# Economy

**Focus US**
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# An update on the yield curve control in the US

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***The US economy is exposed to two immediate threats, the first from the virus, the second from the fiscal cliff. The pandemic is seeing another upsurge and Congress has not (yet) decided to extend support to households. After a sharp rebound in May and June, demand has tended to level off in recent weeks. There is a risk that the economy could stall or even relapse. What can the Fed do to minimise this risk? Keeping policy interest rates at zero, providing the necessary liquidity, extending the QE are a given. Some members of the FOMC would also like to strengthen the guidance on longer rates via some "yield curve control". Here we take stock of this key debate for the future of US monetary policy.***

## The week's focus

After strengthening in May and June, the US economy is showing signs of weakness again. The pandemic had subsided from April to early June, suggesting that the worst was over, but since then it has gained ground in a large swathe of the country. Restrictions on the use of certain commercial premises have been reinstated here and there. In recent weeks, mobility indicators have shown that households are more cautious, staying at home more. This is leading to a moderation of their spending, as reflected in the volume of credit card purchases. The decline in jobless claims has also slowed markedly. On the other hand, there is a fiscal cliff risk, i.e. that the exceptional measures to help the unemployed may not be extended, at least not in full (see p.3). These measures are scheduled to expire at the end of the month. As is often the case, partisan disagreements over the amount and content of the next budget package may only be overcome at the eleventh hour. This is stoking the climate of uncertainty and magnifying the downside risks to activity, employment and inflation.

What can the Fed do to minimise these risks? In the short term, it will continue along the path it has followed in recent months, i.e. of keeping policy rates at zero, serving liquidity needs without restrictions and extending its asset purchase policy. The Fed's assets totalled $ 4,174bn at the start of the year. They rose by $ 3,000bn (+72%) to its recent peak in mid-June. Since then, the balance sheet has tended to shrink (chart lhs). This should not be interpreted as the Fed's desire to tighten its policy, but merely the fact that the markets have returned to their normal functioning, implying a reduced need for liquidity. In particular, the Fed stopped its special repo operations and reduced its dollar swap lines with the major foreign central banks. All told, financial conditions have returned to their pre-pandemic state (see chart rhs).

### US: Fed's assets

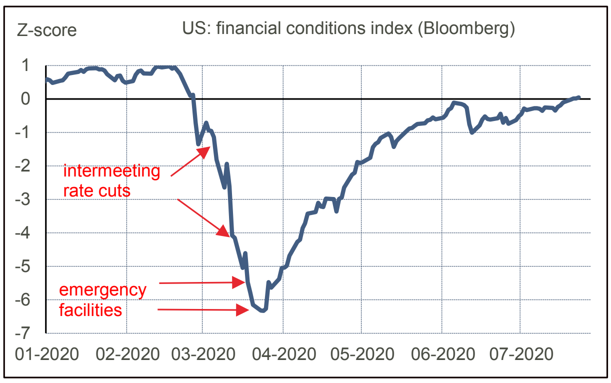
Federal reserve banks consolidated statement (bn$)

| Assets | 1 Jan.2020 | June 10 | July 22 |
|---|---|---|---|
| Gold/FX Reserves * | 18 | 18 | 18 |
| Loans | 0 | 98 | 93 |
| - o/w PD credit facility | 0 | 0 | 2 |
| - o/w MMMF liq.facility | 0 | 98 | 18 |
| - o/w PPP liq.facility | 0 | 0 | 69 |
| Repo | 256 | 167 | 0 |
| Central bank swap | 4 | 445 | 122 |
| Securities | 3740 | 5988 | 6239 |
| - o/w Treasuries | 2329 | 4150 | 4266 |
| - o/w MBS | 1409 | 1836 | 1971 |
| **TOTAL** | **4174** | **7169** | **6965** |

* not all Gold/FX reserves recorded in FRB accounts, gold valued at historical cost
PD: primary dealer , MMMF: money market mutual fund, PPP: Paycheck Protection Program

