



A Glossary for the Troubled Global Economy

Why in News?

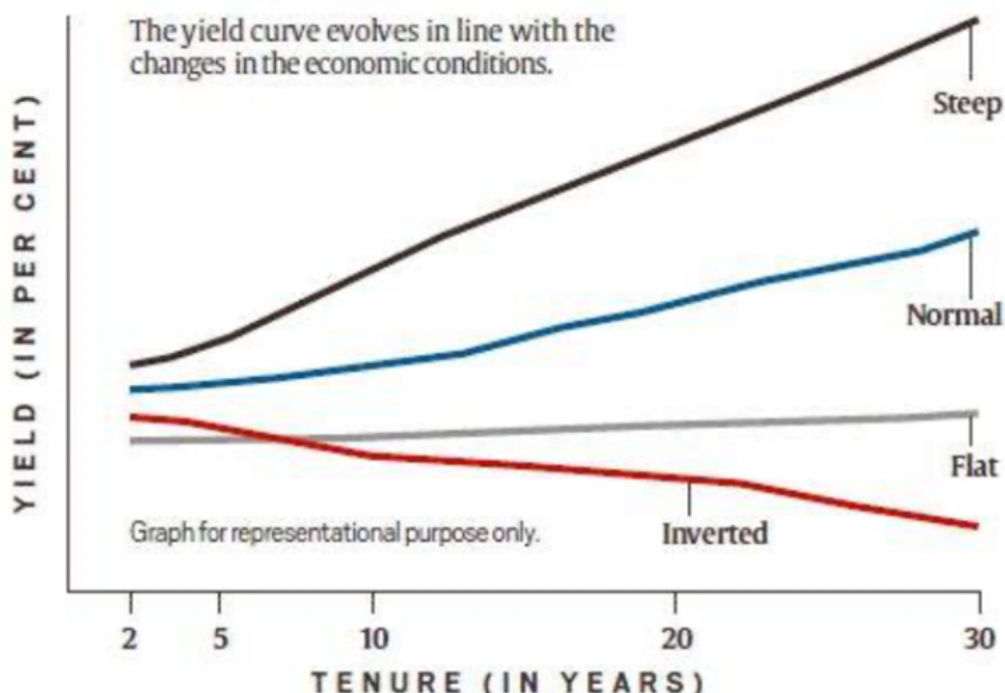
Recently, US' [Inflation](#) hit a record high of 9.1% in June 2022, the highest in 40 years.

- US observers have argued that the **US central bank will not be able to achieve a soft landing** for the economy if the yield curve inverts.
- **Start of reverse currency wars** has also been predicted.

What is Bond Yield Inversion?

- **Bonds:**
 - **Bonds** are essentially an **instrument through which governments** (and also corporations) **raise money from people**.
 - A bond's yield is the **return to an investor from the bond's coupon** (interest) **payments**.
 - Typically, **government bond yields** are a good way to understand the **risk-free interest rate** in that economy.
- **Yield Curve:**
 - 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**.

DIFFERENT TYPES OF YIELD CURVES



▪ **Bond Yield Inversion:**

◦ **Under Normal Circumstances:**

- **Any economy would have an upward** sloping yield curve.
 - As one lends for a **longer duration** — or as one buys bonds of longer tenure — **one gets higher yields.**
 - If one is **parting with money for a longer duration**, the return should be **higher.**
- When investors feel **confident** 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.**

◦ **Suspicious Circumstances:**

- 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.**

What is Soft-landing?

- The process of **monetary tightening** that the **US Federal Reserve** is currently unveiling involves **not just reducing the money supply but also increasing the cost of money** (that is, the interest rate).
 - The US' Federal Reserve is **doing this to contain soaring inflation.**
- 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 Wars?

- A flip side of the US Federal Reserve 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** as the dollar is more in demand than yen, euro, yuan etc.
- A relative weakness of the local currency of other countries against the dollar makes their **exports more competitive.**
 - For instance, a Chinese or an Indian exporter gets a massive boost.
 - In the past, the US has 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.**

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Q. Indian Government Bond Yields are influenced by which of the following? (2021)

1. Actions of the United States Federal Reserve
2. Actions of the Reserve Bank of India
3. Inflation and short-term interest rates

Select the correct answer using the code given below.

- (a) 1 and 2 only
- (b) 2 only
- (c) 3 only
- (d) 1, 2 and 3

Ans: (d)

Explanation:

- Bond is an instrument to borrow money. A bond could be issued by a country's government or by a company to raise funds.
- Bond yield is the return an investor realizes on a bond. The mathematical formula for calculating yield is the annual coupon rate divided by the current market price of the bond.
- Movements in yields depend on trends in interest rates, it can result in capital gains or losses for investors.
- A rise in bond yields in the market will bring the price of the bond down.
- A drop in bond yield would benefit the investor as the price of the bond will rise, generating capital gains.
- Fed tapering is the gradual reduction in the bond buying program of the US Federal Reserve. So, any actions of the United States Federal Reserve impact the bond yield in India. **Hence, 1 is correct.**
- The actions of the RBI plays a crucial role in determining the yield of government bonds. The sovereign yield curve has a special significance for monetary policy in influencing a wide array of interest rates in the economy. **Hence, 2 is correct.**
- Inflation and short-term interest rates also influence the yield of government bonds. **Hence, 3 is correct.**
- **Therefore, option (d) is the correct answer.**

Q. With reference to 'IFC Masala Bonds', sometimes seen in the news, which of the statements given below is/ are correct? (2016)

1. The International Finance Corporation, which offers these bonds, is an arm of the World Bank.
2. They are the rupee-denominated bonds and are a source of debt financing for the public and private sector.

Select the correct answer using the code given below:

- (a) 1 only
- (b) 2 only
- (c) Both 1 and 2
- (d) Neither 1 nor 2

Ans: (c)

Explanation:

- The World Bank Group, which is a vital source of financial and technical assistance to developing countries, consists of five distinct yet complementary organizations, viz.,
- International Bank for Reconstruction and Development (IBRD),
- International Development Association (IDA),
- International Finance Corporation (IFC), **hence, statement 1 is correct.**
- Multilateral Investment Guarantee Agency (MIGA),
- International Centre for Settlement of Investment Disputes (ICSID).
- Membership in IFC is open only to member countries of the World Bank. Its board was established in 1956. IFC is owned by 184 member countries, a group that collectively determines the policies. Through a Board of Governors and a Board of Directors, the member countries guide IFC's programs and activities.
- Masala Bonds are rupee-denominated borrowings issued by Indian entities in overseas markets. Masala means 'spices' and the term was used by International Finance Corporation (IFC) to popularise the culture and cuisine of India on foreign platforms. The objective of Masala Bonds is to fund infrastructure projects in India, fuel internal growth via borrowings and internationalize the Indian currency. **Hence, statement 2 is correct.**
- **Therefore, option (c) is the correct answer.**

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