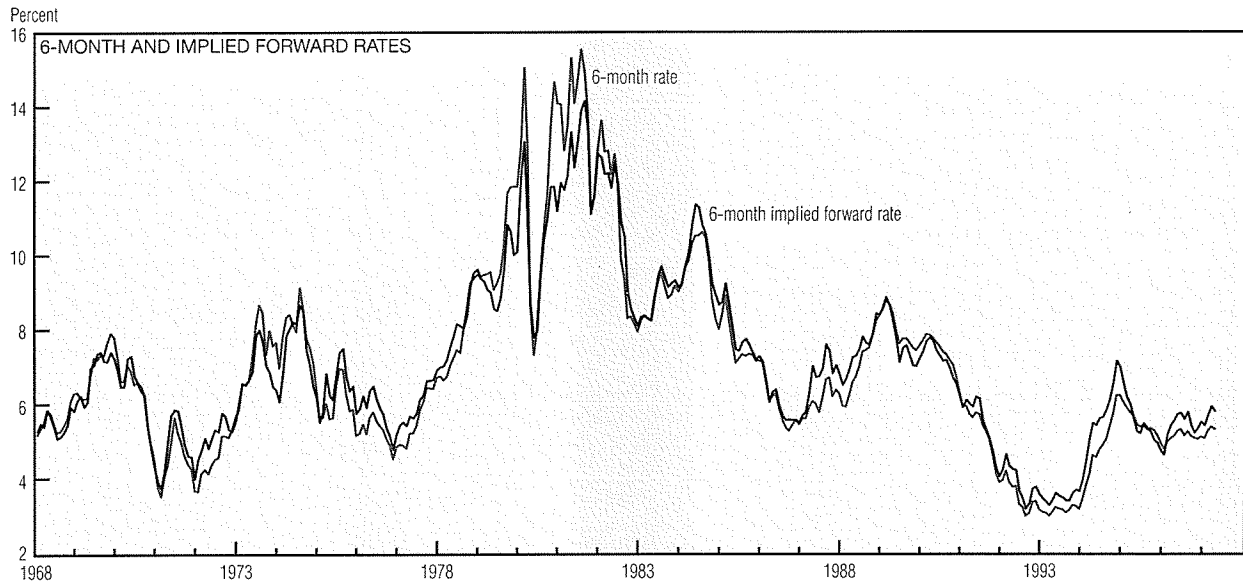
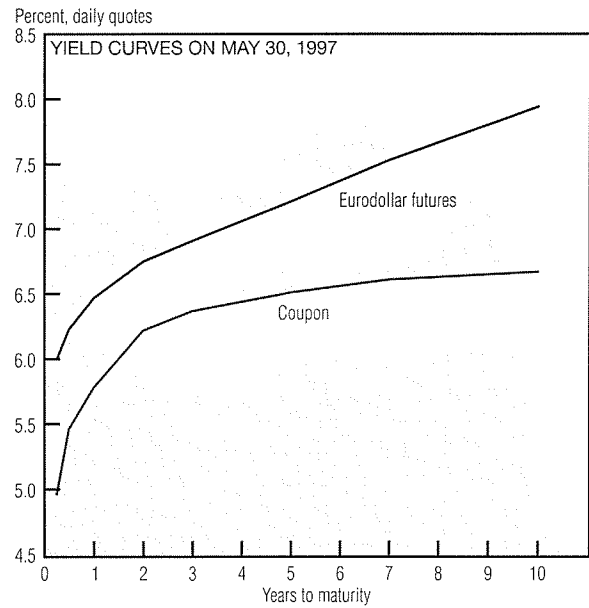
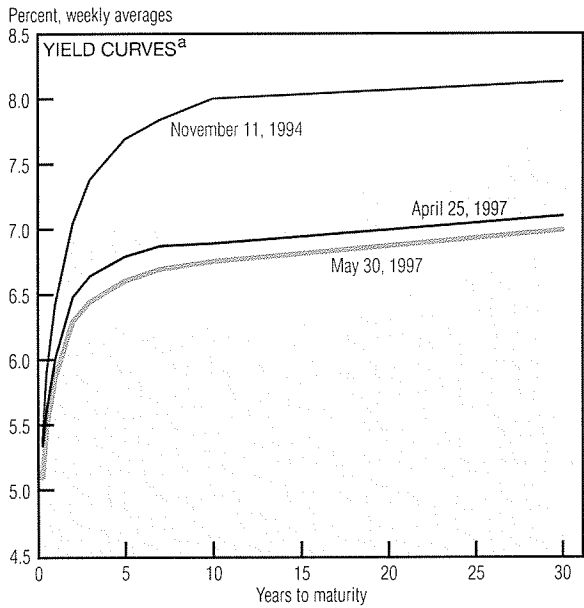


# Interest Rates



a. All instruments are constant-maturity series.

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

Since April, interest rates have shifted downward. The bellwether 30-year rate dropped below 7%, and shorter rates responded similarly. Between April and May, the yield curve also steepened somewhat, with the 3-year, 3-month spread widening from 130 basis points to 135, and the 10-year, 3-month spread moving from 155 basis points to 166.

Although these spreads remain higher than average, they are still well below those of November 1994, when they stood at 202 and

264 basis points, respectively. An alternative yield curve, Eurodollar futures contracts, shows a different aspect of the market. Based on the London Interbank Offered Rate, which includes default risk, this alternative is higher than the Treasury yield curve. It is also steeper, with a 10-year, 3-month spread of 194 basis points.

The expectations hypothesis tries to explain the yield curve as an average of today's short rate and *expected* future short rates. If this is so, the yield curve should predict

future short rates. The expected future interest rate derived in this manner is called the *implied forward rate*. As a predictor of future rates, the 6-month implied forward rate does not do so well. Generally, the forward rate rises with current rates rather than with future rates. This suggests that long-term bonds pay high rates, not because rates are expected to rise in the future, but because the return to holding bonds is high. For example, people may demand such long-term bonds for retirement or college tuition.