A glossary for the troubled global economy

Why in news?

With the US' inflation rate at 9.1% in June, the highest in 40 years, Yield inversion, soft-landing and reverse currency war is seen in the big picture.

What has been happening in the global economy?

- Notwithstanding rapid increases in interest rates by the US central bank, the inflation rate for June came in at 9.1 per cent.
- This is the highest in 40 years in the US.
- This points to an inversion of the US yield curve and to argue that the US central bank will not be able to achieve a soft-landing for the economy.
- However, the US dollar continues to gain against all other currencies.
- In what is being seen as a reverse currency war, most central banks across the world are trying to raise their interest rates to counter the Fed's actions and ensure their respective currency claws back value against the dollar.

What are bonds?

- A bond is an instrument to borrow money and is like an IOU.
- A bond could be floated/issued by a country's government or by a company to raise funds.
- Since government bonds (referred to as G-secs in India, Treasury in the US, and Gilts in the UK) come with the sovereign's guarantee, they are considered one of the safest investments.
- As a result, they also give the lowest returns on investment (or yield).
- Investments in corporate bonds tend to be riskier because the chances of failure (and, therefore, the chances of the company not repaying the loan) are higher.

What are bonds yields?

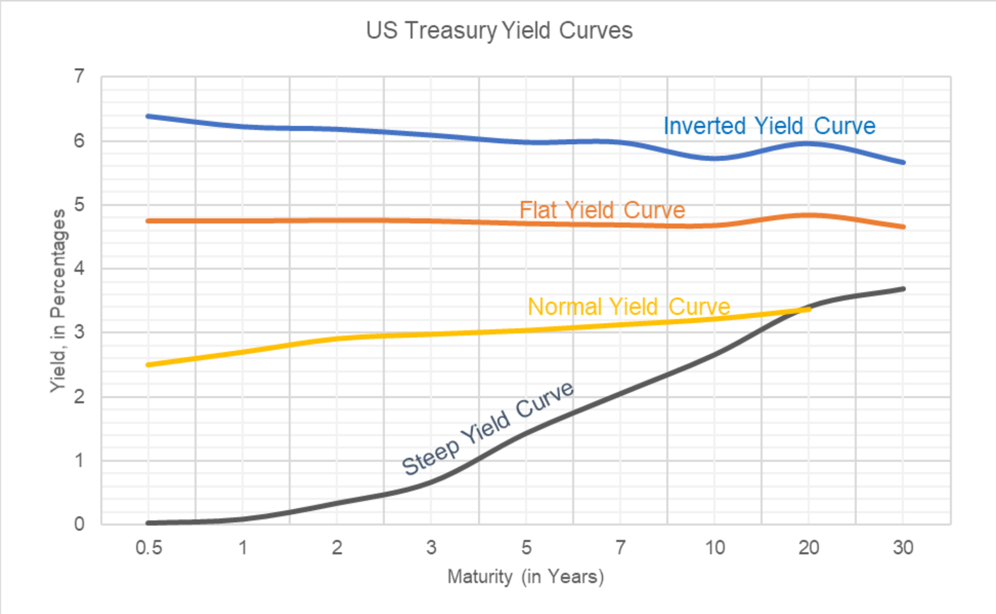
- The yield of a bond is the effective rate of return that it earns.

- However, the rate of return is not fixed — it changes with the price of the bond.
- Every bond has a face value and a coupon payment.
- There is also the price of the bond, which may or may not be equal to the face value of the bond.

What is bond yield curve inversion?

- Bonds are essentially an instrument through which governments (and also corporations) raise money from people.
- Typically government bond yields are a good way to understand the risk-free interest rate in that economy.
- The yield curve is the graphical representation of yields from bonds (with an equal credit rating) over different time horizons.
- In other words, if one was to take the US government bonds of different tenures and plot them according to the yields they provide, one would get the yield curve.
- However, there are times when this bond yield curve becomes inverted.
- For instance, bonds with a tenure of 2 years end up paying out higher yields (returns/ interest rate) than bonds with a 10 year tenure.
- Such an inversion of the yield curve essentially suggests that investors expect future growth to be weak.
- This corresponds that, when investors feel buoyant about the economy they pull the money out from long-term bonds and put it in short-term riskier assets such as stock markets.
- In the bond market, the prices of long-term bonds fall, and their yield (effective interest rate) rises.
- This happens because bond prices and bond yields are inversely related.
- However, when investors suspect that the economy is heading for trouble, they pull out money from short-term risky assets (such as stock markets) and put them in long-term bonds.
- This causes the prices of the long-term bonds to rise and their yields to fall.
- Over the years, inversion of the bond yield curve has become a strong predictor of recessions.
- And, for it to be taken seriously, such an inversion has to last for several months.
- Over the past few weeks, such inversion is happening repeatedly in the US, suggesting that a recession is in the offing.
- In the current instance, the US Fed (their central bank) has been raising short-term interest rates, which further bumps up the short-end of the

yield curve while dampening economic activity.



What is Soft-landing?

- The process of monetary tightening that the US Fed is currently unveiling involves not just reducing the money supply but also increasing the cost of money (that is, the interest rate).
- The Fed is doing this to contain soaring inflation. Ideally, the Fed or any central bank doing this would like to bring about monetary tightening in such a manner that slows down the economy but doesn't lead to a recession.
- When a central bank is successful in slowing down the economy without bringing about a recession, it is called a soft-landing — that is, no one gets hurt.
- But when the actions of the central bank bring about a recession, it is called a hard-landing.

What is Reverse Currency War?

- A flip side of the US Fed's action of aggressively raising interest rates is that more and more investors are rushing to invest money in the US.
- This, in turn, has made the dollar become stronger than all the other currencies.
- That's because the dollar is more in demand than yen, euro, yuan etc.
- On the face of it, this should make all other countries happier because a relative weakness of their local currency against the dollar makes their exports more competitive.
- For instance, a Chinese or an Indian exporter gets a massive boost. In

fact, in the past the US has often accused other countries of manipulating their currency (and keeping its weaker against the dollar) just to enjoy a trade surplus against the US.

- This used to be called the currency war.
- However, today, every central bank is trying to figure out ways to counter the US Fed and raise interest rates themselves in order to ensure their currency doesn't lose too much value against the dollar.

What is the way forward?

- The important thing to understand is that a stronger dollar has had a key benefit, importing cheaper crude oil.
- On the other hand, a currency which is losing value to the dollar, finds that it is getting costlier to import crude oil and other commodities that are often traded in dollars.
- However, raising the interest rate is not without its own risks.
- Just like in the US, higher interest rates will decrease the chances of a soft-landing for any other economy.

Reference

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