PRESERVER PARTNERS

September 2020

What Is Yield Curve Control?

Yield Curve Control ("YCC"), also referred to as an interest rate peg, is an unconventional way for a central bank to promote economic growth and inflation. YCC occurs when a central bank publicly announces and executes purchases of government bonds at a specific maturity to ensure that yields are maintained at the desired level. Because bond prices are inversely related to their yields, buying bonds and pushing up their price leads to lower rates. In contrast, under Quantitative Easing ("QE"), a central bank injects a certain amount of money into the economy by buying Treasury securities. Under YCC, the Federal Reserve would commit to keeping bond yields at a pre-determined level, by buying as many bonds as necessary. Since the interest rates paid by business and household spending decisions are linked to government bond yields, YCC is efficient because it directly lowers rates. YCC would peg longer-term interest rates to a lower level and will encourage investments and spending by businesses and households.

YCC was last used in the U.S. between 1942-1951 to help finance World War II expenditures. In 1942, the Federal Reserve and Treasury agreed that the Federal Reserve would cap the Treasury's borrowing costs by buying any government bond that yielded above 0.375% on 3-month Treasury bills and 2.5% on longer-term bonds. The Federal Reserve was able to maintain these pegs without having to buy large amounts of bonds until 1947 as market participants were active in supporting the yield curve control policy.

Are There Any Central Banks Exercising YCC?

In 2016, the Bank of Japan (BOJ) experimented with interest rates pegs in an effort to fight against deflation. Japan chose to pin 10-year rates at zero percent. Using YCC to adjust their purchases to maintain

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the target rate, the Japanese central bank was able to lower government borrowing costs and maximize the effect of fiscal spending. The BOJ faces the challenge of a deep-rooted expectation that low inflation will persist.

Australia and New Zealand implemented versions of YCC earlier this year in response to COVID-19. Australia is targeting three-year bond yields at 0.25%. Since setting this target rate in March 2020 and beginning a surge of purchases, the Reserve Bank of Australia hasn't had to buy bonds for eight weeks because they were able to achieve their target quickly and maintain it at the desired level. Australia's three- to ten-year yields curve has steepened about 40 basis points from early March. The Reserve Bank of New Zealand also set their target interest rates to 0.25% and pledged to buy up NZ$60 billion ($38.7 billion) of bonds over 12 months. New Zealand's 2-10 year yield curve has gone up about 30 basis points since early March. If the Fed decides to implement YCC, it would likely select Treasury debt with short- to intermediate-term maturities between two and five years as its initial target, expanding to longer-term bonds, if necessary.

Who Benefits from YCC? How?

In theory, YCC should create a trickle-down effect that positively impacts the economy. If the Federal Reserve pegs a low interest rate on Treasury securities, it should lead to lower interest rates on mortgages, car loans, and corporate debt, as well as higher stock prices and a cheaper U.S. dollar. All of this would encourage spending and investment by businesses and households. However, the success of YCC depends on the Fed's ability to persuade financial markets it is committed to the program. If investors believe that the Fed will stick to this program for the duration of the peg, then they will begin trading securities at prices consistent with the peg. The cap on long-term interest rates could decrease bank profitability, which depends on a wider spread in rates. Highly leveraged companies and capital-intensive industries such as auto, airlines, shipping, construction, etc. should face improved earnings under YCC as financing rates will be low. Under YCC, the Federal Reserve could avoid fixing the nominal rate below zero, create more flexible financial conditions and keep government borrowing costs low.

Who Is Hurt By YCC? How?

If the Federal Reserve's commitment to the peg were not credible then investors would be less willing to buy bonds at the target price and the Federal Reserve would have to purchase large amounts of the pegged securities. The fragility of the central bank's credibility is one of the more obvious risks associated with YCC. YCC is aimed at stimulating economic activity and inflation, however YCC combined with aggressive U.S. government deficits has the potential to suddenly create high inflation. Heightened inflation rates can be troublesome for equities and bond holders as they may induce negative returns and create a loss in principal. If inflation were to overheat as a response to YCC, the Federal Reserve would be forced to abandon their commitment to the target rate or allow inflation to run higher. By contrast, it is also important to understand that while YCC is focused on stimulating inflation, it may not lead to inflation at all. In the past four years, the policy adopted by Japan has not provided much encouragement that their implementation of YCC has improved inflation. Another risk is that under YCC the U.S. dollar could face a sharp decline in value due to a rising budget deficit, which may limit the appeal of U.S. assets to overseas investors. Another consideration is that lower U.S. yields could push domestic investors abroad in search of income.

What are the Short- and Long-Term Affects of YCC?

If the Federal Reserve chooses to implement YCC and pegs a very low interest rate, it could find that its ability to raise rates after the crisis is constrained by the large budgetary impact on the U.S. Treasury of even a small increase in borrowing costs. By targeting shorter term bond yields, the Federal Reserve would face a less painful policy exit, however, it would limit the boost to credit conditions. The long-term effects of YCC on bond markets are not entirely clear, particularly if the Federal Reserve targeted longer-term bond yields.