

Footnote: How the Yield curve can be a guide to monetary policy

If the net demand for credit is rising as economic activity starts to accelerate, it tends to put upward pressure on market determined interest rates (longer term rates). However, if the central bank does not also adjust upwards its short-term (cash) interest rate target, then it will have to print more money (create more credit) to prevent the short-term interest rate from rising. The yield curve thus steepens. This central bank created credit will accommodate faster growth in economic activity. Thus, a steepening in the yield curve, long-term interest rates rising relative to short-term rates, will be indicative of a more accommodative monetary policy. In contrast, suppose the net demand for credit falls, putting downward pressure on the long-term interest rate. In order for the central bank to prevent a fall in the short-term interest rate, it would have to extinguish some credit it had previously created. This would lead to a slowdown in the growth of money and economic activity. In this case, a flattening in the yield curve would be indicative of more restrictive monetary policy.