Ask an Economist: Policymakers have options for additional accommodation

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Brent Bundick and A. Lee Smith explain the tools and measures available if central bank officials choose a path of further accommodation.

To help return employment and inflation to their longer-run objectives, the Federal Open Market Committee (FOMC) in March 2020 lowered the target range for the federal funds rate to near zero, announced large-scale purchases of Treasury and agency mortgage-backed securities, and established several liquidity and credit facilities. In an Economic Bulletin published in July 2020, Federal Reserve Bank of Kansas City Research and Policy Advisors Brent Bundick and A. Lee Smith wrote that scope for further accommodation remains. These options include forward guidance and a tool known as yield curve control.

How could these policy tools be used, and what are the intended effects?

Both yield curve control and forward guidance could reduce longer-term interest rates that are most relevant for households and businesses. Yield curve control directly targets longer-term rates by committing the central bank to buying or selling Treasury securities to achieve a desired yield. In contrast, forward guidance reduces longer-term interest rates by lowering expectations for the path of short-term rates as well as reducing uncertainty around that path. While forward guidance and yield curve control policies might seem different, they have some overlap. In targeting rates at a specific time horizon, yield curve control explicitly ties monetary policy to a date on the calendar, similar to a type of forward guidance that the committee used many times over the last decade.

Does yield curve control have any potential costs or additional benefits relative to forward guidance?

By creating a direct link between monetary and fiscal policy, yield curve control has the potential to erode the independence of the central bank. In the absence of a yield curve control policy, unexpected changes in the supply of government debt can influence Treasury yields. For example, the May 6, 2020, Treasury Quarterly Refunding Statement revealed a larger-than-expected amount of long-term debt issuance. This announcement steepened the Treasury yield curve, with yields on five-year, seven-year, and 10-year Treasury notes increasing on the day of the statement. If these higher government borrowing rates are passed on to other market rates, the increase in government borrowing could reduce or “crowd out” private spending by households and firms. This increase in yields may not have materialized if monetary policy had an explicit yield curve target in place. Instead, investors would have expected the central bank to absorb the increased Treasury issuance to achieve their targeted Treasury rate.

While this added channel of yield curve control likely provides some additional accommodation relative to forward guidance, the explicit linkage between fiscal and monetary policy could create challenges for central bank independence. Based on the FOMC's previous use of forward guidance, we argue that date-based forward guidance has the potential to deliver much, though not all, of the accommodation of yield curve control without creating challenges for central bank independence.

Further Resources

For more information on this topic, read the full Economic Bulletin.
