Global Macro Research

1 October 2025

8:39 minute read

#US / #Monetary policy / #Inflation

For professional and institutional investors only – not to be further circulated. In Switzerland for qualified investors only. In Australia for wholesale clients

Thinking through the Fed's "third mandate"

The Fed's 'third mandate' – promoting "moderate long-term interest rates" – is gaining attention, raising the risk of mandate creep toward fiscal dominance. We outline three phases: an initial dovish tilt, markets pricing higher inflation tolerance, and eventual yield-curve control with financial repression. The latter would mean subordination of monetary policy to fiscal needs, risking unanchored inflation expectations, dollar weakness, and asset-price dislocations.

Key Takeaways

- Stephen Miran and other Trump administration officials have recently invoked the Fed's 'third mandate' of "moderate long-term interest rates."
- A modest shift in the Fed's reaction function toward lower rates doesn't imply fiscal dominance, but mandate creep could evolve into a regime break.
- We identify three phases of fiscal dominance. In phase one, policy rates are cut more than they otherwise would be, boosting growth and risk assets. In phase two, markets question inflation tolerance, pushing expectations and term premia higher. But this rise in long-term yields undermines cheaper funding. In phase three, a politicised Fed does explicit yield-curve control (YCC) and financial repression to cap long-end yields.
- US YCC would be far more disruptive than the Fed's QE or Japan's YCC, which were deployed for monetary, not fiscal, objectives.
- A better historical analogy is the Fed's use of yield caps during and after WWII, which kept rates low but saw inflation peak near 20%, before the 1951 Treasury-Fed Accord restored independence.
- While fiscal dominance remains a low probability, the risk has risen – which could keep the dollar under pressure and gold supported as markets gauge how far a Trump-era Fed might go.

Discussion of the "third mandate" is becoming more frequent

Section 2A of the Federal Reserve Act lays out the objectives of monetary policy as being:

"…to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

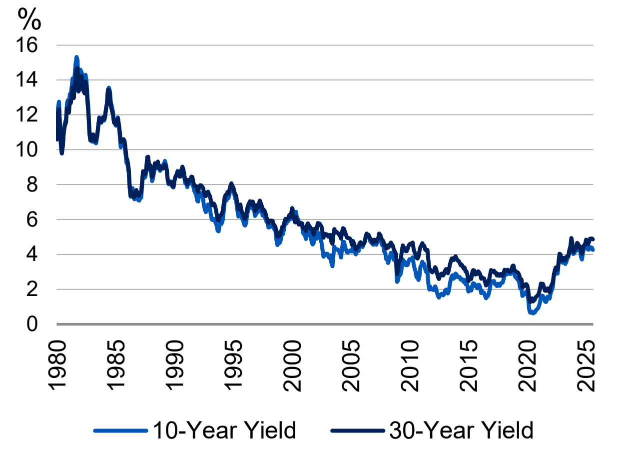
The long-standing convention has been to think that targeting the first two objectives (the dual mandate of maximum employment and stable prices) creates the conditions for long-term rates to settle at moderate levels. So, the Fed has not foregrounded the "moderate long-term interest rates" part of the Act.

However, as we pointed out back in July, talk about the so-called "third mandate" has recently increased.

In his congressional testimony to be appointed to the FOMC, Governor Stephan Miran unusually underlined the importance of the Fed's mandated goal of moderate long-term interest rates, alongside the more familiar dual mandate goals. And Treasury Secretary Scott Bessent has also been pointedly highlighting moderate long-term interest rates as part of the Fed's mandated goals.

