

## ABSTRACT

### **A Capital-Based Explanation of an Inverted Yield Curve**

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This paper presents an answer to why the yield curve tends to invert one year before a recession. The capital-based macroeconomic model used in this paper makes a distinction between individual production plans and the social structure of production. The analysis traces out the effects of an injection of short-term working capital into the model. There are two consequences of this injection: the Wicksell effect and the Fisher effect. The Wicksell effect entails the downward pressure on interest rates, while the Fisher effect entails the upward pressure on interest rates.

The analysis then compares the effects of monetary injections with the effects of monetary intermediation. The conclusion reached is that although there are some positive aspects of monetary intermediation, malinvestments still accumulate in the economy.

The analysis then shows that short-term credit can create both short- and long-term malinvestments in the social structure of production. The restricted model demonstrates that, during the malinvestment boom phase, both short- and long-term malinvestments emerge in the early stages of production. These malinvestments are unsustainable and must be liquidated.

The crunch phase of the business cycle begins this process of liquidation. This phase may take the form of a credit crunch, a real resource crunch, or a combination of the two. Each scenario culminates in an inverted yield curve approximately one year before the upper-turning point of a recession. Each recession since the mid-1950s is categorized and is placed into either the credit crunch or the real resource crunch scenarios.

This paper also provides a detailed survey of the literature on the appearance of inverted yield curves before economic downturns.

Additionally, this paper builds a modified Preferred-Habitat Theory of the yield curve on a time-preference based theory of interest. The purpose of this modification is to base the theory on a microeconomic foundation and to demonstrate that a monetary authority can create a relatively stable term structure of interest in disequilibrium.