

Bretton woods

The cavernous Mount Washington Hotel, situated in Bretton Woods, N.H., was the scene in 1944 for the refashioning of the world's monetary system. Representatives of 44 nations, led by the United States and Great Britain, resolved to anchor the dollar to gold and the other currencies to the dollar. The arrangements thereby established lasted, in one form or another, until 1971, when the dollar was redefined as a piece of paper of no intrinsic value.

Harry Dexter White, representing the U.S. Treasury, and John Maynard Keynes, speaking for the British Treasury, were the principal monetary architects. They sought to bring order out of the chaos of the 1930s, when governments manipulated the value of their currencies to steal a competitive march on their neighbors. The Bretton Woods dollar was defined as one thirty-fifth of an ounce of gold, while the values of the other currencies, major and minor, were fixed in terms of the dollar.

White and Keynes wanted only so much fixedness. Yes, exchange rates would not be allowed to float, but nations could devalue by 10% at will and by another 10% if they felt they really had to. As to the golden dollar, only governments could make the conversion from paper to bullion and back again; American citizens could not legally own gold, let alone redeem their Federal Reserve notes for it.

White, a New Dealer and in his spare time a Soviet agent, and Keynes, a devout believer in the efficacy of central bank management, each rejected the liberal ideals of the classical gold standard, in which anyone could exchange metal for paper and money and merchandise moved freely from one participating gold standard nation to another. A characteristic feature of the Bretton Woods system was tight government control of investment capital.

Sharp devaluations, notably of the pound, marked the early years of the Bretton woods system. Later, the United States began to run short of gold. Only in the early to mid-1960s did the world's currencies behave in the ways that White and Keynes intended them to.

The World Bank and International Monetary Fund, institutions created to support and administer the Bretton woods system, survive. Hardy institutions, bureaucracies are.

Associated Articles

March 18, 2013: An article about Bretton Woods

Collateralized debt obligation

A mortgage-acquisition contraption disastrously popular in the early and mid-2000s. Collateralized debt obligations (CDO) financed these assets with layers of liabilities. Equity was the junior-most layer, or "tranche," with mezzanine debt, junior debt and senior debt completing the right side of the CDO balance sheet.

The CDO was a work of financial engineering. It was structured to apportion losses, should they arise, among the liability holders according to the seniority of their claims. Thus, the equity tranche bore the first loss. The mezzanine level was next in line, followed by the higher-ranking classes of debt. At the penthouse of the structure were the senior claimants whose holdings were typically

rated triple-A.

The popularity of CDOs levitated along with house prices and mortgage debt. Issuance reached \$520 billion in 2006, up from \$68 billion in 2000, according to the Securities Industry and Financial Markets Association.

A 2012 study by Fitch Ratings entitled, "Global Structured Finance Losses, 2000-2011 Issuance," found that 51.7% of the value of the CDOs that came into the world over that dozen-year span have been, or will eventually be, lost. "Problematic" assets were one cause of this shocking record; CDOs held lots of subprime residential mortgage-backed securities. Extreme leverage was another source of trouble; some CDOs piled \$100 worth of assets on just \$1 of equity, with the result that losses reached even the supposedly insulated triple-A tranches. Needless to say, neither the engineers who designed the CDOs nor the investors who bought them nor the agencies that rated them were counting on a nationwide bear market in houses.

"Losses are especially severe for structured finance CDOs issued at the peak of the market," according to Fitch, "with approximately 80% of the 2006 and 2007 vintage issuance expected to be written off. This severe underperformance mirrors that of the more problematic assets securitized in structured finance CDOs—subprime residential mortgage-backed security bonds and, to a lesser extent, commercial mortgage-backed security bonds—with the higher losses resulting from the additional leverage created by the CDO structures."

In defense of the fundamental design of the CDO, let the record show that asset-backed securities (ABS) stocked with assets other than bubble-era home mortgages have performed creditably. Again to quote Fitch: "Consumer assets, which account for 28.3% of the overall U.S. structured finance balance, have especially proven their resilience throughout the crisis. No losses are expected on credit-card transactions, only two auto ABS tranches are expected to incur losses and student-loan transactions have low net losses of 0.3%."

Associated Articles

Aug 11, 2006: English majors' revenge

Deflation

A derangement of money or credit, a symptom of which is falling prices. Not to be confused with a benign, i.e., downward shift in the composite supply curve, a symptom of which is also falling prices. In a genuine deflation, banks stop lending. Prices tumble because overextended businesses and consumers confront the necessity of selling assets in order to raise cash. When prices fall because efficient producers are competing to deliver lower-priced goods and services to the marketplace, that is called "progress."

