

THE TERM STRUCTURE OF INTEREST RATES

In Chapter 11 we assumed for the sake of simplicity that the same constant interest rate is used to discount cash flows of any maturity. In the real world this is rarely the case. We have seen, for example, that in late 2000 short-term bonds and notes carried yields to maturity of about $6\frac{1}{4}$ percent while the longest-term bonds offered yields of only 6 percent. At the time when these bond prices were quoted, anyway, the longer-term securities had lower yields. This, in fact, is an uncommon empirical pattern. It is far more common for longer-term bonds to offer higher yields, but as we shall see below, the relationship between time to maturity and yield to maturity can vary dramatically from one period to another.

In this chapter we explore the pattern of interest rates for different-term assets. We attempt to identify the factors that account for that pattern and determine what information may be derived from an analysis of the so-called **term structure of interest rates**, the structure of interest rates for discounting cash flows of different maturities.