*Sources: Fed, Bloomberg, ODDO BHF Securities*

### US: financial conditions index



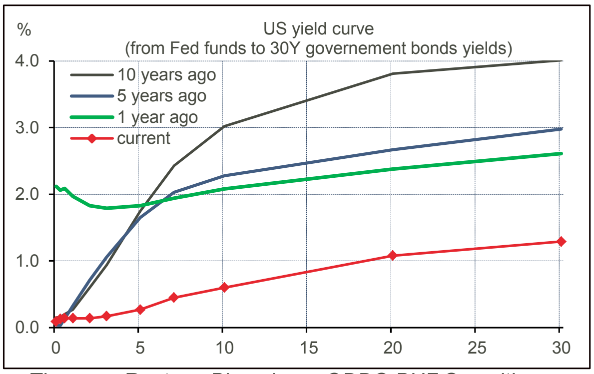
In the longer term, the Fed has several options. One, fairly radical, has already been ruled out: that would be to put policy interest rates in negative territory, as is done in Japan and Europe. The Fed believes that this policy could have undesirable side effects and cause more harm than good to the US financial system.

Another way to increase monetary accommodation would be to change the forward guidance on policy rates. Most FOMC members have approved this principle, but the way to proceed is not clear-cut. The Fed has once introduced a data-based guidance in the past, but without success. At the end of 2012, with unemployment at 8% and inflation at 1.5%, the Fed had committed not to exit the zero interest rate policy until unemployment exceeded 6.5% or inflation moved back above 2.5% (the so-called Evans rule). It thus made its monetary policy dependent on rising inflationary pressures. The problem is that unemployment has been falling steadily (3.5% at the low point) without inflation starting to rise again. Unemployment-wage and wage-price relations are no longer as stable as they once were. In 2014, the Fed therefore abandoned this rule, which created a gap between its actions and its rhetoric. Another way of proceeding could be to reformulate the inflation target, not by changing the target value (2%) but by taking to an average over several years (average inflation targeting). In short, 2% would be targeted not at a given point but over a certain period of time. Since 2015, PCE inflation has been around 1.5% per year. Were the Fed to go down this path, it would signal that it would be willing to tolerate - and therefore to desire - inflation above 2% for a certain period of time. Given the structural impediments to higher inflation, this would reinforce the accommodative bias of monetary policy. The strategy review has often mentioned this possibility.

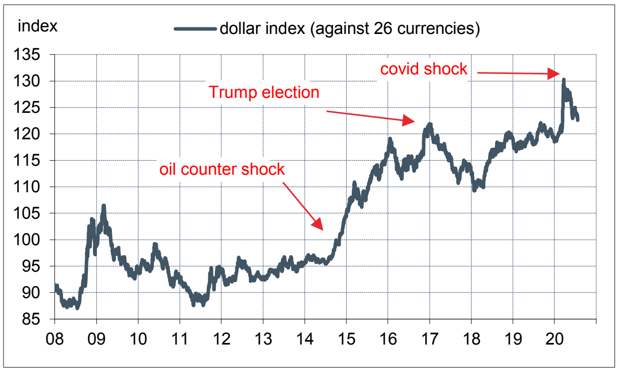
A third option would be to set caps or targets on the yield curve (YCT policy). Currently, the Fed sets the Fed funds rate in order to guide the overnight market rate, but the influence on longer-term maturities is only indirect, reflecting its asset purchases and communication. No quantified target has been set. To date, all US rates are very low, a situation unprecedented for central bankers (chart lhs). This stems from structural factors like the global savings glut and the scarcity of risk-free assets but also temporary factors like the downward risk caused by the pandemic, not to mention the influence of the Fed's current policy. When these risks ease we may see tension on rates, creating financial instability. Adopting a target or cap on long rates is seen as a means to prevent this. Moreover, the day that the Fed deems that the fundamental conditions are in place to normalise its monetary policy - not for a very long time - it would be better if there were no misunderstanding regarding its intentions. The *taper tantrum* episode of 2015 when Ben Bernanke alluded to the end of QE, has left a bitter taste.

There are some historical precedents for controlling the yield curve; in the US during and after the Second World War, in Japan since 2016 with a target of 0.10% on the 10-year government bond rate, in Australia since March 2020 with a target of 0.25% on the 3-year rate[1]. FOMC discussions reveal the Australian option as the most interesting for the US. Like the Fed, the RBA has the dual-mandate of full employment and inflation. Moreover, three years is an intermediary horizon, with the ability to bolster guidance on short rates and a longer-term influence on the yield curve in reasonable operational conditions. Such a policy does not come without a cost. If the central bank wants its target/cap for long rates to be credible it must be willing, in the event of stress, to purchase assets on an unlimited basis, at the risk of losing control of its balance sheet or triggering a depreciation in the currency (chart rhs).