An extreme example of a genuine deflation occurred after World War I. During the war, belligerent governments resorted to money printing to bridge the gap between income and outgo. In the United States, the Federal Reserve quashed interest rates and liberally extended credit to induce the public to buy war bonds. The result was soaring consumer prices—up 18% in 1918—and artificially low borrowing costs.

By late 1919, the inflated structure of wartime prices began to sag. In early 1920, a worldwide depression got under way. In the United States, the governor of the Federal Reserve Bank of New York, Benjamin Strong, confided that “[w]e must deflate.” Up went interest rates and down plunged commodity prices. From May to December 1920, the Federal Reserve’s index of 12 commodity prices fell by 40%. Between July and December 1921, a price index of 10 crops plunged by 57%. Wages and consumer prices registered substantial, though less dramatic, declines. By mid-1921, America’s depression had bottomed and recovery begun. Prices stabilized, and deflation ended.

In 2013, central bankers the world over define deflation as a fall in prices, no matter what the cause. Many central banks, including the Federal Reserve, the Bank of Canada, the Reserve Bank of Australia and—as of January 2013, the Bank of Japan—“target” a rate of rise in prices of around 2%, and they fret that a rate of inflation of less than 2% will somehow lead to deflation. The merits of this approach to monetary policy can be endlessly argued, but the fact is that it’s something new under the sun.

Prices fell persistently in the final quarter of the 19th century. A portion of the American electorate sent up a hue and cry against the decline and demanded that the government take inflationary countermeasures. But William Jennings Bryan, the political champion of the inflationists, was defeated for the presidency each of the three times he ran, starting in 1896. And when prices, on average, began to creep upward starting within a few years of Bryan’s defeat, Americans began to complain about the high cost of living.

In 20th-century America, the CPI registered 12 consecutive months of year-over-year “deflation” in 1954-55 with few people seeming to notice, much less worry, to judge by coverage in the leading newspapers. In 1961-64, the CPI never showed an average annual increase of as much as 2% (the maximum was 1.65% in 1963), a record that, again, excited scant public or official concern. Consumer prices showed monthly year-over-year declines in nine of the 12 months in 2009, the year following a major credit crisis, but this bout of “deflation” reflected a run-up in prices in 2008 more than a run-down of prices in 2009; it was more optical than actual.

Nowadays, to forestall what is popularly called deflation, the world’s monetary authorities are seemingly prepared to pull out every radical policy stop. Where it all ends is one of the great questions of contemporary finance.

Associated Articles

Jan 14, 2005: There ought to be deflation

European Central Bank

The amalgamation of the 17 national central banks in the euro zone. While the constituent national banks pool their balance sheets for common policy, each NCB continues to exist as a distinct entity that conducts monetary operations on behalf of the European Central Bank in each respective home country. Like the Federal Reserve, the ECB sets the main policy rate for the euro area. Unlike the Fed, the ECB is bound by only one policy mandate, the thing called “price stability,” which it defines not as stability but as inflation, though only a little bit of inflation, say 2% per annum over the medium term. The ECB is also enjoined to promote “sustainable development” and “full employment” in a “highly social market economy,” but these are desiderata; price stability is front and center. In

addition to picking interest rates, the ECB conducts foreign exchange operations for the euro zone, holds foreign currency reserves, promotes the smooth operation of payment systems, issues banknotes, collects statistics, supervises banks and has truck with institutions like the IMF and the Fed.

The ECB's focus on inflation is not entirely single-minded, as the world's financial markets learned to their immense relief on July 26, 2012. In remarks at the Global Investment Conference in London, the Ben S. Bernanke of the ECB, Mario Draghi, vowed to "do whatever it takes to preserve the euro." To this, he added for dramatic effect: "And believe me, it will be enough."

In late 2011 and early 2012, the ECB discounted hundreds of billions of euros of collateral in 12- and 36-month loans to Europe's beleaguered banks through the ECB's so-called Long-Term Refinancing Operations (LTRO). The ECB has purchased sovereign bonds through a variety of programs beginning with the Securities Markets Program (SMP) in 2010 and through its Outright Monetary Transactions (OMT) in 2012. Throughout the crisis, the ECB has expanded the collateral that troubled lenders can post at the discount window. For those financial institutions that could not meet the ECB's relaxed collateral requirements, the ECB has allowed individual NCBs to discount questionable assets issued by the euro zone's more troubled lenders.

