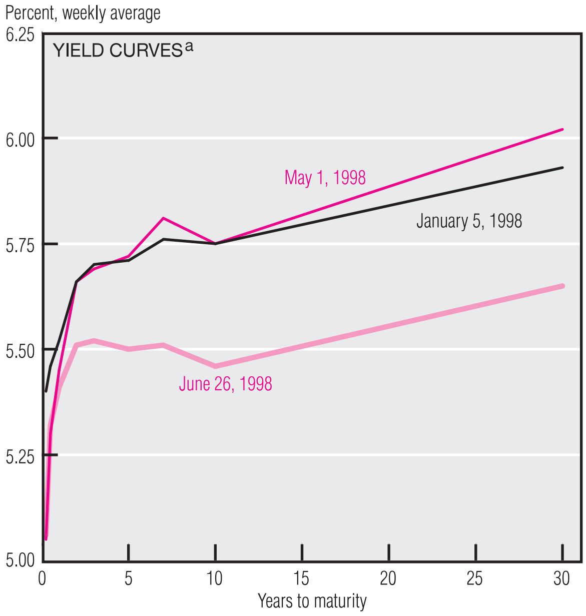
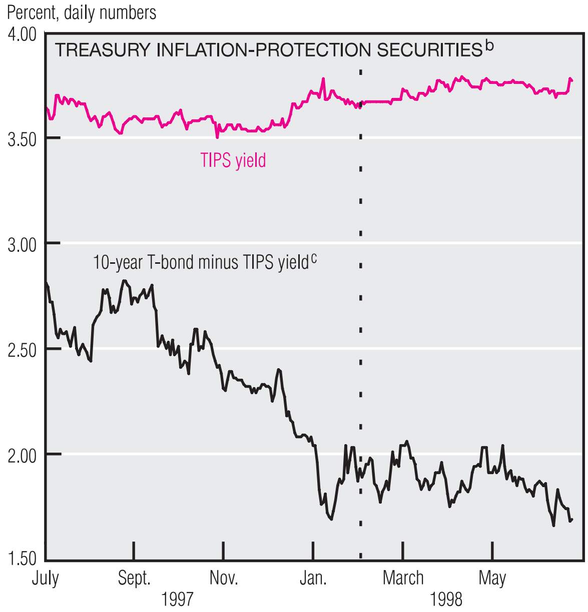
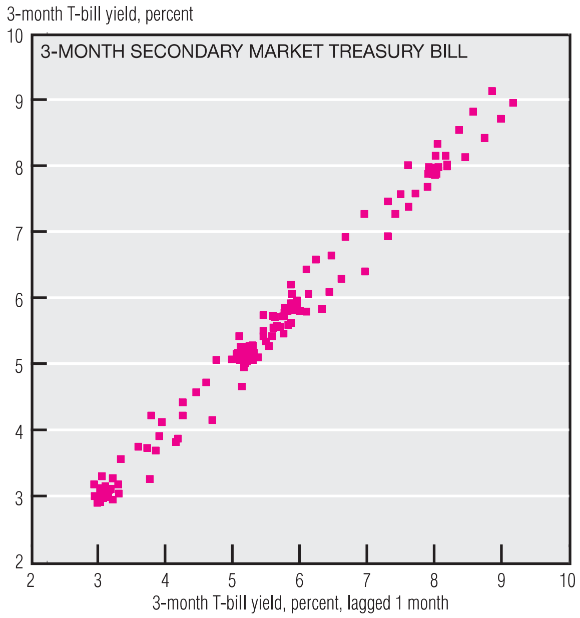
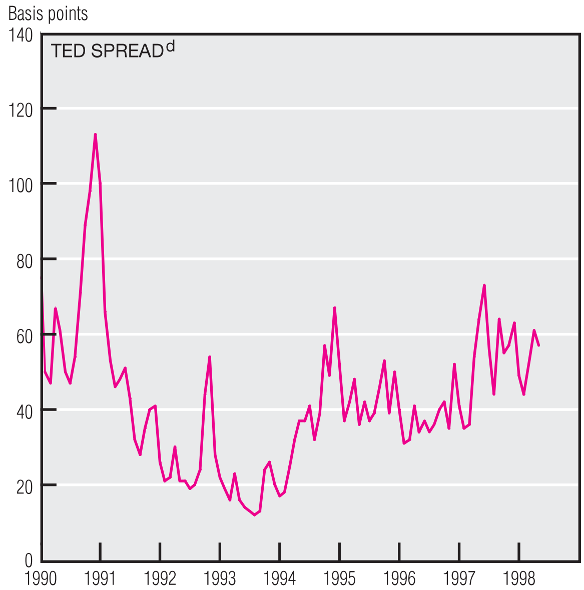
Interest Rates









a. All instruments are constant-maturity series.
b. Vertical line marks the change from the TIPS series that is due to mature in 2007 to the series due to mature in 2008.
c. 10-year Treasury bond constant-maturity yield minus the yield quote for the TIPS-adjusted series.
d. 3-month Eurodollar rate minus the 3-month secondary market Treasury bill rate.
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg information services.

In the past several months, the yield curve has flattened noticeably, with the benchmark 10-year, 3-month and 3-year, 3-month spreads decreasing from 70 to 40 basis points and from 64 to 46 basis points. The middle continues to show some inversions, where shorter rates exceed longer ones. The long bond rate, which as of May 1 had surpassed its early January level, has since dropped 37 basis points.

A controversy swirls around whether a flattening yield curve indicates slower economic growth or a new age of low inflation. One measure of inflationary expectations (at least those of bond market participants) is the spread between the yield on nominal 10-year bonds and the yield on 10-year Treasury Inflation-Protection Securities, which has fallen 35 basis points since its recent peak in early May. This may indicate lower expected inflation, although the current 1.69 value is in line with January levels.

Interest rates' rather gradual movement can be pictured in a different way. Interest rates show strong persistence, or, in statistical jargon, high serial correlation: If they are high today, they will probably be high tomorrow. Still, large movements can occur, especially in spreads, one of which is now being closely watched because of the Asian crisis: The Treasury-to-Eurodollar (TED) spread has been rising throughout most of 1998, although its most recent moves have been downward. The rise shows that investors demand a higher return for holding dollar-denominated assets overseas rather than as U.S. Treasuries, perhaps signifying greater worry over international considerations.