Core Economics: Concepts and Applications

By Subodh Mathur, Ph.D. MIT http://www.profmathur.com

Chapter 5: The bond market

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Chapter 5

The bond market

The bond market is the place where loans are bought and sold. It functions in complex ways that are often not intuitive, and its jargon can be daunting.

When I taught economics in universities, I found that most of my students had hardly any understanding of the bond market, even when they had some sense of the stock market.

Why should we look at this market? Let's look at what James Carville, one of President Clinton's political advisers, said about the bond market. He said, "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a 400 baseball hitter. But now **I would like to come back as the bond market**. **You can intimidate everybody**."

The bond market intimidates borrowers by collectively changing one of their key financial parameters. This parameter is called their loans' yield, which we will discuss in detail in this chapter. An increase in a borrower's yield is often interpreted as a judgment that the borrower's financial standing is worsening. The result is that the next time a borrower takes out a loan, the interest rate is likely to be higher.

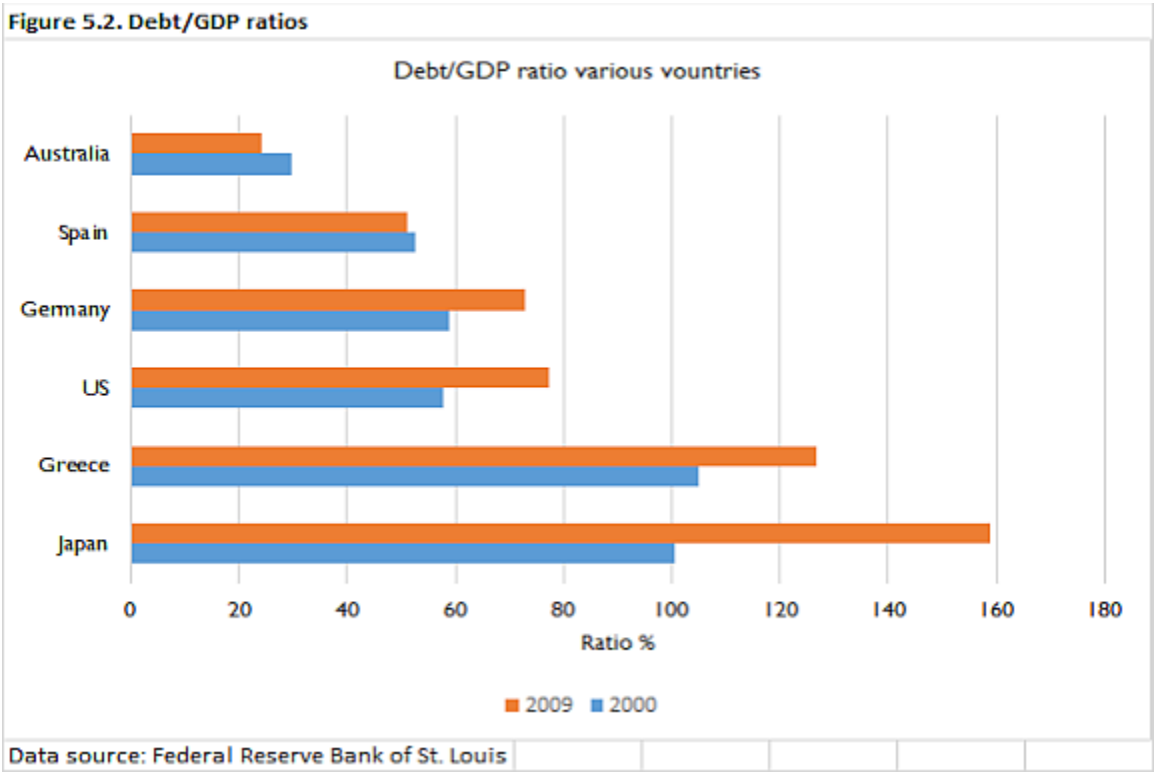
That's bad news for governments that borrow money regularly to finance their budget deficits. In 2010, the yields on Greece's loans went up so much that Greece was forced to ask for a financial bailout, as we discuss later in this chapter.

Bond market experience in Greece and Germany

Bond market pressurized Greece in 2010

By the year 2000, the Government of Greece had already accumulated a lot of debt. Its debt/GDP ratio was over 100%, much higher than in other countries, as shown in Figure 5.2. And Greece continued to accumulate more debt. By the beginning of 2009, Greece's debt/GDP ratio was more than 125%. (While this was considered very high at that time, after the coronavirus-induced economic crisis in early 2020, the debt/GDP ratios of many countries have gone up.)