**US: yield curve at different dates from 2010 to 2020**




**Dollar: exchange rate against the basket of currencies**




*Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities*

[1] See Garbade (2020), Managing the Treasury Yield Curve in the 1940s, New York Fed staff report, February; Higgins & Klitgaard (2020), Japan's Experience with Yield Curve Control, New York Fed blogpost, 22 June; FOMC (2020), Discussion of forward guidance, asset purchases, and yield curve caps or targets, Minutes, 10 June.

Last year, the Fed launched a strategic review, the conclusions of which are expected before the end of 2020. The current crisis increases the need to clarify as much as possible the Fed's actions and communication. But there is no real urgency requiring an imminent decision. Many on the FOMC still question on which side the cost/benefit balance of a yield curve control strategy will lean. On the one hand, it should help influence economic financing conditions and steer market expectations as efficiently as possible. On the other, they need to accept that once targets/caps are set, long rates will lose their signalling role on future growth and/or future inflation. Lastly, there is the potential for political interference. Might the government not be tempted to call into question the Fed's independence to set rate targets itself? Lael Brainard, an influential voice on the Board and in favour of a form of yield curve control, acknowledges that there needs to be more extensive analyses and debate[2]. It is probably too soon to expect a decision at the FOMC meeting on **29 July**, but Jerome Powell could signal that the Fed is actively examining modifications to its forward guidance later in the year.

## Economy

- After 15 weeks of uninterrupted decline, new jobless claims ticked up slightly in the week of **18 July** (+109k to 1.4M). The number of claimants is stable at around 32 million, including 14m under the pandemic unemployment assistance (PUA) programme. Other high-frequency data (household pulse survey, homebase) point to a stabilisation or even a slight dip in employment, after two months of sharp increases. This, coupled with the news concerning the epidemic, may explain why household confidence is no longer improving. The University of Michigan index has eroded in **July** (73.2 vs 78.1). The Bloomberg index has been largely flat in the last three weeks.
- Existing home sales jumped in **June** (+20.7% m-o-m) to 4.72 million, i.e. 19% below their pre-pandemic level. A similar trend can be seen in housing starts (+17.3% m-o-m) at 1.2m, i.e. 24% below their February level.

## Monetary and fiscal policy

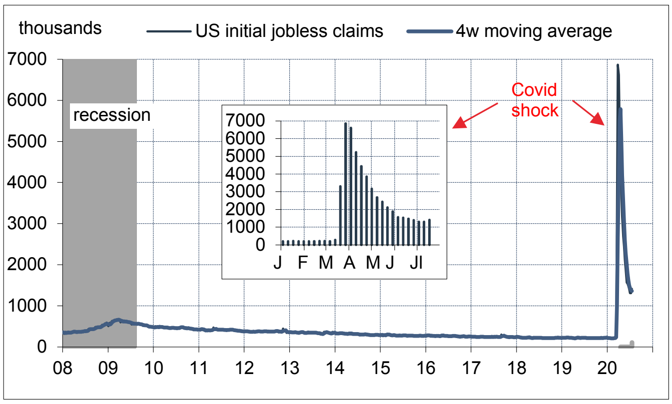
- The Senate Banking Committee approved on **21 July** the nomination of Judy Shelton to the seat on the Federal Reserve Board of Governors. This removes an obstacle to her possible appointment by a vote of the full Senate, even though certain GOP senators have doubts about her. This nomination put forward by Donald Trump – some believe that, if re-elected, he plans to appoint Judy Shelton as Fed chair once Jerome Powell's mandate is up – raises many questions. As regards the form, the choice is clearly based on partisan considerations, Judy Shelton having stood out above all thanks to her constant praise for the president, to whom she was an advisor in the 2016 election. As regards the substance, Judy Shelton's thinking on monetary matters has varied significantly. At once time she was in favour of a return to the gold standard, the most extreme form of monetary orthodoxy, but more recently she has been favourable to the most flexible monetary policy possible (in accordance with the president's wishes).
- We still have little information on the next budget package, other than that there will be no cut in the payroll tax as sought by Donald Trump. We seem instead to be moving towards an extension of help for the unemployed, but less than the current $ 600 per week. Various figures have been mentioned ($ 400 per week, $400 per month, 70% of the last wage). The GOP plan is set to be presented next week.

