Monetary Policy Innovations …

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1. Yield Curve Control Risks

2. Market Maker of Last Resort

* These are my views only, NOT the BoE's.

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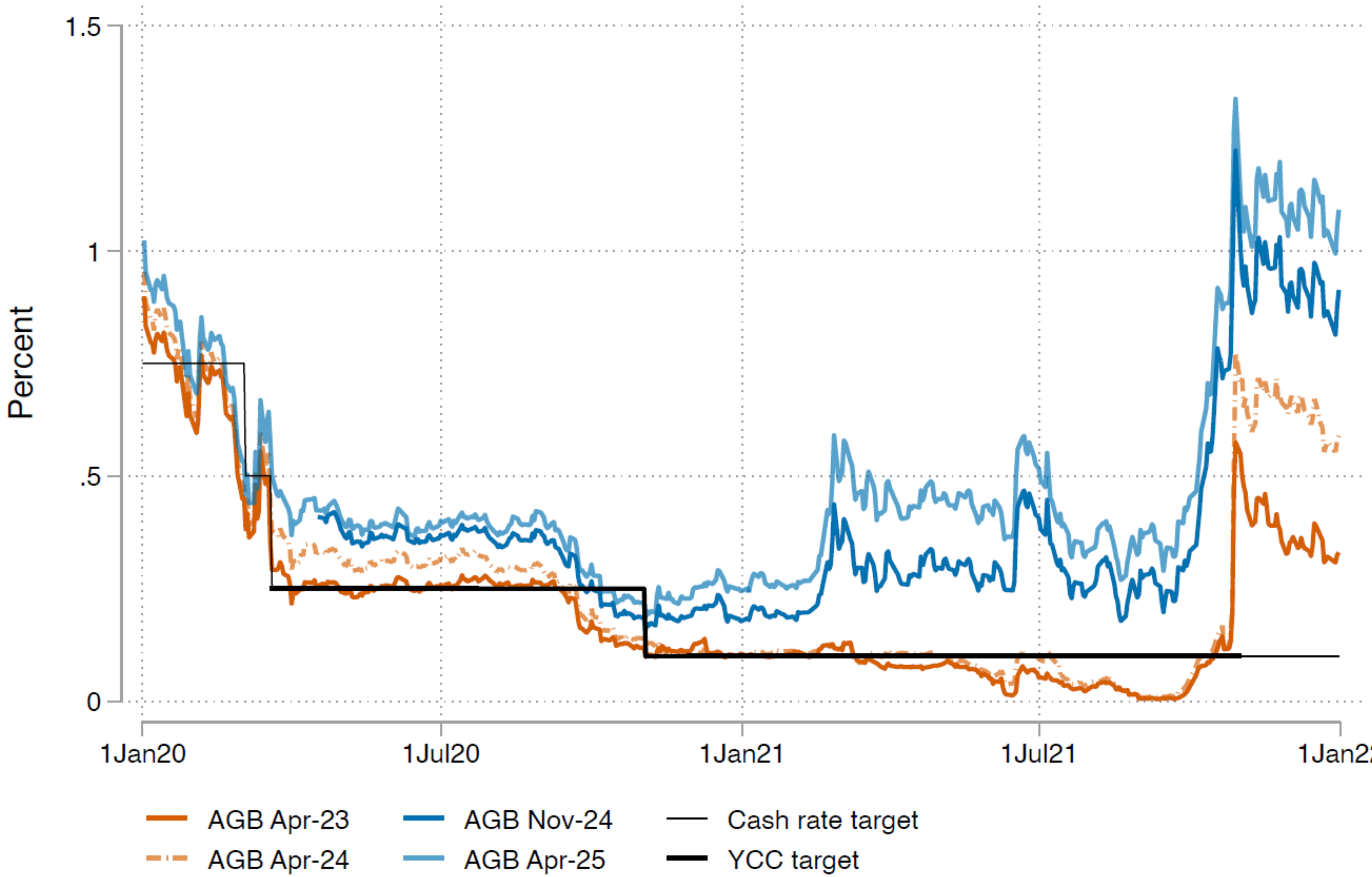
The Reserve Bank of Australia implemented a yield curve control policy (YCC) by announcing in March 2020 that it would stand ready to purchase Australian government securities (AGBs) in the secondary market via long-dated open market operations (OMOs) to target a yield of 0.25%



