THE OUTLOOK | By Nick Timiraos

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Yield Caps on Table in Next Recession

As part of their contingency planning for the next recession, Federal Reserve officials are looking at a stimulus plan the U.S. last used during and after World War II.

From 1942 until 1951, the Fed capped yields on Treasury securities—first on short-term bills and later on longer-term bonds—to help finance war spending and the recovery.

More recently, the Bank of Japan employed something known as yield-curve control, holding rates on 10-year government bonds at zero by committing to buy those securities at whatever price is needed. Bond yields and prices move inversely.

At issue is how the central bank should manage a faltering economy when short-term interest rates are already low.

In the past three downturns, the Fed cut its benchmark rate by around 5 percentage points. The rate today is in a range between 1.5% and 1.75%, leaving less room to counteract a downturn. Central-bank officials are likely to hold this rate steady at their meeting Tuesday and Wednesday.

The Fed's playbook for the next recession will rely heavily on two tools it deployed during and after the 2007-09 recession—bond purchases, sometimes called quantitative easing, or QE, and forward guidance about plans to hold rates at very low levels for longer than investors expect.

They are also inspecting new approaches. "The law of diminishing returns is a very powerful force in economics, and so we have to be concerned that it may also apply to quantitative easing," said Fed Vice Chairman Richard Clarida in public comments earlier this month.

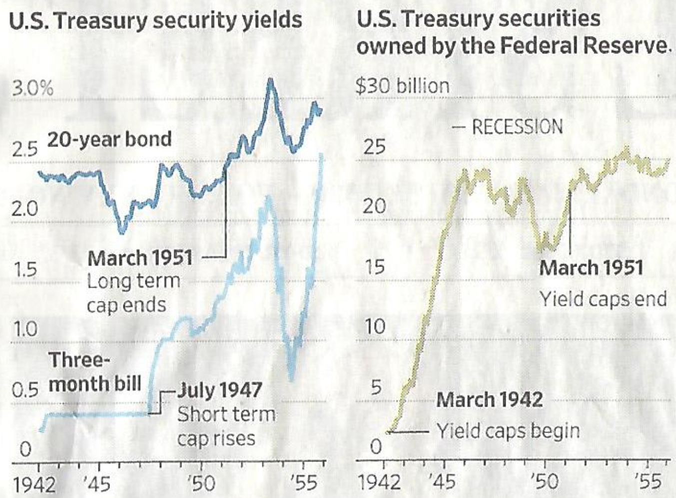
At their October meeting, officials said they thought capping yields on short-to-intermediate-term securities could be an effective way to augment their other tools.

"Short-term yield-curve control is something that is worth looking at," said Fed Chairman Jerome Powell at a moderated discussion shortly before that meeting.

By contrast, Fed officials are unimpressed with negative rates, which have been used in Europe and Japan. They worry this policy could do more harm than good in the U.S. because of important differences in market structure.

Yield caps would be a cousin to QE. In QE, the Fed committed to purchasing fixed amounts of long-term securities. With yield caps, by contrast, the Fed would commit to purchase unlimited amounts at a particular maturity to peg rates at the target.

The Federal Reserve capped yields on Treasury securities to support economic growth during and after World War II.



Sources: Federal Reserve via Johns Hopkins University; National Bureau of Economic Research (20-year bond)

The goals of either approach are similar: drive down longer-term interest rates to encourage new spending and investment by households and businesses. Bond buying can also lower long-term rates by signaling the Fed's intentions to keep rates lower for longer than markets expect.

There are risks. If investors grew less willing to buy securities because they thought the Fed might abandon its peg, for example because inflation accelerated unexpectedly, then the Fed would have to increase its purchases to maintain the peg.

Some officials think capping yields could deliver the same amount of stimulus while acquiring fewer securities than they did through their bond-buying programs from 2012 until 2014, when the Fed purchased more than $1.6 trillion in Treasury and mortgage securities.

"This could be pretty powerful if you could convince yourself you could manage the exit strategy and you weren't too worried about losing control of the size of the balance sheet," said Nathan Sheets, a former senior Fed economist who is now chief economist at investment-advisory firm PGIM Fixed Income.

The Bank of Japan, for example, has been buying 10-year government bonds since launching a QE program in 2013, but has purchased fewer bonds since mid-2016, when officials pledged to fix yields at zero.

Here's how it might work. If the Fed cut rates to zero and concluded it was likely to hold rates at that level for at least two years, it could enhance this commitment by capping yields on every Treasury security that matures before January 2022.

"It has some appeal as a way to reinforce forward guidance. You're going to keep rates lower for a long time, and 'you really mean it,' " said William English, a former senior Fed economist who now teaches at Yale University.

To drive down longer-term yields, the Fed could pair such an approach with additional purchases of longer-dated securities with traditional QE.

A tricky question could be deciding how far out on the yield curve to peg rates. Former Fed Chairman Ben Bernanke often argued that the maturity and risk-profile—not the size—of its securities holdings determined the degree to which bond purchases stimulated the economy. Under such thinking, purchasing longer-dated assets provided more stimulus.