## The week ahead

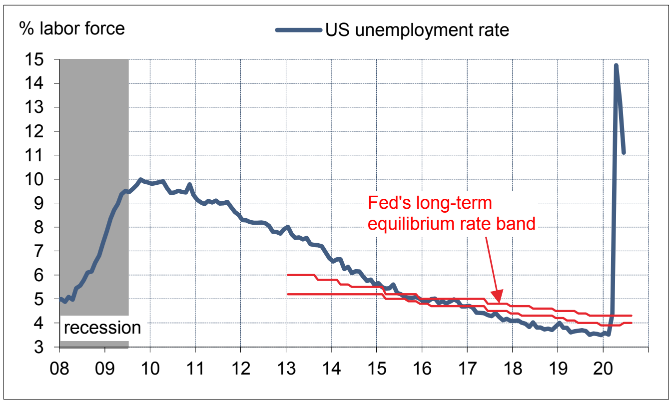
- The main event will be the FOMC meeting and the press conference by Jerome Powell that will follow on **29** (see above).
- The initial estimate for the Q2 national accounts is due to be released on **30**. In **Q1**, real GDP fell by 5% q-o-q at an annualised rate, because of the collapse in activity and demand from mid-March. The fall continued and worsened throughout April, but in May and June there was a very strong recovery that was particularly clear in retail sales. **Q2** GDP will therefore reflect radically different trends, first negative and then positive. On average, the contraction looks set to be of historic proportions. On **17 July**, the Atlanta Fed's most recent nowcast estimated that the drop would be -35% q-o-q on an annualised basis. Consensus forecasts vary between -26% and -40%. According to the Atlanta Fed, most of the fall in real GDP will come from the negative contribution of spending on goods (for -3 points) but above all from spending on services (-18 points).

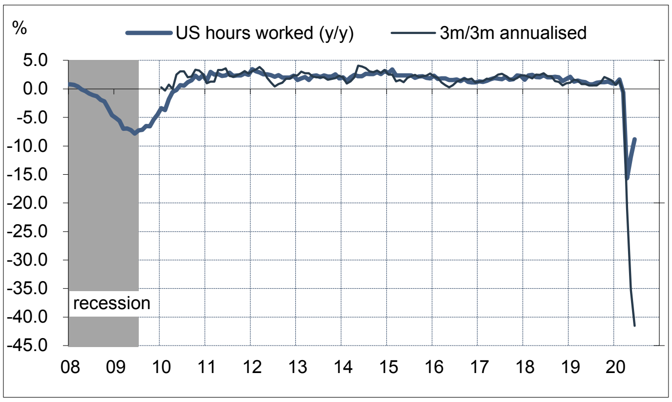
[2] See Brainard (2020) Navigating Monetary Policy through the Fog of COVID, speech of 14 July

