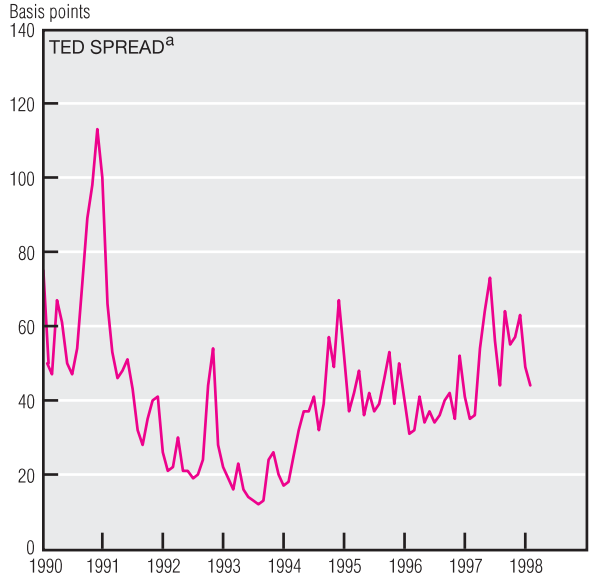
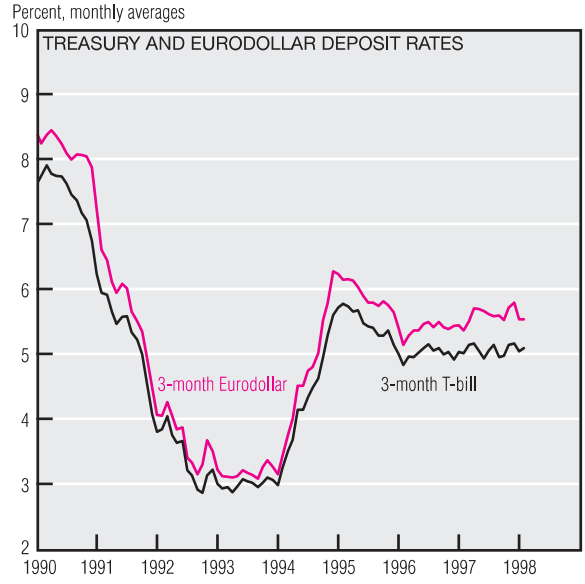
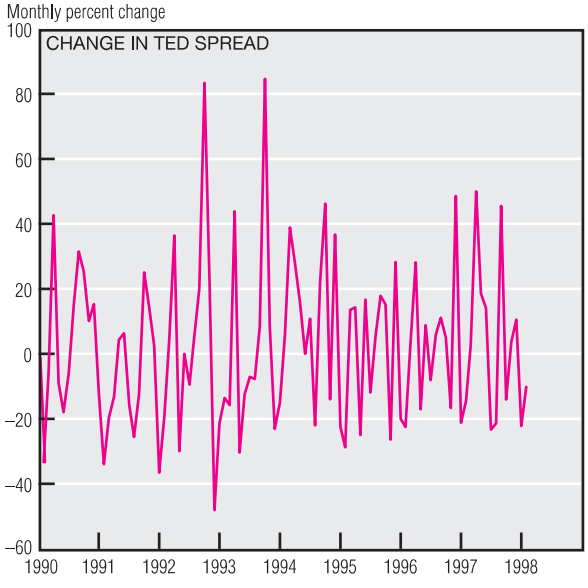
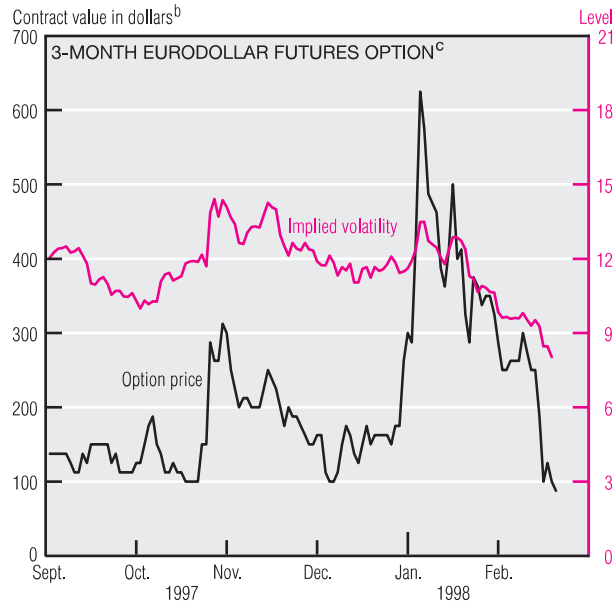
The TED Spread









a. 3-month Eurodollar rate minus 3-month Treasury bill rate.
b. Price of the futures option times $2,500, the value of one point.
c. For June 1998 at a strike price of 94.5.
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg information services.

With Southeast Asia's financial woes looming large in the minds of economists, the TED spread—the difference between interest rates on Treasury securities and Eurodollar instruments of the same maturity—has become an attractive measure of international financial uncertainty. This spread reflects the risk surrounding overseas deposits, without the complication of exchange rate risk. The Eurodollar embeds the default risk of the issuing bank and is generally higher than the corresponding U.S. Treasury security.

At first glance, Treasury and Eurodollar rates appear to track each other closely, but further observation reveals an active spread between them. The Gulf War produced a large gap in 1990–91, while last year's spikes have been attributed to introduction of the Euro, transfer of power in Hong Kong, and the Southeast Asian financial crisis. The variability of the spread also fluctuates, having shown a marked increase in 1992–93.

One of the many ways investors can protect themselves from uncertainty is by entering the options market. The June 1998 call, at 94.5, gives the investor the right, but not the obligation, to purchase a Eurodollar futures contract at 94.5 (out of 100). For a buyer to land "in the money," the contract price would have to exceed that amount at expiration.