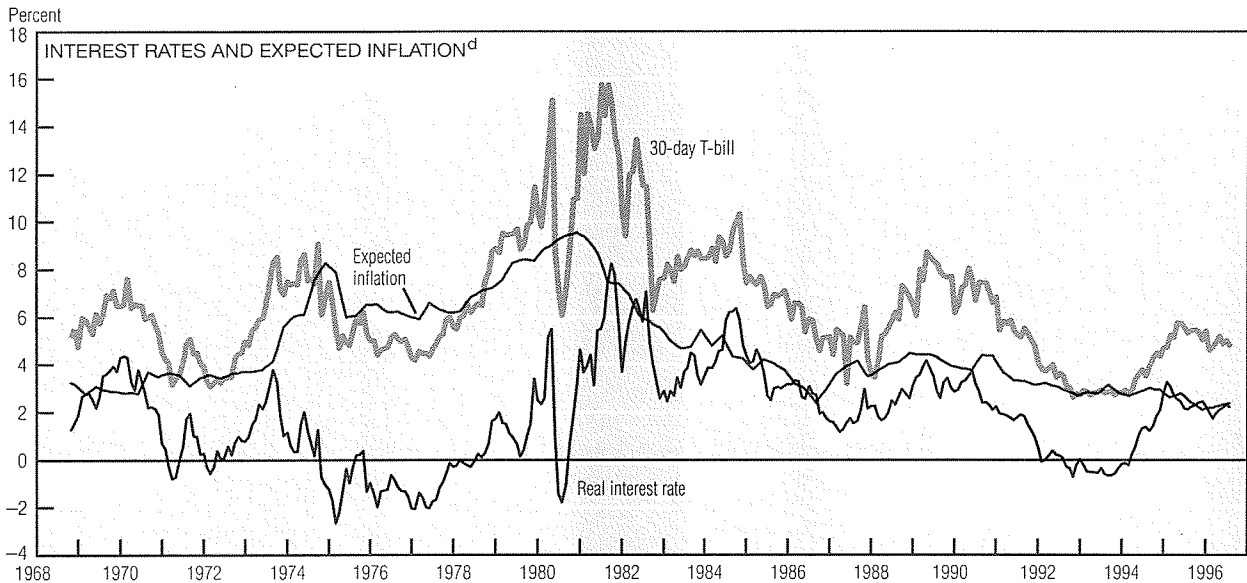
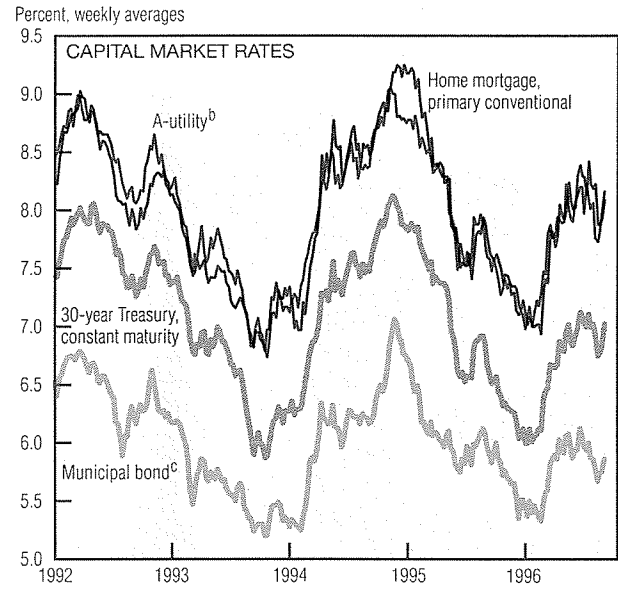
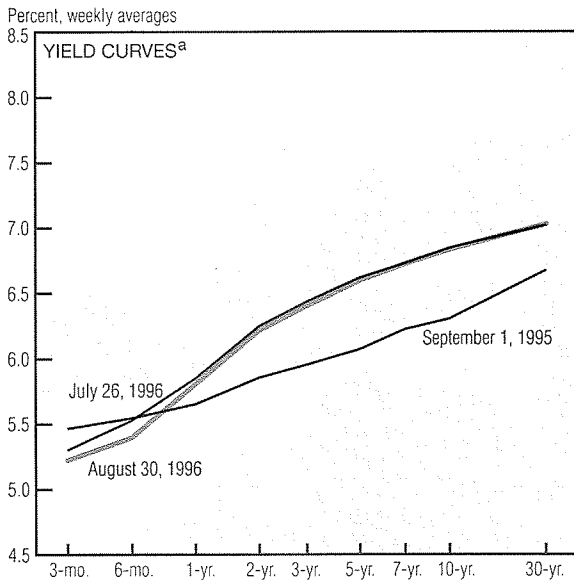


Interest Rates



a. All instruments are constant-maturity series.

b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.

c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.

d. The real interest rate and expected inflation rate are from the Survey of Professional Forecasters and are calculated using the 30-day T-bill rate.

SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; and *The Wall Street Journal*, various issues.

After having spent most of August at lower levels, the yield curve has recently shifted up to where it stood at the end of July. The 3-year, 3-month spread and the 10-year, 3-month spread have both widened slightly, moving to 118 and 161 basis points, still well above their 30-year averages of 80 and 120.

Capital market rates have also followed this pattern, but while 30-year Treasuries and municipal bonds have moved within one basis point of their July values, mortgage rates have not kept pace. Utility rates have moved above mortgage rates

for the first time since the week ending July 5.

Interest rates are usually quoted in nominal terms, but it is sometimes better to look at them from a real, or inflation-adjusted, perspective. Inflation adjustments come in two shapes. After a bond has matured, its return can be adjusted ex post for the inflation that actually occurred. Prior to maturity, a bond's yield can be adjusted ex ante for expected inflation. The bottom chart shows one such ex ante adjustment that accounts for the risk of inflation and the correlation between inflation

and real interest rates.

Since the beginning of last year, real rates have averaged around 2%, rising from negative levels in early 1994 to more than 3% in the first few months of 1995. Expected inflation rates have shown a similar uneven decline, edging down from 2.7% in February 1995 to just below 2.4% last month. These movements seem relatively minor compared to the large shifts of the early 1980s, when the 30-day T-bill went above 15% and real rates dropped by more than 7% in less than a year.