

Harwick

of all maturities.' For the simple case of discount (zero-coupon) bonds, this implies term yields that are averages of current and expected short-term yields (see Box).

To convert the expectations theory into an additional explanation of the term structure, a mechanism for determining expected short-term yields must be specified. Only two of the most common types of expectations—expectations that are positive and regressive—are considered

This statement may be illustrated as follows for 1- and 2-period bonds and a 1-period holding period. The 1-period rate of return on a 2-period zero-coupon bond worth \$1 at maturity is

$$\frac{P_2 - P_1}{P_2} = \frac{\frac{1}{1+r_1} - \frac{1}{1+r_2}}{\frac{1}{1+r_1}} = \frac{1 - \frac{1+r_1}{1+r_2}}{1+r_1} = \frac{r_2 - r_1}{1+r_1}$$

If  $P_2$  is the current price of the 2-period bond and  $P_1$  is the price currently expected to prevail next period on a 1-period bond. If the expectations theory holds (see equation (1) in Box) this rate-of-return equals  $R_1$ —i.e., the expected 1-period returns on 1- and 2-period bonds are equal. As indicated in the Box, these results hold precisely under conditions of certainty.

Figure 1  
Panel A: yield curves for high-grade corporate bonds, 1900-1929

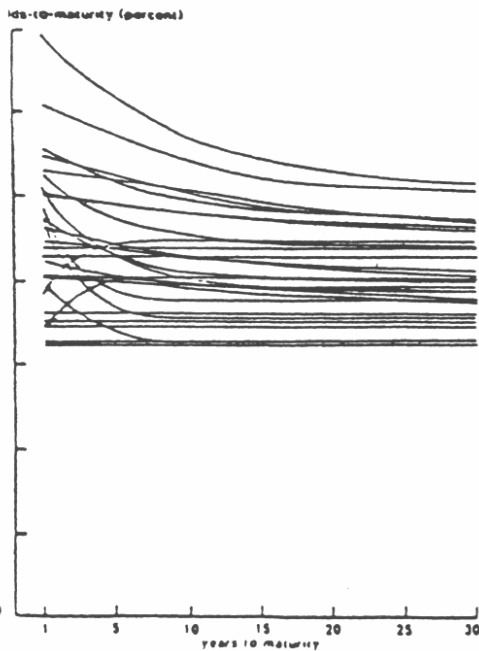


Figure 1  
Panel B: yield curves for high-grade corporate bonds, 1930-1982