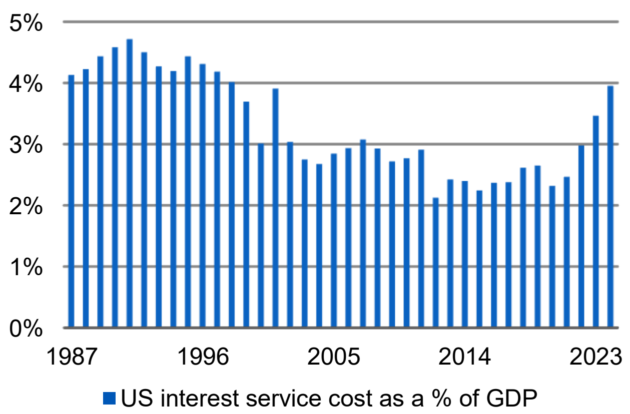
More broadly, President Donald Trump's pressurising of the Fed has been couched in fiscal terms, emphasising the need to reduce the cost of servicing US government debt (see Figures 1 and 2).

Figure 1: US long-term interest rates have been rising…



Source: Aberdeen, Haver, October 2025

Figure 2: …which, alongside a higher debt load, means debt servicing costs are at multi-decade highs



Source: Aberdeen, Haver, October 2025

The Fed will become more focused on long-term interest rates

In principle, emphasising moderate long-term interest rates as a distinct third mandate does not necessarily entail a regime shift in how monetary policy is conducted. It simply adds another objective to the Fed's trade-off space, shifting its reaction function in response to shocks.

All else equal, this would deliver lower interest rates on average, but it would not imply that low rates are pursued *regardless* of other considerations.

For example, beyond simply setting the fed funds rate slightly lower than it would otherwise be, the Fed may manage the average duration of its bond holdings to make it somewhat longer (potentially putting downward pressure on long-term yields), or use "open mouth operations" (i.e. forward guidance and other communication with the market) to opine on bond market functioning or influence pricing.

All this could be in the context of closer cooperation with the Treasury, as the latter skews bond issuance to the shorter end of curves where demand has been stronger (including from stablecoin providers) or builds treasury purchases into trade deals.

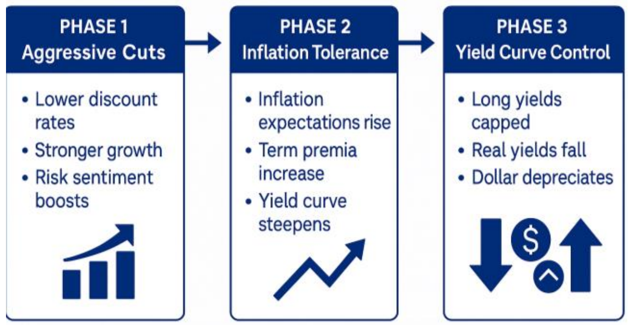
This is distinct from fiscal dominance, which represents a fundamental regime shift, in which the overriding objective becomes ensuring more favourable financing conditions for the fiscal authority.

But, in practice, a shift in how the mandate is construed, or even just an implicit tilt in policymakers' reaction functions to favour lower rates at the margin, can easily become a regime shift as fiscal concerns grow more pressing. Indeed, the interaction of monetary policy with financial markets may accelerate this process, blurring the line between mandate creep and fiscal dominance.

Three stages to US fiscal dominance

One way to think about this process is through three phases of fiscal dominance (see Figure 3).

Figure 3: Three phases towards fiscal dominance



Source: Aberdeen, October 2025

In the first phase, policy rates are cut more than implied by standard monetary rules. The justification could be couched in normal monetary policy language about r* and the balance of risks, or could involve a more explicit preference for lower rates for their own sake. Either way, the effect is stimulative, with lower rates and stronger nominal growth boosting risk sentiment.