Associated Articles

Dec 2, 2011: How the bond vigilantes got fat

Federal Reserve

America's central bank, called into being by the Federal Reserve Act, which President Woodrow Wilson signed (using four gold pens) on Dec. 23, 1913.

The act projected an institution to "provide for the establishment of the Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper and to establish a more effective supervision of banking in the United States, and for other purposes."

It's unlikely that the founders of the Federal Reserve would recognize their own handiwork if they could somehow inspect it from wherever it is the progenitors of central banks go after they die. Perusing the Fed's Web site, they would read that the first purpose of the institution they conceived is to conduct "the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices."

In 1913, the concept of a "macro economy" was yet unarticulated. Neither had the idea of "monetary policy" been hatched. As the gold standard was still in place, the principal duty of a central bank was to exchange currency for gold and gold for currency at the statutory rate (a dollar was defined as a little less than one-twentieth of an ounce of gold).

"Full employment"? Not until 1921 did the Department of Labor make its first official survey of national employment conditions. "Stable prices"? Here the founders—notably Rep. Carter Glass, a Democrat from Virginia, the chief legislative sponsor of the Fed—would nod in recognition, for there

was popular grumbling in 1913 about the high cost of living. But the idea that the central bank, by means of discretionary purchases of massive volumes of government securities and federally guaranteed mortgages, should target a certain rate of inflation would be incomprehensible. Still more daft to the founders would be the vision of a Federal Reserve note uncollateralized either by gold or by self-liquidating commercial paper. In debate in the House of Representatives, Glass snorted in derision at the charge that the Federal Reserve would produce “fiat currency.”

The authors of the Federal Reserve Act envisioned an institution that would function passively. It would not print money but rather make it “elastic” by expanding and contracting the supply of currency according to the needs of trade. It would forestall panics by centralizing the nation’s gold reserve and by lending to banks in times of financial stress, though only to solvent banks presenting good collateral. Manipulating interest rates and conducting open market operations in order to steer the American economy was not the approach Glass had in mind.

But the founders never really got the central bank (or rather, as they insisted, the decentralized central bank) of their imagining. The classical gold standard perished in World War I. Under Benjamin Strong, the Federal Reserve Bank of New York, then as now the flagship bank of the Federal Reserve System, took up open market operations to smooth out bumps in the business cycle in the 1920s. Gone was the original doctrine of central-bank passivity. Came the Depression and more of the founders’ ideas went by the wayside. The coming of federal deposit insurance in 1933 marked the beginning of the long-running trend to socialize banking risk.

H. Parker Willis, Glass’s right-hand man and first secretary of the Federal Reserve Board, let the evolved Fed have it with both barrels in his 1936 book, “The Theory and Practice of Central Banking.” Central banks. . .,” wrote Willis, “will do wisely to lay aside their inexpert ventures in half-baked monetary theory, meretricious statistical measures of trade and hasty grinding of the axes of speculative interests with their suggestion that by so doing they are achieving some sort of vague ‘stabilization’ that will, in the long run, be for the greater good.”

Well-wrought words but futile: “Stabilization” has become the modern central-banking watchword. Thus, the Fed has been Johnny-on-the-spot following financial disturbances ranging from the 1987 stock-market crash to the 1994 peso devaluation to the 1998 Long-Term Capital Management crisis. It has, of course, intervened in unprecedented ways in the debacle of 2007-09. On Jan. 2, 2008, the sum of the Fed’s earning assets, known as Reserve Bank credit, footed to \$891.7 billion. By Oct. 22, 2008, the sum had more than doubled to \$1,803.3 billion. A balance sheet that was 95 years in growing to not quite \$900 billion was only 294 days in doubling. It did so in the joint causes of stabilizing the overleveraged American economy and of defending the solvency of the banks and other financial institutions judged too big to fail.

In 1991, the Truth in Savings Act was passed to enlist the Fed in the cause of protecting thrifty Americans against deceitful financial advertising. But after decades of aggressive financial market interventions, savers now earn interest rates hardly worth being deceitful about.

Associated Articles

Mar 8, 2013: Shot clock for capitalism

Apr 22, 2011: The whys and wherefores of QE3

Fiat money

Scrip that derives its value from the imprimatur of a government. Today's dollar, for instance, owes its value not to the cost of the high-grade paper on which it's printed, but to the legend the Bureau of Engraving and Printing of the Department of the Treasury affixes to that paper, i.e., "This note is legal tender for all debts, public and private."

