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INTRODUCING HOW THE WORLD WORKS

Salon staff writer Andrew Leonard is on special assignment to grapple with the mysteries of globalization. That's a big beat to cover -- too big for any one story or book. But there's a global conversation taking place online that may be up to the task, and that's where "How the World Works" comes in.

"How the World Works" is a blog that aims to bite off small pieces of the big story, while at the same time engaging with the vast complexity of the Internet's multi-threaded dialogue on the global economy. A full introduction can be read [here](#). Previous stories by Leonard on some related topics are linked below.

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You can e-mail me directly at aleonard@salon.com. But to join



How the World Works

BY ANDREW LEONARD

When the yield curve flips ...

If you haven't already seen "[Every Breath You Take](#)," the hilarious satirical video made by Columbia Business School students poking fun at their dean, Glenn Hubbard, and his supposed disappointment at not being named chairman of the Federal Reserve, well, now's your chance. Salon reader Kathy Przekopp alerted me to it last night, labeling it an "economic commentary music video." Who could resist that?

Considered by many to be the intellectual architect of George W. Bush's tax cuts, [Hubbard](#) was chairman of the Council of Economic Advisers from 2001 to 2003. For a dour assessment of his tenure, you can read Clinton-era Treasury economist Brad DeLong's [take here](#). Slate columnist Chris Stuellentrop wrote a [solid assessment](#) toward the end of his chairmanship. Both offer the same criticism. In his zeal to push his preferred economic policies, Hubbard adopted Bush loyalist rhetoric that contradicted views set forth in his own textbooks.

But as I noted [earlier this week](#), the man who did end up getting the job of Federal Reserve chairman, [Ben Bernanke](#), could be headed for rocky waters. Hubbard might end up better off carping from the sideline. Let's unpack the critical stanza:

"First you move your lips
Hike a few more BPs
When demand then dips
And the yield curve flips
I'll be watching you"

BPs are "basis points" -- one point is 1/100 of a percent. So when Bernanke raises rates by .25 percent, that is equal to a rise of 25 basis points. The yield curve, in this instance, is the difference between the interest rates on short-term and long-term Treasury bonds. Usually, short-term bonds offer a lower interest rate than long-term bonds. The yield curve, in other words, is pointed up. But every now and then, the yield curve flips, and short-term rates are higher than long-term rates. In the past, such an "[inverted yield curve](#)" has been seen as a pretty good predictor of an imminent recession. In fact, just after Christmas, short-term bond rates did poke above long-term ones, and there was much fluttering on the economic blogs. However, according, again, to DeLong, the old connection between yield curves and recessions has [been broken](#).

"Usually," writes DeLong, "an inverted yield curve is the result of a lot of domestic investors' thinking the Fed is going to cut short-term interest rates over the next couple of years, and so buying medium- and long-term bonds to lock in higher yields and reap hoped-for capital gains as interest rates fall. What makes the Fed cut short-term interest rates? A recession."

"This inversion of the yield curve, however, is generated not by domestic investors' thinking that a recession is on the way, but by foreign central banks' desires to keep buying lots of dollar-denominated bonds in order to keep their currencies from appreciating."

"Thus while an inverted yield curve is usually a sign that a bunch of people are trading bonds on their belief that a recession is likely, that is not what is going on in this case."

Right now, the yield curve is pretty flat, which is yet another signal that no one really knows where the economy or the Fed is headed. If prices of consumer goods continue to spike, Bernanke's Fed is likely to continue to raise rates. But if economic growth starts to slip, a U-turn could be in the offing, or at least a pause in rate hikes. In any case, we should all be watching.

-- Andrew Leonard

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