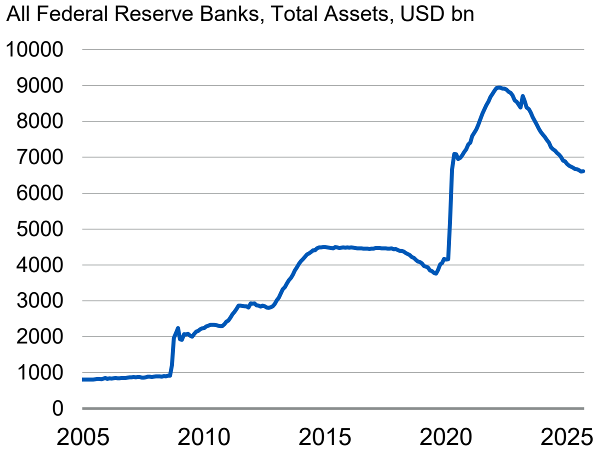
In the second phase, markets increasingly notice the willingness of the Fed to tolerate higher inflation. Inflation expectations move higher, with long-term yields rising and investors demanding more term premia. The yield-curve steepens, and market volatility increases. Crucially, and ironically, Treasury's average cost of borrowing rises. This is consistent with our bond market rout risk scenario.

In the third phase, monetary policy is explicitly used to contain long-term bond yields, as the fiscal requirements of lower funding costs dominate. This may involve targeted asset purchases and eventually yield-curve control, combined with regulatory policy and other forms of financial repression to absorb Treasuries. Long-end nominal yields would fall, and real yields would collapse, as inflation expectations ratcheted higher still. The dollar would fall sharply, and gold and related assets would perform very well, while equities would likely weaken.

Distinguishing fiscal dominance from quantitative easing

Of course, the Fed has conducted large scale purchases of Treasuries previously, through the various rounds of QE initiated since 2008. These operations caused the Fed's balance sheet to increase (see Figure 4) and had the explicit objective of lowering long-term interest rates.

Figure 4: The Fed's balance sheet grew significantly after the GFC and pandemic



Source: Haver, Aberdeen, October 2025

Teasing out the exact market impacts of QE is notoriously difficult. But broadly speaking, QE probably did put downward pressure on long-term yields and the dollar and upward pressure on inflation expectations. But, quite conspicuously, it did not cause a loss of inflation credibility, and was (in)famously supportive of risk sentiment.

So, the question might be: why should asset purchases under the third phase of our fiscal dominance typology not be more like this experience of QE?

The answer is that the response of financial markets to a large extent turns on *why* the policy instrument is being used.

QE was *monetary policy* aimed at stimulating an economy in which interest rates had fallen to the lower bound, but which still had a large output gap. Asset purchases helped towards the inflation (and labour market) mandates by stopping inflation falling further still. QE was done to achieve the dual mandate, not in spite of it.

However, asset purchases conducted for *fiscal policy* reasons mean that monetary policy would likely be inappropriate given inflation and unemployment.

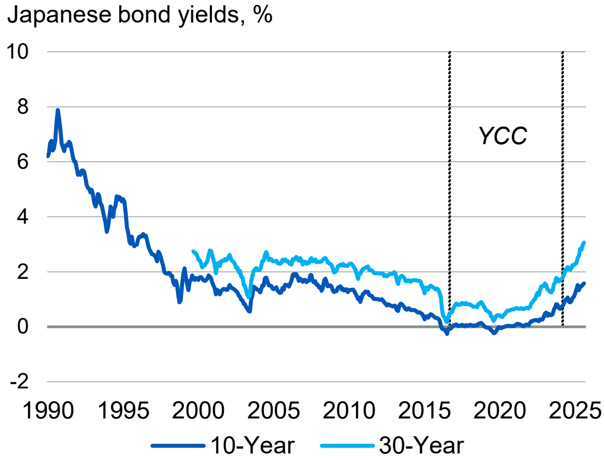
As financial markets understand this distinction, inflation expectations would move higher. And as real rates fall in response to higher inflation expectations, this could feed back into still higher inflation. In fact, inflation expectations could eventually increase without bound, with negative consequences for the real return of risk assets.

Comparisons with Japanese YCC

In stage three of fiscal dominance, the level of longer-term yields could be explicitly pinned down by the Fed, and then the balance sheet allowed to expand to whatever size is necessary to maintain the peg.

Investors have recent experience of yield-curve control, with the Bank of Japan (BoJ) pegging 10-year yields at 0% from September 2016, before abandoning the policy in March 2024 after various tweaks (see Figure 5).