The word "note" is a telltale anachronism. A note is a credit instrument, a promise to pay. A banknote was a promise to pay money, usually gold. But the 21st-century dollar is itself the thing that is being paid, that and no more. In the language of finance, it is uncollateralized. Under a metallic system, paper notes are convertible into the underlying coin. Again, in the language of finance, the notes are "derivatives," their value deriving from the underlying coin.

From the Founders through the mid-20th century, the mainstream of monetary thinking opposed the fiat dollar. The Continentals of the Revolutionary War and the Greenbacks of the Civil War were demonstrably prone to debasement. In the final quarter of the 19th century, Populist and Greenback agitators were loud and long for an inconvertible dollar—or, at least, a dollar convertible into cheap silver rather than dear gold. But with the enactment of the Gold Standard Act of 1900, which defined the dollar as slightly less than one-twentieth of an ounce of gold, the monetary question seemed to be settled for all time.

But came the Depression and the administration of Franklin D. Roosevelt, and the dollar was redefined, i.e., devalued, to one thirty-fifth of an ounce of gold. This was in 1934. Thirty-five years later came the administration of Richard M. Nixon, and the currency was redefined as no fixed weight of gold. This was on Aug. 15, 1971. At a stroke, the dollar became an uncollateralized, fiat currency, the value of which fluctuates with the supply of, and demand for, slips of green paper of no intrinsic value.

The late John Exter, a hard-money man who came by his views despite, of (or even perhaps because of) his many years of service at the Federal Reserve Board, the Federal Reserve Bank of New York and what is today Citigroup, called the modern fiat dollar an "IOU nothing."

Associated Articles

Mar 23, 2012: Piece of my mind

Gold standard

A monetary system under which currencies were defined by gold and redeemable into gold. Exchange rates were fixed, and gold moved freely from one gold-standard country to another.

Gold has served as money since antiquity. "The gold standard," or the "classical gold standard," is a phrase that properly refers to the system in place between approximately 1880 and 1914. Then, money was defined as a weight of gold. Bank notes and other credit instruments were freely exchangeable into gold at the fixed and statutory rate. Gold coins passed from hand to hand. The term "sound money" derives from the pleasing ring of a gold coin striking a hard surface.

The final two decades of the 19th century were characterized by gradually falling prices, while the

first decade and a half of the 20th century was characterized by gradually rising prices. However, when measured over the sweep of years, as Roy Jastram showed in his book "The Golden Constant," gold has tended to hold its value, and prices denominated in gold have tended to remain stable.

"It was," writes the economist Michael Bordo of the era of the gold standard in *The Concise Encyclopedia of Economics*, "... a period of unprecedented economic growth with relatively free trade in goods, labor and capital."

"Only a trifling number of countries were forced off the gold standard, once adopted," relates Arthur I. Bloomfield, in a monograph published by the Federal Reserve Bank of New York in 1959, "and devaluations of gold currencies were highly exceptional. Yet all this was achieved in spite of a volume of international reserves that, for many countries at least, was amazingly small and in spite of only a minimum of international cooperation, or of international agreements or commitments, on monetary matters." The classical gold standard was interrupted by the outbreak of World War I and was never restored.

Under the gold standard, money was a unit of measurement, like a yard or an inch. The dollar was defined as roughly one-twentieth of an ounce of gold, the pound sterling as roughly one-fifth of an ounce of gold. The dollar-sterling exchange rate was therefore fixed at roughly \$5 (the fixed and seemingly permanent rate of exchange was \$4.867, to be exact). This fixedness encouraged trade, but forestalled the kind of so-called aggressive money-policy interventions in vogue today. As there was only so much gold, there could be only so many dollars, pounds, French francs or German marks.

The British economist T.E. Gregory wrote of the system's "sweet simplicity." The exchequers or central banks of participating nations agreed to exchange currency for gold and gold for currency, at the official rate, on demand. Central bankers operated unobtrusively. They advanced funds against good collateral to solvent commercial banks, but they refrained from monetizing government securities. Neither did they engage in open-market operations with intent to steer the economy hither and yon. In fact, the very concept of the "macroeconomy" was yet uninvented.

"[T]he gold standard period witnessed a great expansion of trade," writes Kenneth W. Dam in his book, "The Rules of the Game," "and it is worth emphasizing in view of the attitudes taken during the Bretton Woods period, a flow of private investment on a scale the world had never seen, and, indeed, relative to other economic aggregates, was never to see again."

