

One fortnight has taken a lot out of global monetary policy stances

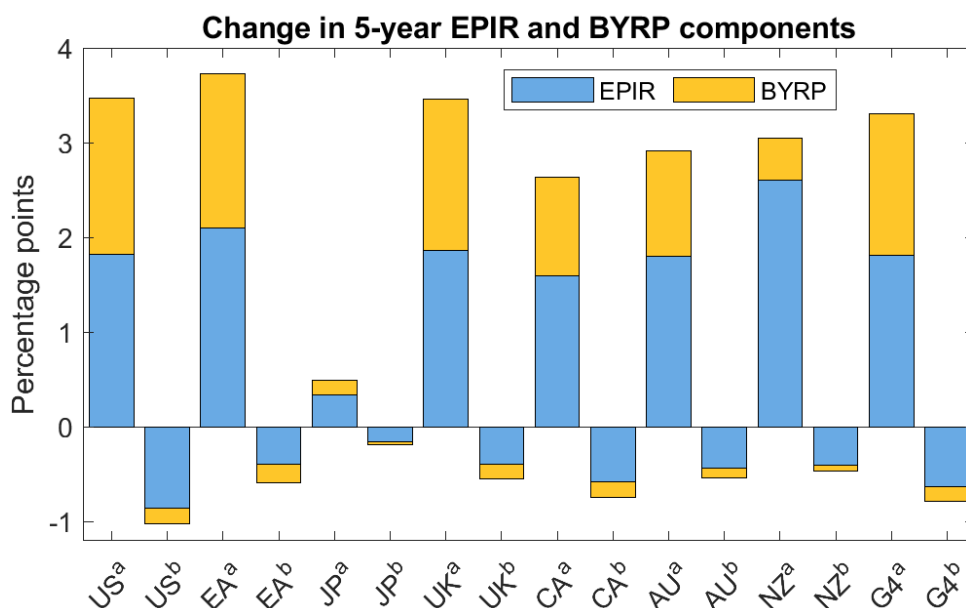
Leo Krippner, 28 March 2023

Given the recent decline in bond yields on banking sector worries, it's timely to provide an update on the yield curve decompositions I undertake for the G4 and dollar-bloc economies. Briefly, I use a yield curve model estimated with interest rate and survey data to decompose the fitted yield curve as follows:

$$R \text{ fitted} = \text{EPIR} + \text{BYRP}$$

where EPIR is the average Expected Policy Interest Rate component up to each maturity on the yield curve, and BYRP is the Bond Yield Risk Premium component.¹

The following figure uses the results for the 5-year maturity on the yield curve. The first bar ('a') for each economy contains the changes in the EPIR and BYRP from 22 September 2021 to 8 March 2023, which is the period from the first hint of post-COVID tightening by the Federal Reserve up to two days prior to collapse of Silicon Valley Bank.



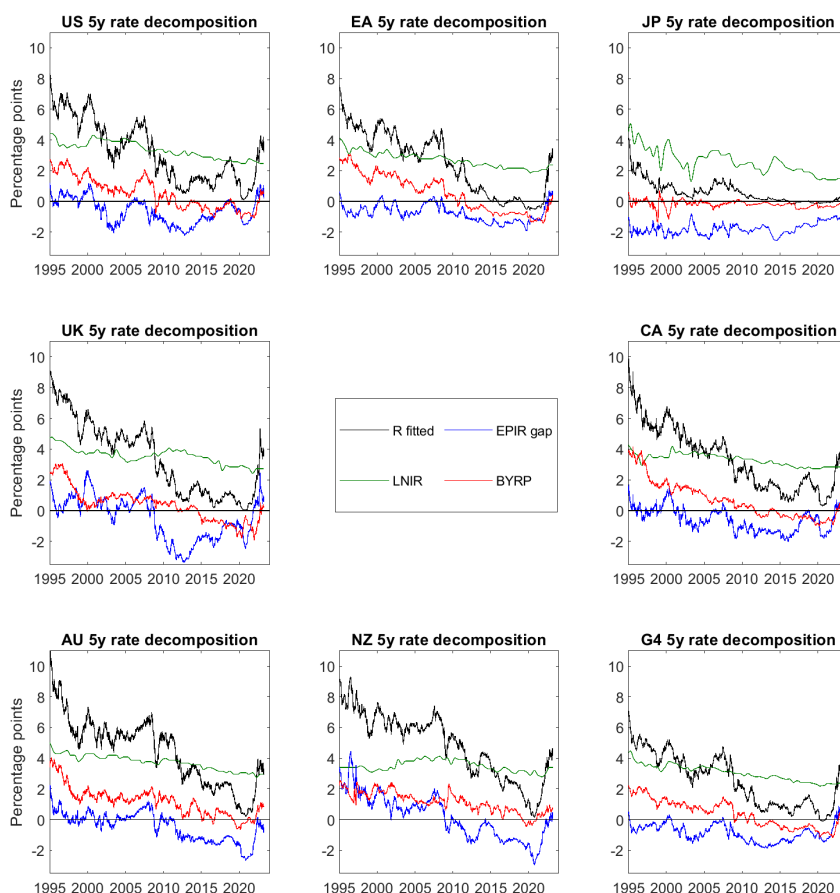
Notes: (1) The economies are the United States, the Euro Area, Japan, the United Kingdom, Canada, Australia, New Zealand, and the G4 GDP-weighted average; (2) 'a' denotes the period from 22-Sep-2021 to 8-Mar-2023, and 'b' denotes the period from 8-Mar-2023 to 24-Mar-2023.

For the US, the 5-year rate rose by 3.47% over this period, with the EPIR contributing 1.82% and the BYRP contributing 1.65%. The EPIR reflects the rise in the actual and expected Federal Funds Rate (FFR) since September 2021, and the BYRP reflects aspects such as Quantitative Tightening (QT) and changes in the inflation risk premium. With the exception of Japan, other economies have had similar changes over the same period, and for similar reasons.

¹More discussion on yield curve decompositions and their interpretation is contained in my 28 March 2022 note "Unwind of negative bond risk premium to underpin rising yields". This and the dataset underlying this post are available at <https://www.ljkmfa.com/visitors/>, or a log-in to the site can be created.

Against the longer-term perspective, the second bar ('b') contains the component changes over the two-week period from 8 March to 24 March. Over that fortnight, the US 5-year rate has dropped by 1.03%, with the bulk of the change due to the 0.86% EPIR decline. To be clear, the latter means that the average expected FFR over the next five years has fallen by 0.86%. The change in the BYRP has so far been relatively muted, at 0.16%, consistent with no change to the Federal Reserve's QT messaging or to inflation risks. Other economies have seen similar but smaller declines in the EPIR.

Banking sector worries, including any further realizations of potential failures and/or the impact on bank lending practices, may contribute toward more restrictive financial conditions. Meanwhile, as indicated in the previous figure and that below, the expected stance of monetary policy has reversed substantially and is now much closer to neutral. In combination, the net overall easing in financial conditions from these two factors seems premature while central banks are still seeking to cool their economies and bring inflation down.



Notes: This figure includes the nominal Long-horizon Natural Interest Rate (LNIR), which is based on survey expectations of long-horizon nominal GDP. It also expresses the EPIR relative to the LNIR as the EPIR gap, hence indicating whether the PIR and its expectations is accommodative or restrictive. Hence:

$$R \text{ fitted} = \text{LNIR} + [\text{EPIR} - \text{LNIR}] + \text{BYRP}.$$