Monetary Policy Innovations …
Anil Kashyap*
NBER Asset Pricing Program
October 28, 2022

1. Yield Curve Control Risks

2. Market Maker of Last Resort

* These are my views only, NOT the BoE’s.
The Reserve Bank of Australia implemented a yield curve control policy (YCC) by announcing in March 2020 that it would stand ready to purchase Australian government securities (AGBs) in the secondary market via long-dated open market operations (OMOs) to target a yield of 0.25%.
Might Japan Be Close to Giving Up on YCC?
Might Japan Be Close to Giving Up on YCC?

Japanese Yield Curves 2 September 2022 (¥/$ = 140)

- Red line: Japan Sovereign
- Blue line: Japan OIS

Yield changes over Years (in percentage points)
Might Japan Be Close to Giving Up on YCC?

Japanese Yield Curves 26 October 2022 (¥/$ = 146.36)
Questions about YCC

• When does pressure emerge?

• For Japan it does not seem to be about inflation? What does this say about the “foolproof way to end deflation”?

• If the BoJ does give up, what kind of instability might ensue?
Liabilities Drive Investments

- UK has large defined benefit pensions, about £1 trillion sits in SPVs to hedge interest rate risk

- (GDP is about £2.4 trillion, total Gilts outstanding about 100% of GDP) Over half the hedges are for indexed bonds

- Rates up are good news for the pensions overall but cause losses on the hedge

- Rate volatility has been unprecedented since September 23 and led to a huge cash squeeze on the SPVs.
**Back of the envelope**

Leverage # from https://www.ft.com/content/4dfd546b-bff6-4dfa-a858-06b855001faa

<table>
<thead>
<tr>
<th>Initial Balance Sheet</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.000 Implied Leverage</td>
<td></td>
</tr>
<tr>
<td>Liabilities Hedged</td>
<td>Assets Held</td>
</tr>
<tr>
<td>1000</td>
<td>666.667 Gilts on repo</td>
</tr>
<tr>
<td></td>
<td>333.333 Cash</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rates up 3 to 5</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.759 Implied Leverage</td>
<td></td>
</tr>
<tr>
<td>Liabilities Hedged</td>
<td>Assets Held</td>
</tr>
<tr>
<td>712.388</td>
<td>522.861 Gilts on repo</td>
</tr>
<tr>
<td></td>
<td>189.527 Cash</td>
</tr>
</tbody>
</table>

➡️ Smaller hedge and with higher leverage
➡️ heterogeneity in initial leverage could mean cash is exhausted
➡️ (borrowing more is not the problem)
## Options

<table>
<thead>
<tr>
<th>Shrink hedge to Return to initial leverage</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.000 implied leverage</td>
<td>--</td>
</tr>
<tr>
<td>Liabilities Hedged</td>
<td>Assets Held</td>
</tr>
<tr>
<td>568.581</td>
<td>379.055 Gilts on repo</td>
</tr>
<tr>
<td></td>
<td>189.527 Cash</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Raise cash to Restore the initial hedge</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.759 implied leverage</td>
<td>--</td>
</tr>
<tr>
<td>Liabilities Hedged</td>
<td>Assets Held</td>
</tr>
<tr>
<td>1000.000</td>
<td>733.955 Gilts on repo</td>
</tr>
<tr>
<td></td>
<td>266.045 Cash</td>
</tr>
</tbody>
</table>

**Frictions:**
1) pooled funds
2) lack of automatic recap or access to back up lines of credit
3) **funds domiciled outside the UK**, pension schemes supervised by the pension regulator
What did the BoE do?

- **Financial** Policy Committee recommended that the BoE take action to prevent gilt market dysfunction from undermining financial stability

- BoE announced a 2 week program to give LDIs time raise cash -- got an indemnity from the Treasury. (Ended program on time.)

- Capped daily purchases, though later expanded the limit and included indexed bonds. **Not about capping yields.**

- Ultimately bought £12 bn conventional, £7bn indexed -- intend to dispose of it promptly.

- Guesses reported that over £40 billion of cash raised
Basis points change since 1 September

- UK 30 year gilt
- US 30 year
- Euro Area 30 year

Celebrate event:
- BOE intervention
- Fiscal event
- MPC decision
- Chancellor resigns
Questions

• What happens if there is no FPC to make a decision? Does that matter?

• How much moral hazard is created? (Who is being taught a lesson if the safe yield curve becomes dislocated?)

• Will temporary and targeted become the standard feature of market maker of last resort?
Some references

David O Lucca and Jonathan H Wright “The Narrow Channel of Quantitative Easing: Evidence from YCC Down Under”

Takeo Hoshi “Unwinding the Unconventional Monetary Policy in Japan”, International Banker: Oct 2022


Jon Cunliffe Letters to the Treasury Select Committee (Oct 5 and 18).

https://committees.parliament.uk/committee/158/treasury-committee/publications/3/correspondence/