Gold had, and, indeed, still has, much to recommend it as a monetary metal. It is scarce, durable, malleable, dense, homogeneous, beautiful and portable. At a glance, anyone can tell it's valuable. And because it is never destroyed, above-ground stocks are immense in relation to current production. If the world's miners stopped digging tomorrow, the gold price would therefore not necessarily go up by much; any year's incremental production (e.g., 85.5 million ounces in 2011) is trifling in comparison to the world's inventory (five to six billion ounces).

"Unlike the paper dollar," writes Lewis E. Lehrman in his book "The True Gold Standard," "a dollar defined in law as a weight unit of gold is the monetary standard which simultaneously provides all the primary functions of true standard money: (1) a stable store of value; (2) a stable measure and unit of account; and, (3) a universally accepted means of payment. A gold monetary standard combines, in one monetary article of wealth, the three primary functions of money. Moreover, the true gold standard of history provides the global networking effects of universally acceptable,

equitable, ubiquitous, standard money. Throughout long historical evolution gold became free trade money."

Associated Articles

Oct 21, 2011: What we've forgotten

Hyperinflation

Inflation of 50% a month for at least one month is the threshold at which a conventional inflation becomes a hyperinflation, judged economist Phillip Cagan in his 1956 study, "The Monetary Dynamics of Hyperinflation." Though inflation is as old as money—or, at least, as old as governments tampering with money—hyperinflation is an affliction of the paper-money regimes of the 20th and 21st centuries. The debasement of the assignat during the French Revolution is the single exception to the rule, relates Peter Bernholz in "Monetary Regimes and Inflation."

Examples of hyperinflations include those in Germany in 1922-23, in Greece during the German occupation in World War II, in Hungary immediately following that war, in Latin America during the 1980s and in Zimbabwe during the first decade of the 21st century. "Hyperinflations are always caused by public budget deficits which are financed by money creation," Bernholz concludes. "If inflation accelerates, these budget deficits tend to increase. . . ."

In Greece in 1941, before the German occupation, a British sovereign—about one-quarter of an ounce of gold—was worth 1,200 Greek drachmas. In 1944, as the Germans hastily departed, a sovereign commanded 71 trillion drachmas.

But Hungary takes the cake for the most extreme hyperinflation ever recorded. From July 1945 until August 1946, according to "The Hungarian Hyperinflation and Stabilization of 1945-46," by William A. Bomberger and Gail E. Makinen (Journal of Political Economy, October 1983), "the price level rose by a factor of 3×10^{25} . When stabilization was achieved on Aug. 1, exchange of old for new currency was at a rate of 400 octillion for one. This contrasts with the conversion rate in Germany's famous hyperinflation of a trillion to one."

Associated Articles

Feb 24, 2012: Greek monetary back story

Interest rate

The cost of hiring money or credit. The rate of interest is the amount of interest per unit of time, typically one year. Thus, at 1% per annum, the borrower of \$100 would annually pay the lender \$1 (for which, in 2013, a time of famine in interest income, the lender might actually be grateful).

There is no one rate of interest but, rather, a myriad of rates. Interest rates vary to reflect the ability and willingness of borrowers to meet their obligations and the ease with which a borrower's promissory note or bond, mortgage, debenture or other evidence of indebtedness can be turned into money. The level of interest rates reflect the quality of the money in which a debt is denominated, the rate at which the lender and borrower are taxed and the confidence in which investors hold the

relevant fiscal and monetary authorities.

Lending at interest was condemned by Plato and Aristotle, Cato and Plutarch. The canonical laws of the Middle Ages forbade it, with the Council of Vienne (1311) declaring, according to the 1912 Catholic Encyclopedia, "that if any person obstinately maintained that there was no sin in the practice of demanding interest, he should be punished as a heretic." But years passed, and the "best authors" came to acknowledge "the lawfulness of interest to compensate a lender for the risk of losing his capital, or for positive loss, such as the privation of the profit which he might otherwise have made, if he had not advanced the loan," relates the same authority.

The encyclopedia here touches on ideas developed by the American economist Irving Fisher (1867-1947). Fisher proposed that the rate of interest is determined by the "impatience to spend income" and the "opportunity to invest it," two distinct and opposing human forces. He defined the rate of interest as a financial bridge over time, as the "link between income and capital." It is the premium paid on money "in terms of money to be in hand one year later," as Fisher wrote in "The Theory of Interest," published in 1930.