David Lucca, Jonathan Wright, "The Narrow Channel of Quantitative Easing: Evidence from YCC Down Under"

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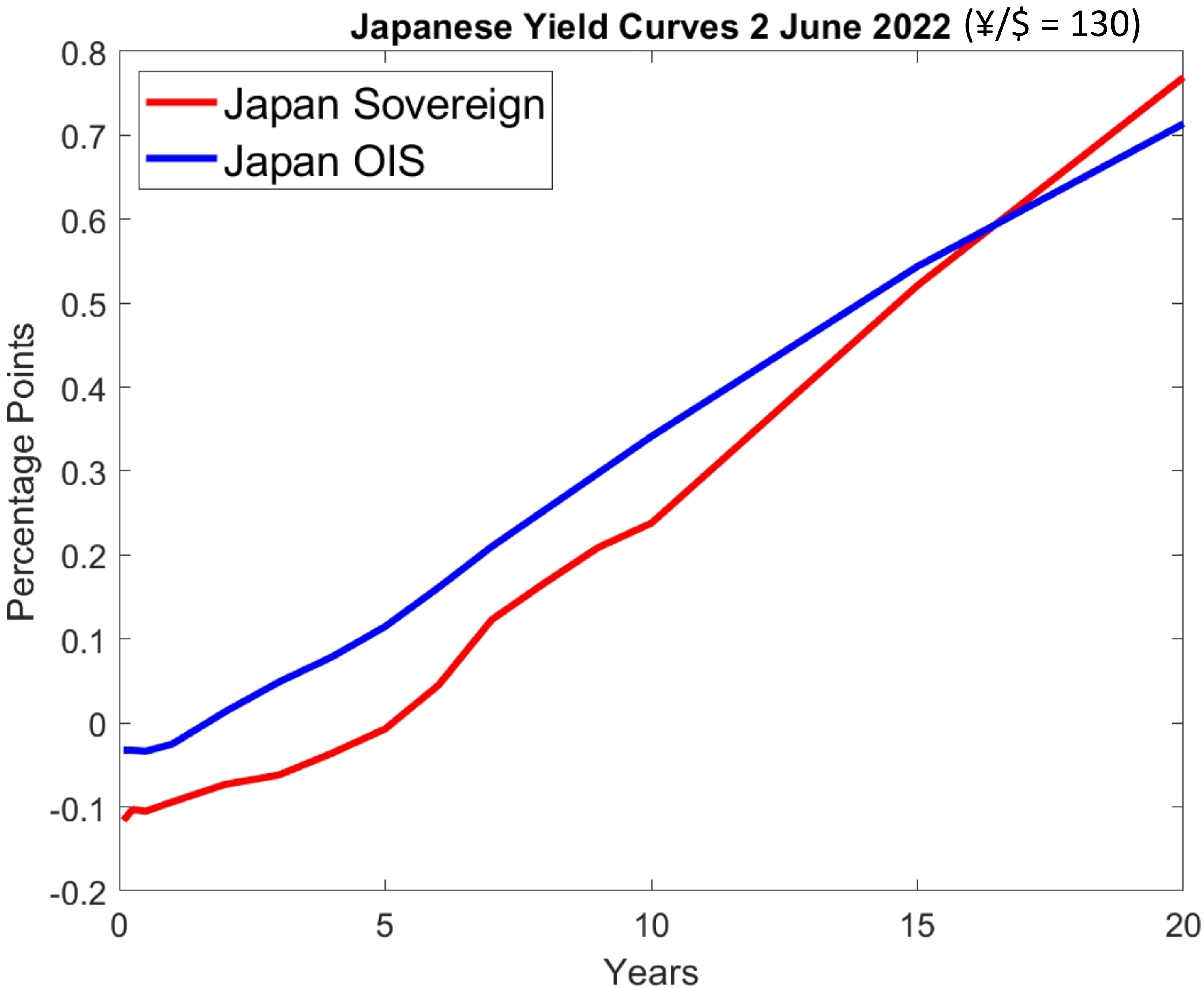
Might Japan Be Close to Giving Up on YCC?



