Abstract: The Yield Curve Conundrum

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Between 2004-2006 the US Federal Reserve relentlessly increased the Federal Funds Target rate by 1/4% at seventeen consecutive Federal Open Market Committee meetings. The Target rose from 1% to 5 1/4%. Short maturity yields dutifully followed the target, but long maturity yields (10 years or more) actually fell until by June 2006 they were less than short maturity yields. Alan Greenspan, Chairman of the Federal Reserve at the time, labeled the unusual behavior of the yield curve a conundrum. We find that unusually strong demand by foreigners for US bonds led to yields 1 ½% lower than they would have been otherwise. Monetary and macroeconomic surprises had almost no effect on long maturity yields.

In the future if foreigners switch their holdings to non-dollar denominated assets US yields will have to rise above what they would have been otherwise.