In the United States, interest rates have risen and fallen at generation-length intervals. Broadly, rates fell from the Civil War to 1900, rose to 1920, fell to 1946, rose to 1981 and have fallen ever since. In outline, the intervals correspond with the rise and fall of average prices. Falling prices have corresponded with falling interest rates, and vice versa.

But the overlap between the trends in average prices and average interest rates is by no means exact. Conditioned by long-trending markets in fixed-income securities, investors are inclined to look backward to familiar experience rather than forward to a change in financial direction.

Thus, in 1899, the president of the Equitable Life polled scores of Wall Street personages to ask what he might expect to earn per annum on high-grade bonds over the next generation. Yields had been falling for almost 35 years; what might the future hold?

To a man, the 69 respondents agreed that interest rates would decline or remain the same, when, in fact, they were poised to begin a 20-year uptrend. The change in the direction of interest rates coincided with a change in the direction of prices, which stopped dwindling and began rising. With the outbreak of war in 1914, the rate of rise accelerated. Presently, real, or inflation-adjusted, bond yields were substantially below zero.

Fast-forward now to the spring of 1984. Inflation had peaked at 14.6% in 1980. The Federal Reserve had scotched inflation by shutting off the growth in money supply. Yet lenders and borrowers, recalling all too well the 35-year bear market in bonds (1946-81), set the yield on 30-year Treasuries at more than 13%--this at a time when the CPI was registering year-over-year gains of less than 5%.

In the early 1980s, interest rates were higher than they had ever been. At this writing, in May 2013, interest rates are almost as low as they have ever been, while central banks are more aggressively easy than they have ever been in times of peace. If a new up cycle in interest rates were in the cards, one could imagine it beginning at a juncture such as this.

Associated Articles

Sep 21, 2012: Wisdom of crowds

Yield curve

The alignment of interest rates over time.

On a piece of graph paper, draw a horizontal axis and a vertical axis. Along the horizontal axis, mark down intervals of time, 24 hours to 30 years. Along the vertical axis, mark down yields, from the federal funds rate to the 30-year bond. Connect the dots. Voila! You have constructed a yield curve.

Notice that—as of springtime 2013—the curve is upward sloping, i.e., longer-dated securities fetch more than shorter-dated ones do. This positive slope is said to be the norm. And it is the norm for the modern age of paper money.

In the years leading up to the founding of the Federal Reserve in 1913, however, the conventional slope of the yield curve was negative. Money-market interest rates were volatile, but usually pitched higher than long-term bond yields.

A positive-sloping yield curve facilitates borrowing short and lending long. The ability to fund long-term assets with short-term debt lubricates credit formation and speculation. For this reason, among others, an upward-sloping yield curve is associated with expanding economies, a flat or negatively sloping curve with contracting ones.

In the early 1980s, Galen Blomster, an economist with Northwestern National Bank, proposed that the shape of the yield curve was a powerful predictor of real final sales over an 18-month horizon.

In a 1991 paper published in *The Journal of Finance* and entitled, “The Term Structure as a Predictor of Real Economic Activity,” Arturo Estrella and Gikas A. Hardouvelis agreed that the shape of the yield curve does have something to say about the future. “The slope of the yield curve,” they held, “has extra predictive power over and above the predictive power of lagged output growth, lagged inflation, the index of leading indicators and the level of real short-term interest rates.” Still, they judged, the yield curve’s forecasting potency was only relatively superior to that of the other indicators cited: “[O]ne should not lose sight of the fact that the absolute forecasting ability is not great.”

Not since 1953 has the American economy entered a recession while the curve, as measured by the difference between the two-year note and the 30-year Treasury bond, was positively sloped. A question that time alone will answer is whether these trusty rules of thumb still pertain in a monetary regime of zero-percent funding costs and massive central bank purchases of longer-dated securities.

Yield curves can be ridden as well as deconstructed. To “ride the curve” is to buy a security with the intention of selling it before it matures. The idea is to capture the capital gain implicit in an upward-sloping curve. If a three-year note yields more than a two-year note, for instance, that yield differential has embedded within it a price differential. One could buy the three-year security and sell it a year hence, capturing both the coupon and the capital gain, rather than, say, buying and

holding a 12-month security in which one would earn the coupon but no capital gain. Of course, the capital gain is hypothetical until it is realized. Nothing says that the yield relationship on which one is speculating has to stand still.

Associated Articles

Jan 13, 2006: Yield curve, where is thy sting?