

Risk Sharing and the Term Structure of Interest Rates

Abstract. I propose a general equilibrium model with heterogeneous investors to explain the key properties of the U.S. real and nominal term structure of interest rates. I find that differences in investors' willingness to substitute consumption across time are critical to account for nominal and real yields dynamics. When the endogenous amount of credit supplied by risk-tolerant investors is low, the aggregate price of risk and real interest rate are high. Thus, real bonds are risky. I study nominal bonds under both exogenous and endogenous (Taylor rule) inflation. I find that when the Taylor loading on inflation is greater than one, the nominal term structure is upward sloping regardless of the correlation between nominal and real shocks. I use the model to shed light on two salient interest rate puzzles: (1) the secular decline of long-term real and nominal rates since the 1980s, and (2) the sudden spike in real yields at the height of the Great Recession