Figure 5.2. Debt/GDP ratios

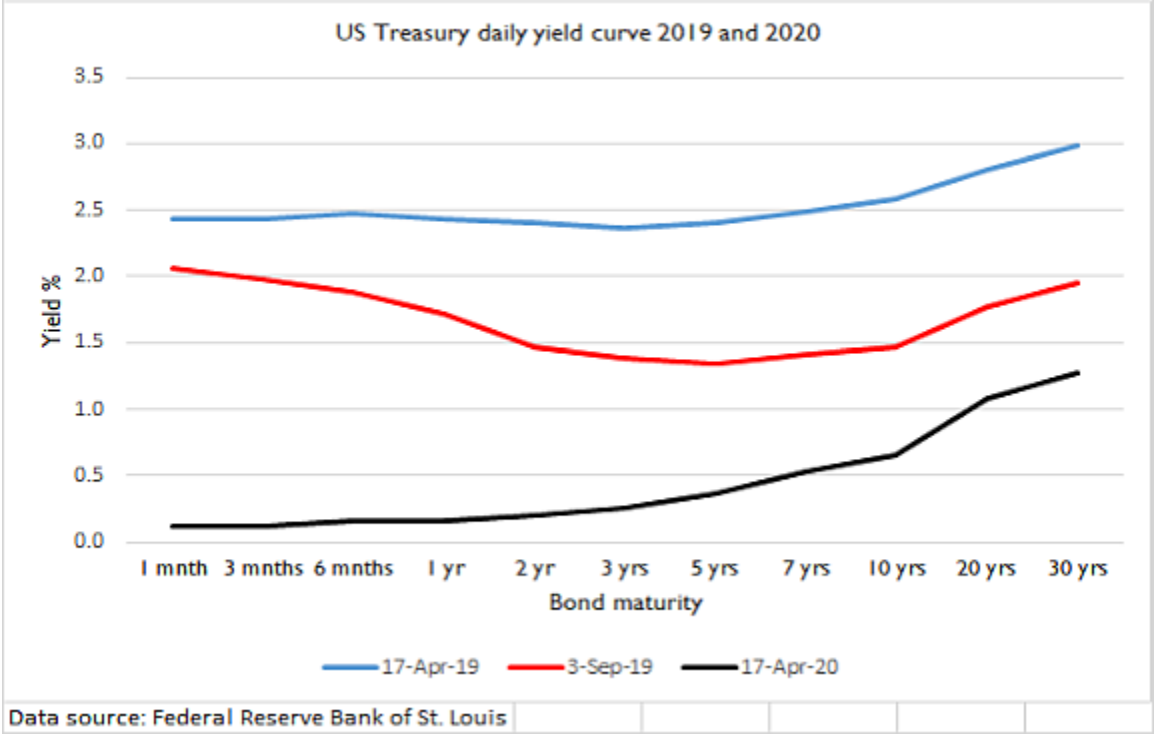


Data source: Federal Reserve Bank of St. Louis

Note that Japan had a higher debt/GDP ratio than Greece in 2009. However, Japan did not suffer the same fate as Greece. Thus, the debt/GDP ratio is not the only factor that determines the yield.

Like other governments, the Greek government had to borrow money to finance its deficits. Greece's need for additional loans was coming on top of an already heavy debt burden. Hence, there were concerns that the Greek government may

Figure 5.6. US Treasury daily yield curve



Data source: Federal Reserve Bank of St. Louis

Start by looking at the daily yield curve for April 17, 2019. The curve conforms to the expectation that rates are higher for longer-term loans. Compare this to the curve for April 17, 2020. All the rates in 2020 are lower than in 2019. That's due mainly to the Fed's actions to reduce interest rates. This shift represents a looser monetary policy designed to boost the economy.

As a result of the Fed's looser monetary policy, the decline is the greatest in shorter-term rates, with the 3-month rate falling from about 2.4% to about 0.1%. On the other end, the drop is the smallest for the 30-year rate, which fell from about 3% to 1.3%. This differential decline shows that **the Fed has a much higher ability to change short-term rates than to change long-term rates.**

How does the Fed influence these rates, which are ultimately set by market forces? We will discuss this next – after we look at the daily yield curve for September 3, 2019.

The yield curve for September 3, 2019, is called an inverted yield curve. In such a curve, long-term rates are lower than short-term rates. It's common to use the 10-year rate to represent the long-run, and the 3-month rate to represent the short-term. Thus, a common comparison is between 3-month and 10-year