## Appendix 1 - Labour market

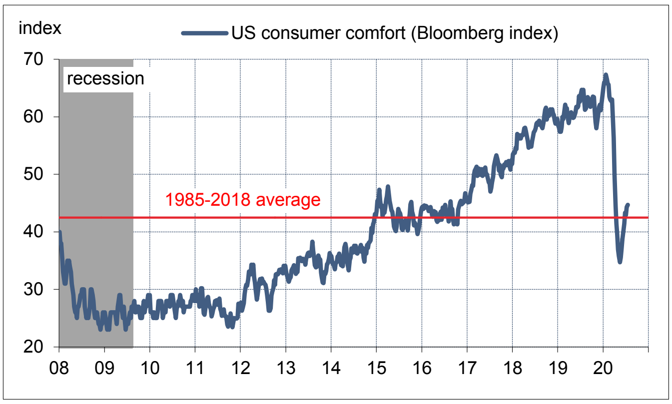


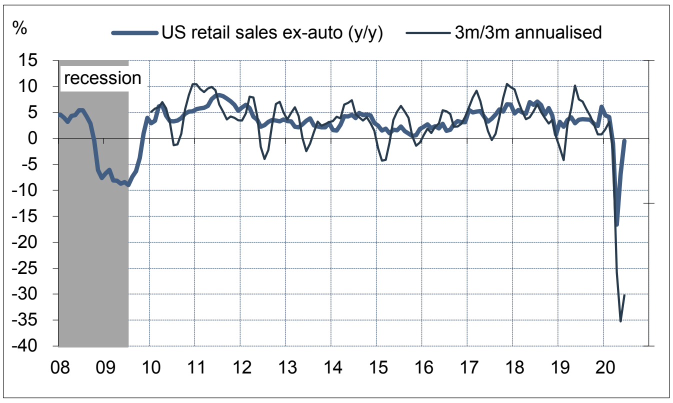


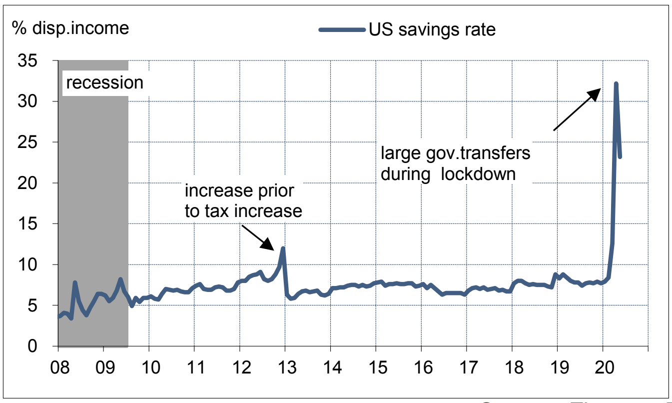


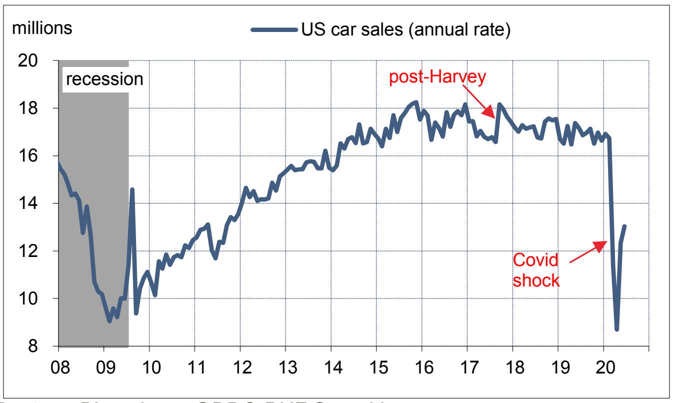




## Appendix 2 - Consumer



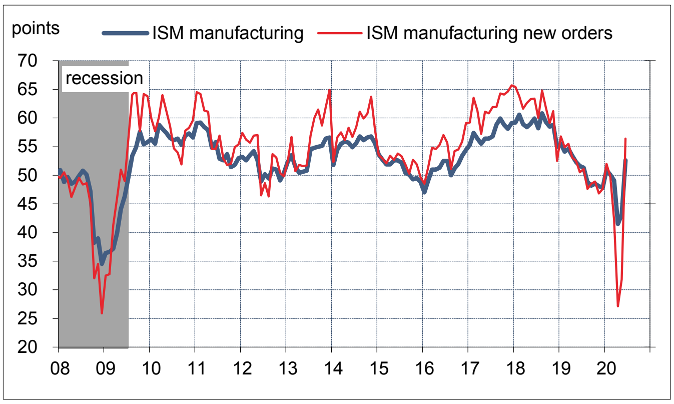



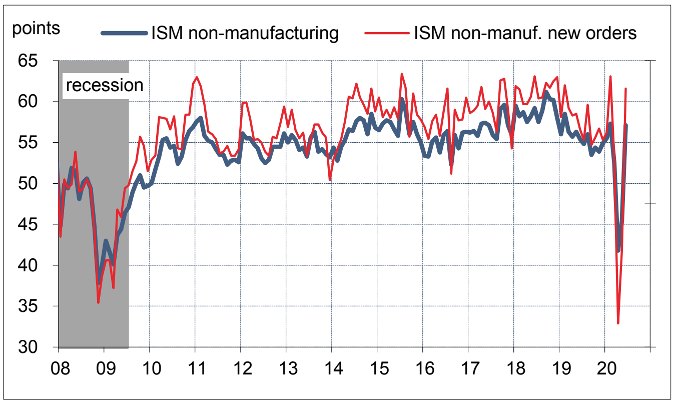