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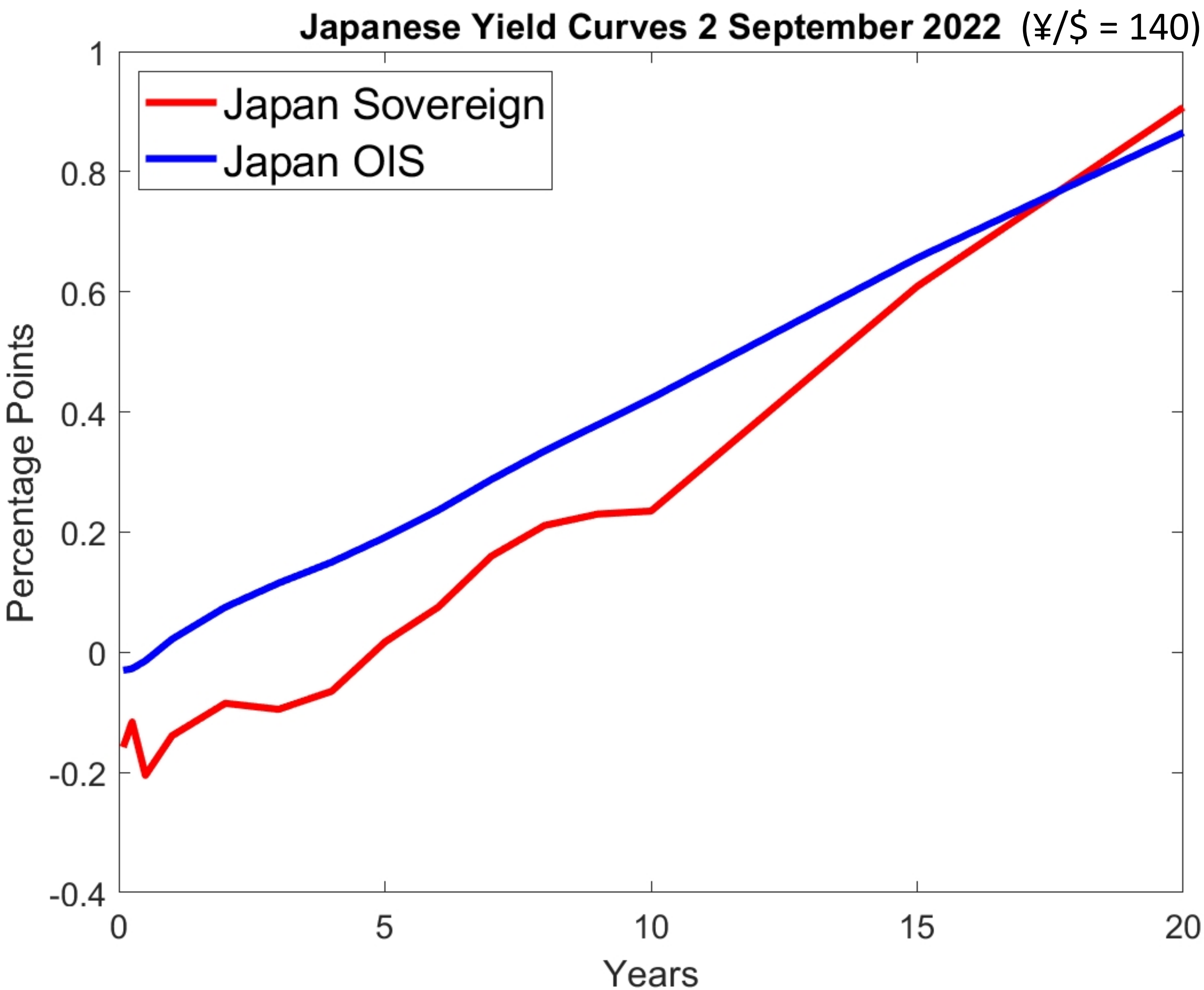
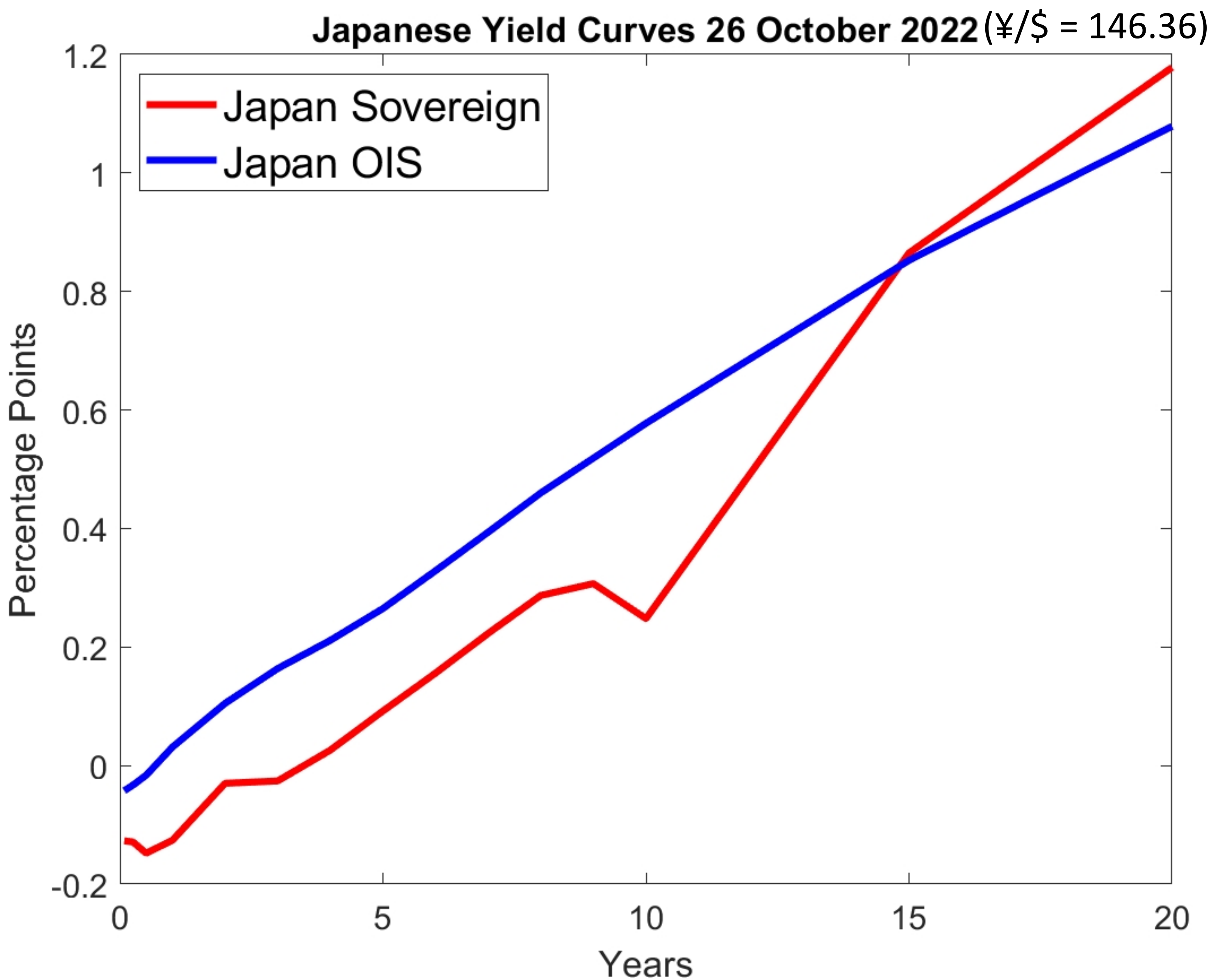


