Interest Rates, Inflation, and Bonds: Who Sets Long Yields?

Name Date Class

Reading

1 In the autumn of 2024, the US Federal Reserve cut its policy rate by a full percentage point over three meetings, and the yield on ten-year Treasury bonds rose by roughly the same amount. Twenty years earlier, the pattern ran the other way: the Fed raised rates steadily from mid-2004, yet the ten-year yield fell by about half a percentage point. In February 2005, the Fed chair, Alan Greenspan, called this gap a **conundrum**. If central banks set interest rates, why do long-term borrowing costs so often move on their own?

2 A government bond is a loan to a state, and its yield is the annual return an investor earns by holding it to **maturity**; when the price of the bond falls, its yield rises. A central bank sets only the shortest rate directly. A ten-year yield is better read as two parts: the average short rate that investors expect over the next ten years, and a term **premium**, the extra return they demand for tying up money for so long. Expected inflation feeds into both, because inflation can **erode** the value of fixed payments. This is a framework, not a measurement: the term premium can only be estimated with models, which often disagree.

3 Seen this way, the 2024 puzzle becomes less strange. It is the expected path of rates, not today's rate, that a long yield reflects. By the time the Fed cut, markets had already priced much of the easing. An analysis by J.P. Morgan in January 2025 attributed roughly half of the rise to stronger US growth than expected and much of the rest to uncertainty about rates and inflation, with little role for deficit worries. A cut can also lift long yields if investors question a central bank's **credibility** and suspect it is easing too early. The 2005 case is harder to settle. A popular explanation was heavy buying of Treasuries by foreign central banks, which some estimates put at up to 0.4 percentage points, but a 2005 San Francisco Fed analysis by Tao Wu found little solid evidence of a lasting effect.

4 A second force is the borrower itself. Yields on **sovereign** debt also reflect each state's **fiscal** position, so heavy borrowing can lift long rates whatever the central bank does. The Reserve Bank of India cut its policy rate by 1.25 percentage points during 2025, to 5.25 percent, yet in the days after its December cut the ten-year yield rose to about 6.6 percent. Dealers quoted by the newspaper Business Standard blamed a heavy supply of government bonds and selling by foreign investors. Britain gave a sharper example in September 2022, when a budget with large unfunded tax cuts sent long yields soaring and the Bank of England had to buy long bonds temporarily to calm the market. In both cases, what lifted yields was the supply of government debt, or doubt about how it would be financed, rather than a change in policy rates.

5 Japan shows how these forces combine. For more than a decade, the Bank of Japan held yields near zero with **accommodative** policy and huge bond purchases, ending negative rates only in March 2024. As the bank steps back, private investors must absorb the bonds of a government whose debt is more than twice the size of the economy. On 1 September 2026, the ten-year yield passed 3 percent for the first time since 1996, Bloomberg reported, even though core inflation was only 1.7 percent in August. A weak yen added pressure: according to UPI, Japan spent a record 15.4 trillion yen buying its own currency between late July and late August.

6 The events of September 2026 illustrate the pricing point. An energy shock linked to conflict in the Middle East turned several central banks **hawkish**. The European Central Bank raised its deposit rate to 2.50 percent on 10 September, and the Fed raised its target range to 3.75 to 4 percent on 16 September, its first rise since 2023. On 18 September, the Bank of Japan raised its rate to 1.25 percent, the highest since 1995, although two board members registered **dissent**. Yet US and Japanese long yields edged down after the decisions, CNBC reported, because markets had begun to **reprice** the path of policy weeks earlier. Analysts at Charles Schwab, using a New York Fed model, estimated that most of the 2026 rise in the US ten-year yield, about 0.8 percentage points, came from higher expected short rates, not from the term premium.

7 Yields also cross borders. When rates rise in large economies, emerging-market bonds lose part of their return advantage, and **outflows** of foreign money can weaken currencies and push local yields higher. In early September 2026, the Indian publication DSIJ linked the climb of India's ten-year yield toward 7 percent to oil prices and US rates, a typical case of **spillover**. This is one reason the long end of the market can be more **volatile** than the policy rate. It is the policy rate that anchors short-term borrowing, but expectations, credibility, public finances, and global flows decide where long yields settle. The next test is whether inflation expectations become **entrenched** and the term premium, small in 2026 by Schwab's estimate, starts to carry more of the rise.

Vocabulary Matching

Match each word from the reading with its meaning. Write the letter on the line.

1	**conundrum**	_____	**A**	the date when a bond's loan must be repaid
2	**maturity**	_____	**B**	an effect that spreads from one place to another
3	**premium**	_____	**C**	changing rapidly and unpredictably
4	**erode**	_____	**D**	favoring higher interest rates to fight inflation
5	**credibility**	_____	**E**	supportive of growth, with low interest rates
6	**sovereign**	_____	**F**	firmly established and hard to change
7	**fiscal**	_____	**G**	the quality of being trusted to keep promises
8	**accommodative**	_____	**H**	an extra amount paid or demanded for a risk
9	**hawkish**	_____	**I**	relating to government spending and taxation
10	**dissent**	_____	**J**	change the price or valuation of something
11	**reprice**	_____	**K**	movements of money out of a country
12	**outflows**	_____	**L**	gradually wear away or reduce the value of
13	**spillover**	_____	**M**	relating to a state that governs itself
14	**volatile**	_____	**N**	a confusing problem that is hard to explain
15	**entrenched**	_____	**O**	disagreement with an official decision