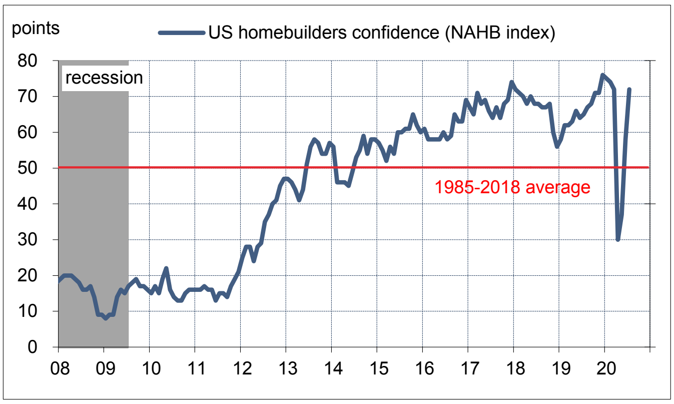



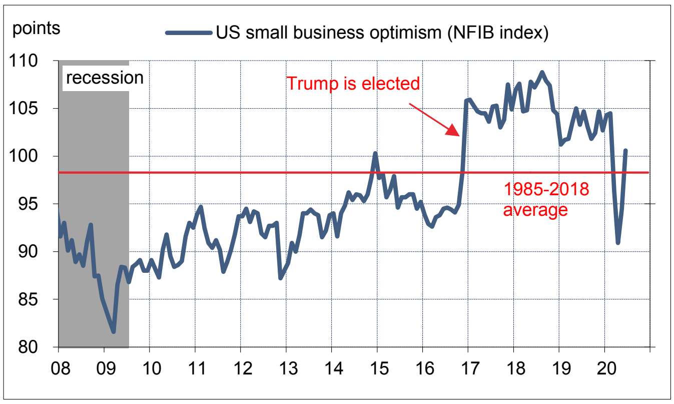

*Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities*

## Appendix 3 - Business climate

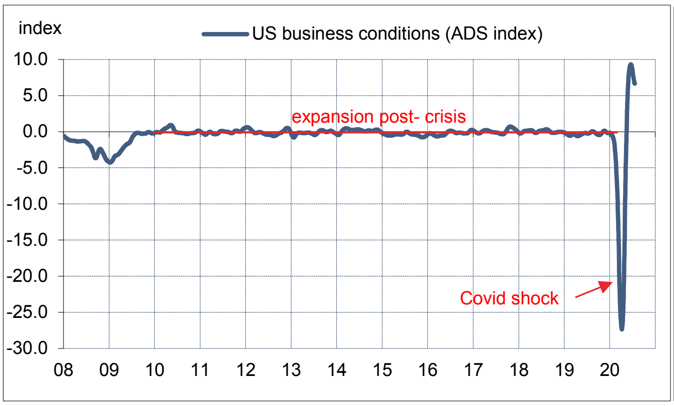


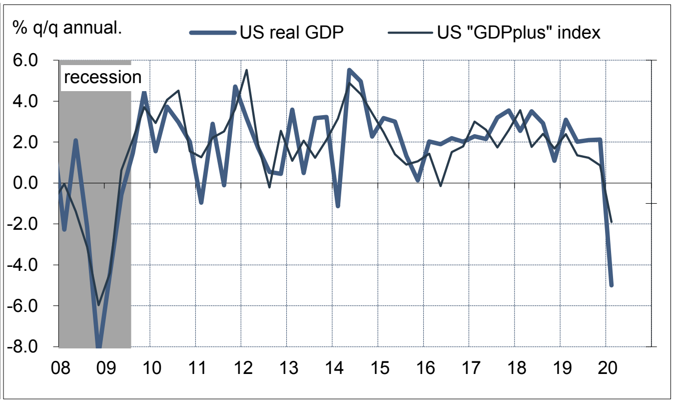



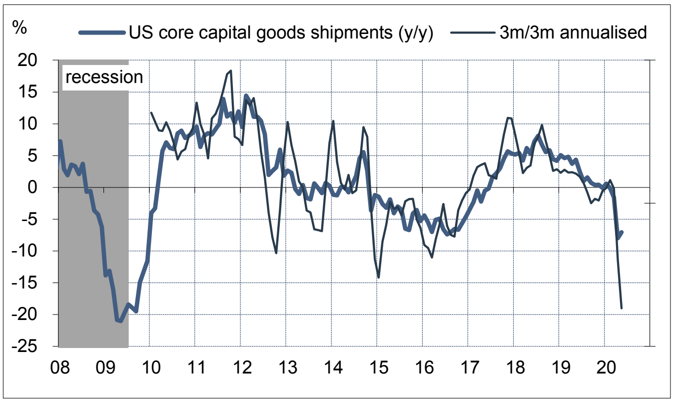