Might Japan Be Close to Giving Up on YCC?



Questions about YCC

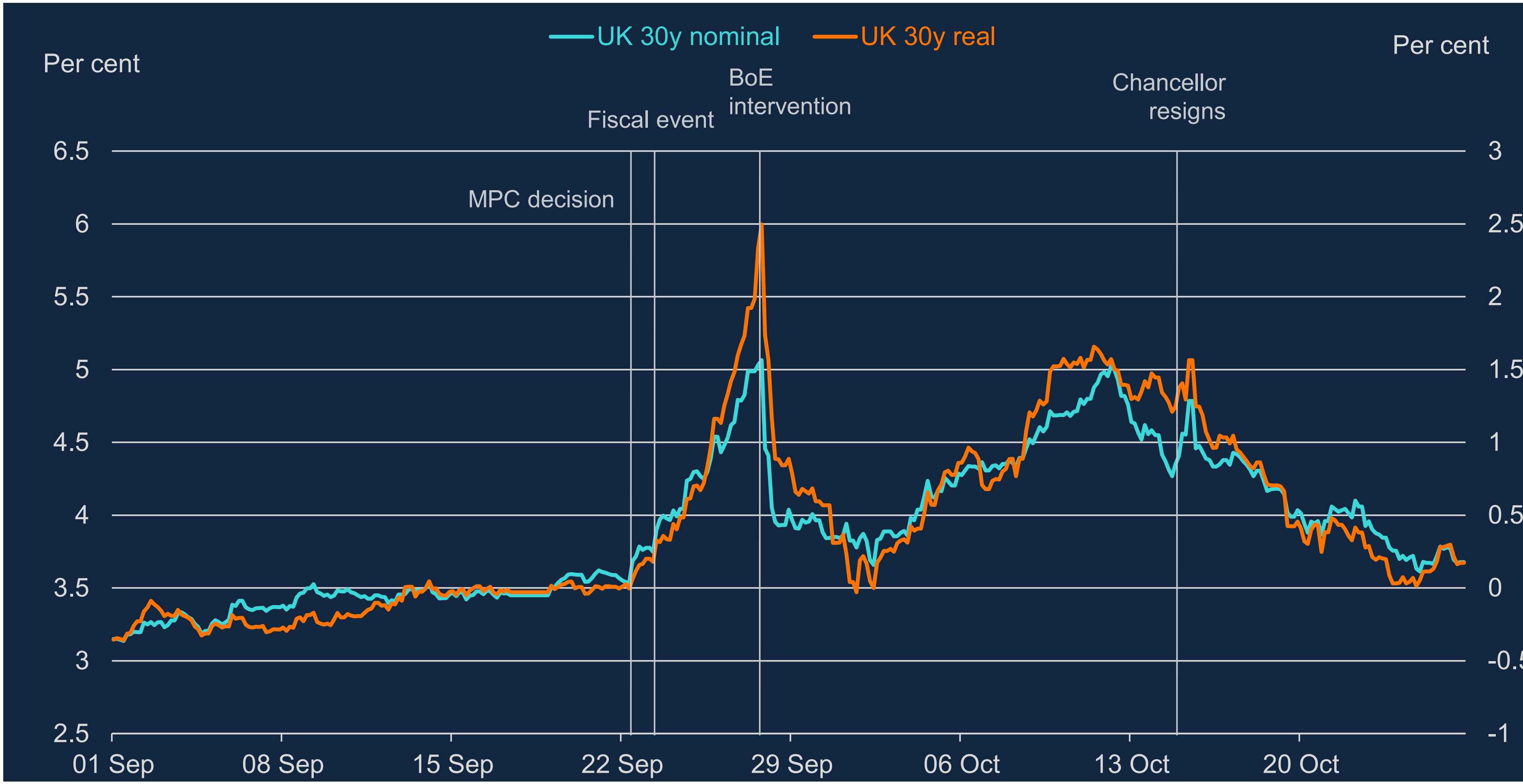
- When does pressure emerge?

- 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.



