Economic SYNOPSES
short essays and reports on the economic issues of the day
2009 ■ Number 26

# Taming the Long-Term Spreads

**Massimo Guidolin,** *Assistant Vice President and Economist*
**Yu Man Tam,** *Senior Research Associate*

The Federal Reserve has aggressively confronted the ongoing recession by cutting the federal funds rate target to a range between zero and 25 basis points and implementing a number of quantitative credit-easing policies. Yields on Treasury bills and notes have decreased sharply in response both to these actions and to weak economic activity. As shown in the chart, decreases in short-term yields preceded those in longer-term yields. Short-term yields on 90-day Treasuries fell from approximately 5 percent to less than 0.25 percent; later, longer-term yields (10-year) decreased to below 3 percent.

Lower long-term market yields are instrumental to the goals of an expansionary monetary policy. But Treasury yields are unusual because there is no default risk; this lowering of Treasury yields needs to be transmitted to yields on other securities. However, this transmission from the long-end of the Treasury yield curve to securities such as corporate bonds and mortgages has proven more difficult than in previous recessions. Corporate and mortgage-backed yields contain a default-risk premium that is reflected in a positive yield spread over Treasury securities. A larger-than-usual risk premium may cause a weak response in private yields. The U.S. corporate bond market is large, with $9.8 trillion in outstanding debt—1.5 times the amount of outstanding Treasuries. The U.S. mortgage market is even bigger—$14.7 trillion at the end of 2008, of which $8.2 trillion is securitized. Given the size of the underlying markets, cutting the cost of capital to firms and households by reducing the yields required on long-term corporate bonds and mortgages is a key policy objective. The top panel of the chart shows that yields have decreased little so far in this recession. On the contrary, the spreads between both investment (Aaa)- and speculative (Baa)-grade corporate bond and Treasury note yields have skyrocketed to unprecedented levels.[1] For instance, the spreads between 8- to 15-year mortgage-backed securities and 10-year Treasury notes surged from a mean of approximately 1.7 percent to 7 percent between August 2007 and March 2009, with a peak in excess of 8 percent after October 2008. The questionable creditworthiness of the issuing firms does not appear to be the main factor behind the recent spread increases: The spread on Aaa corporate bonds—i.e., debt with minimal chance of default—has also increased. For instance, since October 2008 the spreads on Aaa corporate bonds have exceeded 2.5 percent—double historical means.

**Given the size of the underlying markets, cutting the cost of capital to firms and households by reducing the yields required on long-term corporate bonds and mortgages is a key policy objective.**

Lowering long-term yields across a spectrum of instruments is clearly one of the priorities for policymakers. It is well known that credit spreads tend to widen in recessions, but the recent spikes appear to be anomalous and related to the financial turmoil and not to business cycle conditions. Simple back-of-the-envelope calculations suggest that despite the apparent success of quantitative easing in reducing long-term Treasury yields from 5 percent to less than 3 percent, the reduction in the long-term cost of capital perceived by firms and households may be modest if, at the same time, the spreads on other long-term bonds stay abnormally elevated by as much as 150 basis points. Removing conditions of impairment in the broad U.S. financial markets to favor a decline in credit spreads is a prerequisite to shortening the ongoing recession. ■

[1] Long-term corporate bond yields are from Moody's. Data for 8- to 15-year mortgage-backed securities (MBS), computed by averaging the yields of private-label securities with ratings higher than BB, are from Bloomberg/Bear Stearns.

Posted on May 22, 2009