Figure 5: Japanese yield-curve control



Source: Aberdeen, Haver, October 2025

This policy saw the yen depreciate significantly, with USD/JPY falling 18% over the initial three months, and it put some upward pressure on inflation expectations. But expectations did not become unanchored, and the policy was broadly supportive of Japanese risk assets.

In contrast to the hypothetical US scenario of YCC, Japan had experienced two decades of very low inflation by the time the policy was announced. Yield-curve control was the next step in a series of policies to reflate the economy.

So, while Japan certainly has a huge debt load, investors understood the reason for the policy was monetary in nature (i.e. to boost inflation back to target) and not fiscal (i.e. to keep government funding costs artificially low).

Nonetheless, Japanese yield-curve control did cause notable distortions in the JGB market, such as reduced liquidity and price discovery. And the BoJ's ability to maintain the peg came under increasing market pressure and required ever larger interventions (bloating the size of the balance sheet), especially as global bond yields increased after the pandemic.

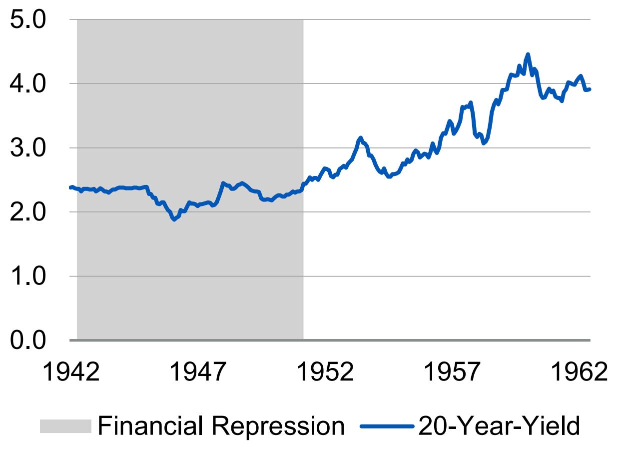
In the case of the Fed, these distortions and pressures would likely be even greater, given the vital role played by Treasuries in the global financial system.

The experience of US financial repression after WW2

The most useful historical analogy to how Fed yield-curve control under the auspices of an explicit fiscal objective may go is the Fed's own experience during and after WWII.

From April 1942 until March 1951, the Fed was committed to supporting US government borrowing by keeping short-term bills at 0.375% and 25-year bond yields capped below 2.5% (see Figure 6).

Figure 6: The Fed capped US bond yields during and after WWII



Source: Aberdeen, Federal Reserve, October 2025 *20-year yield plotted for data availability reasons

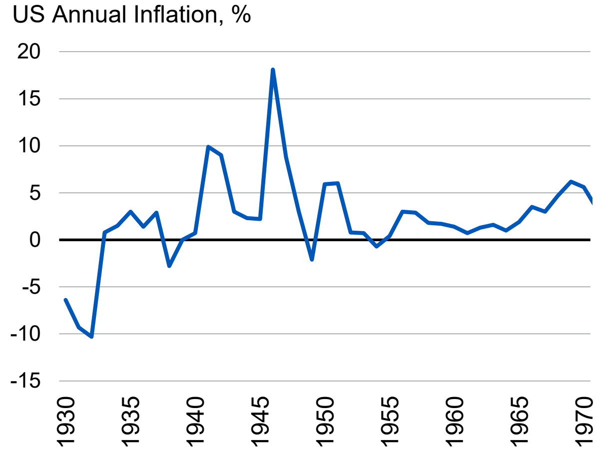
The rationale for this policy during a period of total war is obvious. But after the war ended, the Treasury continued to insist the policy was kept in place to keep debt servicing easier.

While the post-war peak in inflation near 20% was driven by the release of pent-up demand amid demobilisation, the subordinated of monetary policy to fiscal concerns (including as government spending rose in response to the Korean War) prevented the Fed from responding to this price shock (see Figure 7)

In 1951, the Fed was able to re-establish monetary independence through the Treasury-Fed accord, which allowed the Fed to drop the yield targets and set monetary policy in accordance with non-fiscal goals.

