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“Cracking the Conundrum”

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From 2004 to 2006 the Federal Open Market Committee raised the target federal funds rate by 4.25 percentage points, yet long-maturity yields and forward rates fell. We consider several possible explanations for this conundrum of rising short-term and falling long-term interest rates. The most likely, in our view, is a fall in the term premium, probably associated with some combination of diminished macroeconomic and financial market volatility, more predictable monetary policy, and the state of the business cycle.

JEL classification codes: E43, E52, G12