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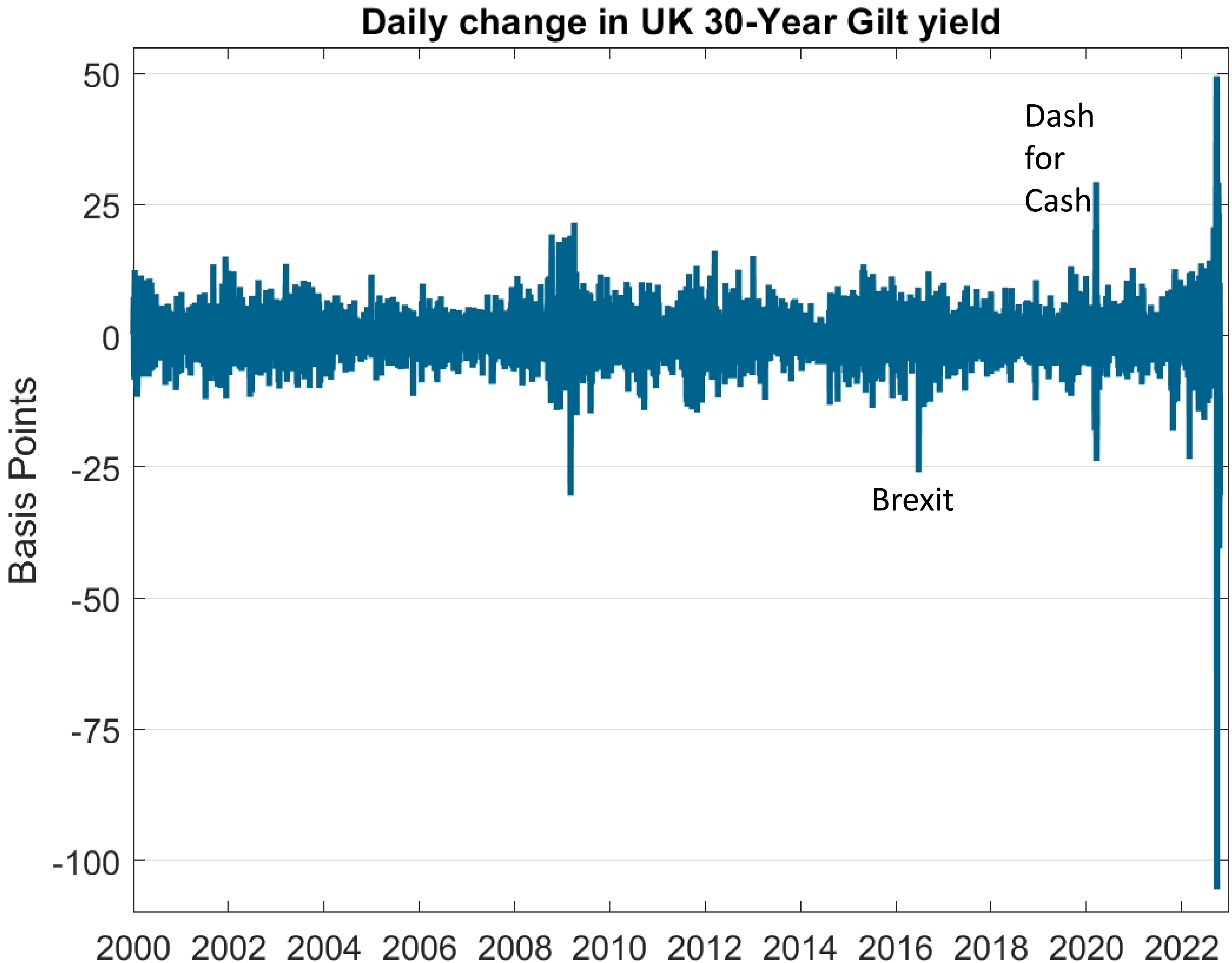

Daily change in UK 30-Year Gilt yield
Basis Points
50
25
0
-25
-50
-75
-100
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
Dash
for
Cash
Brexit

Back of the envelope

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

	Initial Balance Sheet		
3.000	Implied Leverage		
	Liabilities Hedged	Assets Held	
	1000	666.667	Gilts on repo
		333.333	Cash

	Rates up 3 to 5		
3.759	Implied Leverage		
	Liabilities Hedged	Assets Held	
	712.388	522.861	Gilts on repo
		189.527	Cash

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

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Options

	Shrink hedge to Return to initial leverage		
3.000	implied leverage		
	Liabilities Hedged	Assets Held	
	568.581	379.055	Gilts on repo
		189.527	Cash

	Raise cash to Restore the initial hedge		
3.759	implied leverage		
	Liabilities Hedged	Assets Held	
	1000.000	733.955	Gilts on repo
		266.045	Cash