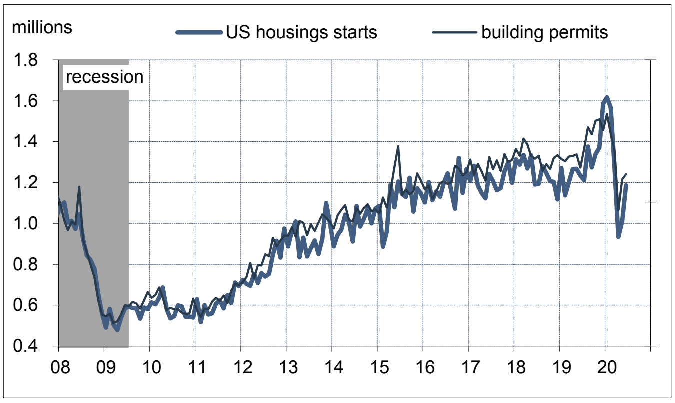




## Appendix 4 - Conditions of economic activity



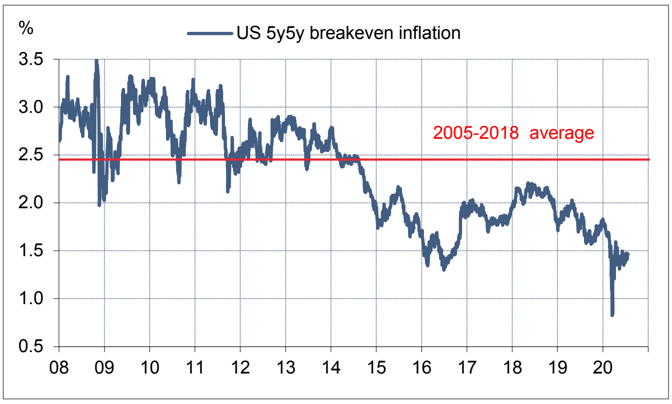



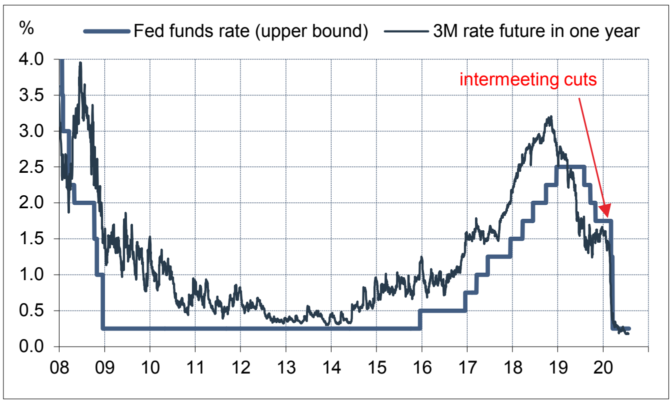



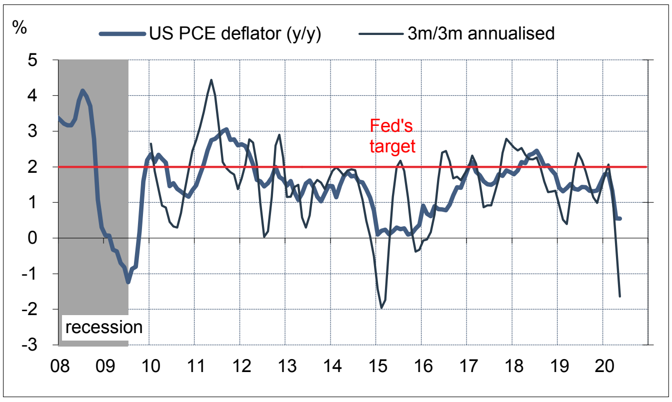



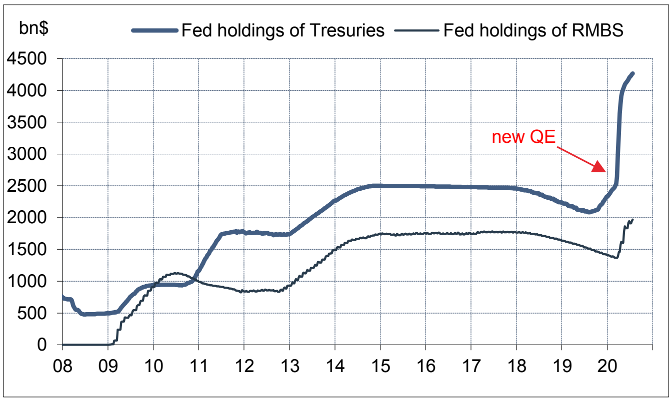

*Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities*

