Equilibrium Yield Curve, Phillips Curve, and Monetary Policy

Abstract:

This paper examines equilibrium yield curves in a model with uninsured shocks to both real income and inflation, optimal savings as a buffer-stock, and nominal interest rates set by a monetary policy rule. Under the income and inflation process estimated by U.S., U.K, German, and Japanese data, the model can replicate a realistic upward sloping yield curve along with the positive correlation between the output gap and inflation (i.e., Phillips curve). A counterfactual analysis indicates that the economy with permanently low interest rates would face a flatter yield curve due to the decline in real term premiums.