While the inflationary consequences of YCC would be less immediate and dramatic today, given the economy doesn't face the same supply shortages and demobilisation pressures as prevailed post-war, the financial market disruption could be bigger.

Figure 7: US inflation surged post WWII, and a regime of fiscal dominance prevented the Fed responding



Source: Aberdeen, Haver, October 2025

Post-war global financial markets were much smaller and faced significantly more constraints, including capital controls as part of the Bretton Woods system.

The economy is much more financialised today, and financial markets much more globalised. It is much easier for domestic and foreign capital to move abroad, putting more pressure on the dollar. Meanwhile the impact of moves in asset prices on the economy is likely to be larger.

A low-probability but high-impact risk scenario

All told, we think the realisation of a full fiscal dominance scenario – i.e. the third phase of our typology – remains a low probability, but high impact, risk.

It has a low probability because it would be very unorthodox (although that has not stopped other policy measures occurring under a Trump presidency!); it is contrary to some of Miran's and Bessent's previously stated views on the conduct of monetary policy and management of the Fed's balance sheet; and it is potentially self-defeating because it could be inflationary, with big negative risk asset implications, and hard to credibly maintain.

However, it has a high impact because such a scenario would represent a radical change to how prices are set for the bedrock assets of the financial system. Lower US bond yields, flatter curves, and dramatically lower real yields as inflation expectations moved higher, would in turn impact asset prices, currency crosses, and savings and investment decisions throughout the global financial system and economy.

Authors:

Luke Bartholomew & Paul Diggle

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Risk warning
The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. Past performance is not a guide to future results.

Copyright in this content from the Global Macro Research team belongs to the Aberdeen Group and our licensors. You may quote this content (excluding any Third Party Data) provided you acknowledge Aberdeen Investments as the source.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by Aberdeen*. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, Aberdeen* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates.

*Aberdeen means the relevant member of the Aberdeen Group, being Aberdeen Group plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. Aberdeen does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. Aberdeen reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither Aberdeen nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective Aberdeen Group members detailed below. The Aberdeen Group comprises Aberdeen Group plc and its subsidiaries: (entities as at 22 September 2025)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa

[1]In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market** ("ADGM"): abrdn Investments Middle East Limited, Cloud Suite 403, 11th floor, Al Sarab Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 5327224, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa:** abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 1 George Street, Edinburgh EH2 2LL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein. Aberdeen Investments Global is a business name of the foregoing entities.

Asia-Pacific

Australia and New Zealand: abrdn Oceania Pty Ltd (ABN 35 666 571 268) is a Corporate Authorised Representative (CAR No. 001304153) of AFSL Holders MSC Advisory Pty Ltd, ACN 607 459 441, AFSL No. 480649 and Melbourne Securities Corporation Limited, ACN 160 326 545, AFSL No. 428289. In New Zealand, this material is provided for information purposes only. It is intended only for wholesale investors as defined in the Financial Markets Conduct Act (New Zealand). **Hong Kong**: abrdn Hong Kong Limited. This material has not been reviewed by the Securities and Futures Commission. **Japan**: abrdn Japan Limited Financial Instruments Firm: Kanto Local Finance Bureau (Kinsho) No.320 Membership: Japan Investment Advisers Association, The Investment Trusts Association, Type II Financial Instruments Firms Association. **Malaysia**: abrdn Malaysia Sdn Bhd, Company Number: 200501013266 (690313 -D). This material has not been reviewed by the Securities Commission of Malaysia. **Thailand**: Aberdeen Asset Management (Thailand) Limited. **Singapore**: abrdn Asia Limited, Registration Number 199105448E. Aberdeen Investments Global is a business name of the foregoing entities.

Copyright © Aberdeen Group plc 2025. All rights reserved.

AA-131025-199648-56

aberdeen
Investments