Fill in the Blank

Choose a word from the box to complete each sentence. Use each word once. The words are already in the correct form.

accommodative	**conundrum**	**credibility**	**dissent**	**entrenched**	**erode**	**fiscal**	**hawkish**	**maturity**
outflows	**premium**	**sovereign**	**spillover**	**volatile**				

1 Choosing between two good job offers was a real _____ .

2 The bond reaches _____ in 2036, when the state repays the loan.

3 Investors pay a _____ for the safest bonds.

4 Inflation can _____ the value of savings.

5 A central bank's _____ takes years to build.

6 The country's _____ debt rating was lowered.

7 The government promised _____ discipline.

8 The bank kept an _____ stance during the crisis.

9 The governor's _____ speech pushed yields higher.

10 The court published the judge's _____ .

11 Foreign investors caused large capital _____ .

12 The banking crisis had a _____ effect on trade.

13 The market was _____ after the announcement.

14 The problem is deeply _____ in the system.

Comprehension Questions

Answer in your notebook or discuss with a partner. Questions 10 to 12 are IELTS-style.

1 What do the two opening examples from 2024 and 2004 to 2005 have in common?

2 How does the reading divide a ten-year yield, and where does expected inflation fit?

3 Why does the writer call this a framework rather than a measurement?

4 How did J.P. Morgan explain the rise in US yields after the Fed began cutting in 2024?

5 Why is the 2005 conundrum harder to explain than the 2024 case?

6 What do the Indian and British examples show about government borrowing and yields?

7 Which factors pushed Japan's ten-year yield above 3 percent even though inflation was low?

8 Why did US and Japanese long yields edge down after the rate rises of September 2026?

9 How can higher rates in large economies affect emerging markets, and what example does the reading give?

IELTS-Style Questions

10 **True, False, or Not Given:** "*The Reserve Bank of India raised its policy rate in 2026.*" Explain your answer using evidence from the reading.

11 **Yes, No, or Not Given:** "*The writer believes that the policy rate alone decides where long-term yields settle.*" Explain your answer using evidence from the reading.

12 **Author's purpose:** Why does the writer open with two puzzles from the United States before explaining what a long-term yield is? What effect does this have?

True or False

Circle T (true) or F (false) according to the reading. Write a correction for each false statement on the dotted line.

1 **T / F** The Fed cut its policy rate by a full percentage point in the autumn of 2024.

2 **T / F** Greenspan used the word conundrum in 2024.

3 **T / F** Central banks directly set ten-year yields.

4 **T / F** The term premium can be observed directly in the market.

5 **T / F** J.P. Morgan found little role for worries about deficits in the 2024 rise.

6 **T / F** The Reserve Bank of India cut its policy rate by 1.25 percentage points during 2025.

7 **T / F** The British bond market stress of 2022 followed a cut in the policy rate.

8 **T / F** The Bank of Japan ended negative interest rates in March 2024.

9 **T / F** The Bank of Japan's September 2026 decision was unanimous.

10 **T / F** Schwab estimated that most of the 2026 rise came from higher expected short rates.

Discussion Questions

Talk with a partner or in a small group. The questions move from personal to more abstract.

1 Before reading, did you assume that long-term interest rates simply follow the central bank? What, if anything, changed your view?

2 In your country, do people usually borrow for a home at fixed or variable rates? How does that affect who feels a change in bond yields first?

3 The reading uses a term premium that cannot be observed. Why might a quantity that has to be estimated still be useful?

4 Why might markets price a rate cut or rise weeks before a central bank announces it? What does that suggest about the value of central bank guidance?

5 Analysts gave different weights to growth, uncertainty, and deficits in the 2024 case. How should a reader handle competing explanations of the same market move?

6 The 2005 conundrum was never fully explained. Is it acceptable for economists to leave such puzzles open, or does that weaken trust in economics?

7 When a government borrows heavily, who should bear the cost of higher yields: taxpayers today, future taxpayers, or bond investors?

8 The Bank of England bought bonds in 2022 while it was trying to fight inflation. Can a central bank pursue market stability and price stability at the same time?

9 Japan's government debt is more than twice the size of its economy, yet it borrowed cheaply for many years. What might explain this, and could it change?

10 Several central banks publish how each board member voted. Does revealing dissent strengthen or weaken a central bank's credibility?

11 Should a country spend its reserves to support its currency, as Japan did in 2026? What are the risks of doing so?

12 How can emerging economies protect themselves from spillover when rates rise in larger economies, and what does that protection cost?

13 Who gains and who loses when long-term yields rise: savers, borrowers, pension funds, or governments?

14 If inflation expectations became entrenched, what would central banks and governments each need to do, and could their goals conflict?

Language Focus: Cleft Sentences: It is … that and What … was

A cleft sentence splits one idea into two clauses to put one part in focus. An it-cleft (It is X that …) highlights X, often to contrast it with something else. A wh-cleft (What … was X) delays the key information to the end of the sentence, where the reader expects new and important content.

In the reading:

- "**It is** the expected path of rates, not today's rate, **that** a long yield reflects."
- "In both cases, **what** lifted yields **was** the supply of government debt, or doubt about how it would be financed, rather than a change in policy rates."
- "**It is** the policy rate **that** anchors short-term borrowing, but expectations, credibility, public finances, and global flows decide where long yields settle."

Practice: Rewrite as a cleft sentence that puts the focus on *expected growth*: *"Expected growth, not deficits, explained most of the rise in yields."*

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Notes