given no indications that it is looking to exit. In our view, the adjustment may also imply a move to a longer-lasting arrangement.

If a central bank were to shorten up the tenor of its target point, it would be in effect allowing the market to control more of the curve. At the same time, the bank would be sending a signal about future rates, before it makes an official step like raising rates. We believe this could reintroduce market drivers and signal views about the exit time frame.

The RBA has said it will end YCC before lifting the cash rate. On February 2, 2021, its most recent meeting, the central bank hinted that it will exit YCC via a shortening in the tenor of its YCC target.

[3] *Bank of Japan: https://www.boj.or.jp/en/mopo/mpmdeci/state_2018/k180731a.htm/*
Nikkei Asia: https://asia.nikkei.com/Economy/BOJ-allows-more-flexible-movement-for-long-term-rate-says-Kuroda
Nikkei Asia: https://asia.nikkei.com/Economy/Bond-traders-measure-Bank-of-Japan-tolerance-on-new-flexible-range

Potential Tweaks

Adjustments to other policy tools could also play a role in an exit from YCC. The ECB's flexible purchase program includes corporates. Under the financial conditions approach, it could shift purchases toward corporates to contain spreads as sovereign yields are allowed to rise.

Traditional QE could also play a role in exiting from YCC by setting forth a measured, time-specific exit from the sovereign market. For example, the RBA's QE program runs for six months at a time, giving the central bank the option to exit from QE before YCC. The ECB also has an asset purchase program that buys a set amount of securities monthly. This could stay in place while it backs away from more explicit efforts at influencing the curve through its pandemic-specific purchase program.

Policy Versus Signal

There is a risk that a YCC policy could displace market signals. If the market thinks central banks are late in adjusting or ending YCC, the reaction in spreads could be more intense, as credit markets face no resistance in repricing the rate path. This risk might be amplified in a particularly strong recovery. Also, central banks could encounter greater pressure on their control targets, forcing them to purchase more bonds or adapt exit plans.

Conclusion

Analysis of monetary policy tools will surely continue as the US economy continues to respond to improving economic growth and inflation rate implications. Additional central banks may turn to YCC for its yield curve precision and potential balance sheet efficiency. However, we believe unknowns persist since none of these central banks have attempted to exit the strategy as yet—nor has the tool been used outside of advanced economies.

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