Economics 302 (Sec. 001)
Intermediate Macroeconomic Theory and Policy (Spring 2011)
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15-1 Bond Prices and Bond Yields

The relation between maturity and yield is called the **yield curve**, or the **term structure of interest rates**.

![Figure 15 - 1](image)

**U.S. Yield Curves: November 1, 2000, and June 1, 2001**

The yield curve, which was slightly downward sloping in November 2000, was sharply upward sloping seven months later.
In November 2000, the U.S. economy was operating above the natural level of output. Forecasts were for a “soft landing,” a return of output to the natural level of output, and a small decrease in interest rates.

The U.S. Economy as of November 2000
15-1 Bond Prices and Bond Yields

The Yield Curve and Economic Activity

Figure 15 - 4

The U.S. Economy from November 2000 to June 2001

From November 2000 to June 2001, an adverse shift in spending, together with a monetary expansion, combined to lead to a decrease in the short-term interest rate.
15-1 Bond Prices and Bond Yields

The Yield Curve and Economic Activity

From this figure, you can see the two major developments:

- The adverse shift in spending was stronger than had been expected. Instead of shifting from IS to IS’ as forecast, the IS curve shifted by much more, to IS’’.

- Realizing that the slowdown was stronger than it had anticipated, the Fed shifted in early 2001 to a policy of monetary expansion, leading to a downward shift in the LM curve.
The Expected Path of the U.S. Economy as of June 2001

In June 2001, financial markets expected stronger spending and tighter monetary policy to lead to higher short-term interest rates in the future.
15-1 Bond Prices and Bond Yields

The Yield Curve and Economic Activity

Financial markets expected two main developments:

- They expected a pickup in spending—a shift of the IS curve to the right, from IS to IS’.

- They also expected that, once the IS curve started shifting to the right and output started to recover, the Fed would start shifting back to a tighter monetary policy.
The Yield Curve and Recessions

10 year-3 month spread

10 year-2 year spread
15-2 The Stock Market and Movements in Stock Prices

Figure 15 – 6 Modified

Standard & Poor’s Composite Index, in Real Terms, since 1970

Note the sharp increase in stock prices in the 1990s, followed by the sharp decrease in the early 2000s.
15-2 Movements in Stock Prices

The Stock Market and Economic Activity

A Monetary Expansion and the Stock Market

Figure 15 - 7

An Expansionary Monetary Policy and the Stock Market

A monetary expansion decreases the interest rate and increases output. What it does to the stock market depends on whether financial markets anticipated the monetary expansion.
15-2 Movements in Stock Prices

The Stock Market and Economic Activity

An Increase in Consumer Spending and the Stock Market

Figure 15 – 8a

An Increase in Consumption Spending and the Stock Market

The increase in consumption spending leads to a higher interest rate and a higher level of output. What happens to the stock market depends on the slope of the LM curve and on the Fed’s behavior.
15-2 Movements in Stock Prices

The Stock Market and Economic Activity

An Increase in Consumer Spending and the Stock Market

Figure 15 – 8b

An Increase in Consumption Spending and the Stock Market

If the LM curve is steep, the interest rate increases a lot, and output increases little. Stock prices go down. If the LM curve is flat, the interest rate increases little, and output increases a lot. Stock prices go up.
15-2 Movements in Stock Prices

The Stock Market and Economic Activity

An Increase in Consumer Spending and the Stock Market

If the Fed accommodates, the interest rate does not increase, but output does. Stock prices go up. If the Fed decides instead to keep output constant, the interest rate increases, but output does not. Stock prices go down.

Figure 15 – 8c

An Increase in Consumption Spending and the Stock Market