Economics 302 (Sec. 001)
Intermediate Macroeconomic Theory and Policy (Spring 2012)
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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

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.
15-1 Bond Prices and Bond Yields

The Yield Curve and Economic Activity

Figure 15 - 3

The U.S. Economy as of November 2000

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.
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.
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 yr - 3 mo spread**
- **10 yr - 2 yr spread**

Graph showing changes in the yield curve over time, indicating periods of recession (gray shaded areas).
The Yield Curve Now (3/21/2012)

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

Figure 15 – 8c

An Increase in Consumption 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.
 Movements in House Prices

Case-Shiller 10 city house price index

Nominal

Real

Yearly

2008-2010

2005-2008

2002-2005

1999-2002

1996-1999

1993-1996

1990-1993

1987-1990

Nominal and real house prices from 1987 to 2010 as indicated by the Case-Shiller 10 city house price index.