## Appendix 5 - Inflation and monetary policy

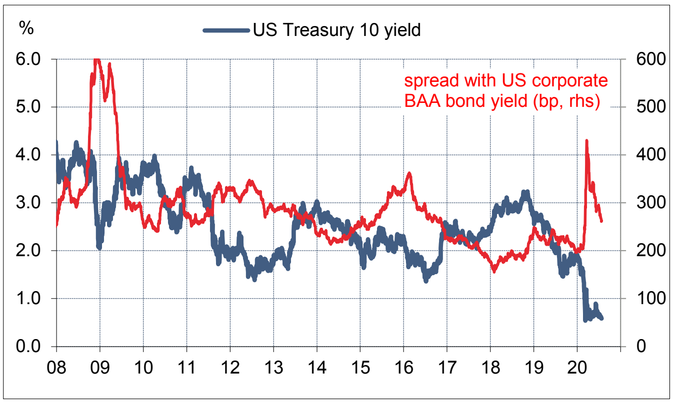


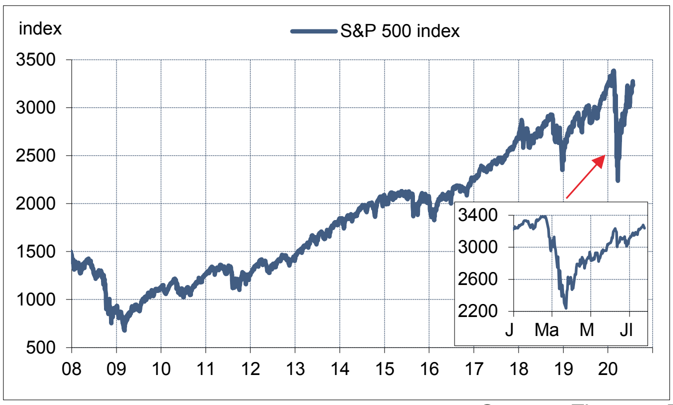



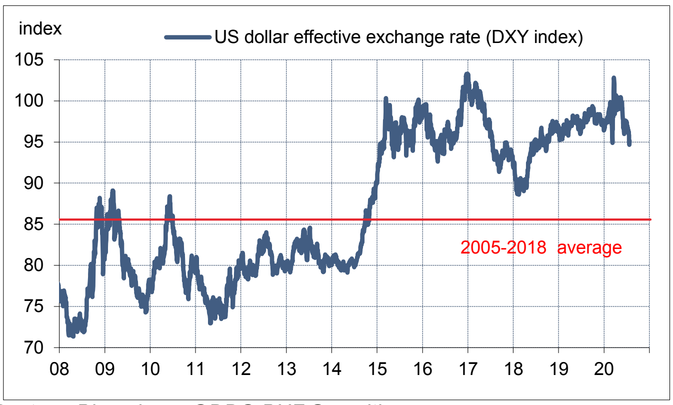




## Appendix 6 - Financial markets








*Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities*

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