

# Monetary Trends



## Bond Market Inflation Credibility

Given the propensity to save, average *real* (inflation adjusted) interest rates tend to rise with an increase in trend real GDP growth because of increased borrowings to finance investment. Given real interest rates, average *nominal* interest rates tend to rise with an increase in inflationary expectations because lenders demand compensation for expected inflation.

Average real GDP growth drifted down from about 4 percent in the 1950s and early 1960s to about 2 percent in the late 1970s and early 1980s, then back up to about 2.5 percent. Average inflation drifted up from about 1 to 2 percent in the 1950s and early 1960s to nearly 10 percent in 1980, then back down to about 3 percent. The five-year average of the five-year Treasury security yield rose from 2 percent in the 1950s to 12 percent in the early 1980s, but then fell back to about 6 percent in the 1990s.

These observations are consistent with inflationary expectations having been the dominating influence on long-term bond yields. Since bond yields rose when inflation accelerated—but real GDP growth slowed—inflation influenced bond yields a lot more than real GDP growth did. Since bond yields fell when inflation decelerated—but real GDP growth stabilized—inflation again influenced bond yields more than real growth did.

The difference between the five-year average of the five-year Treasury security yield and the 10-year average of real GDP growth is an estimate of the bond market's five-year inflation forecast, capturing the inflation risk premium in yields. It is the height of the shaded area in the chart.

This measure of inflation credibility roughly matches current inflation, a reflection that bond

yields have been backward looking in forecasting inflation. It hovered close to zero in the 1950s and early 1960s, which was credibly a zero-inflation-expectations environment. It moved sharply higher to about 10 percent in the early 1980s, then down to about 4 percent in recent years.

The bond market inflation forecast (or premium) over the past five years represents a substantial gain in credibility compared with the early 1980s, but a substantial loss compared with the 1950s and early 1960s. In that era, actual inflation was about 2 percent, but zero inflation was credible in the bond market. In recent years, inflation has been about 3 percent, but 4 percent inflation has been credible in the bond market.

Thus, despite inflation now being the lowest and most stable in decades, bond markets have not been convinced that inflation is down to stay, let alone eliminated. If the inflation premium in bond yields were eliminated, they could fall to match trend real growth, as was the pattern in the 1950s and early 1960s.

—William G. Dewald

**Long Term Yields, Inflation, Real Growth, and Inflation Credibility**