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

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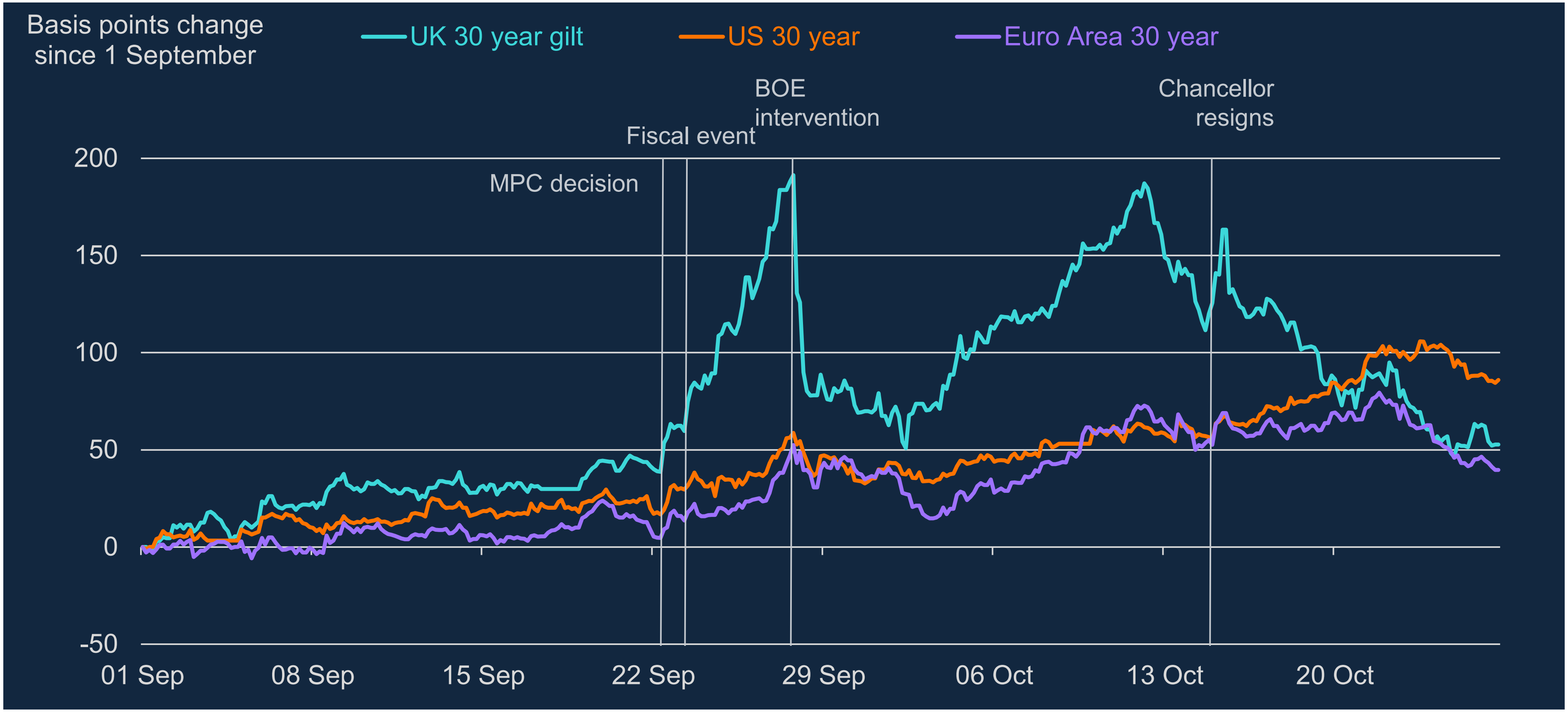
What did the BoE do?

- **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
BOE intervention
Chancellor resigns
Fiscal event
MPC decision
200
150
100
50
0
-50
01 Sep
08 Sep
15 Sep
22 Sep
29 Sep
06 Oct
13 Oct
20 Oct

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

Anil Kashyap "The Dash for Cash and the Liquidity Multiplier: Lessons from March 2020" November 2020 Speech, Bank of England.

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

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