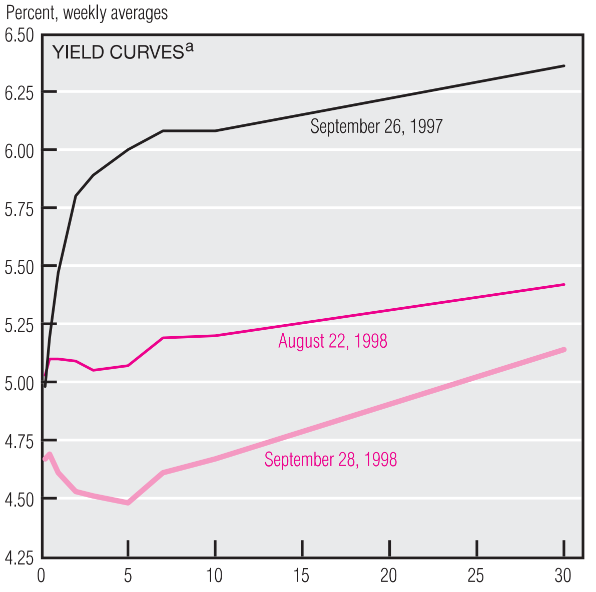
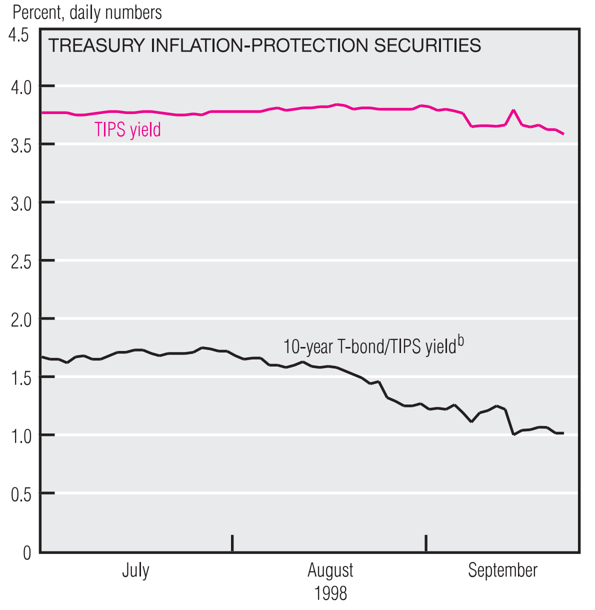
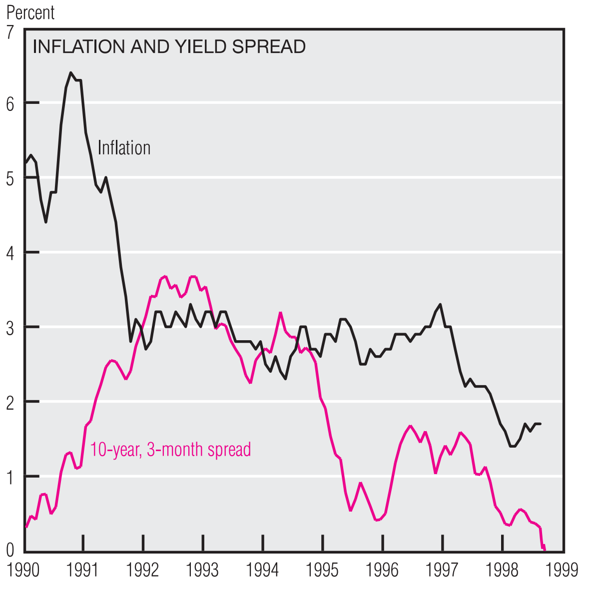
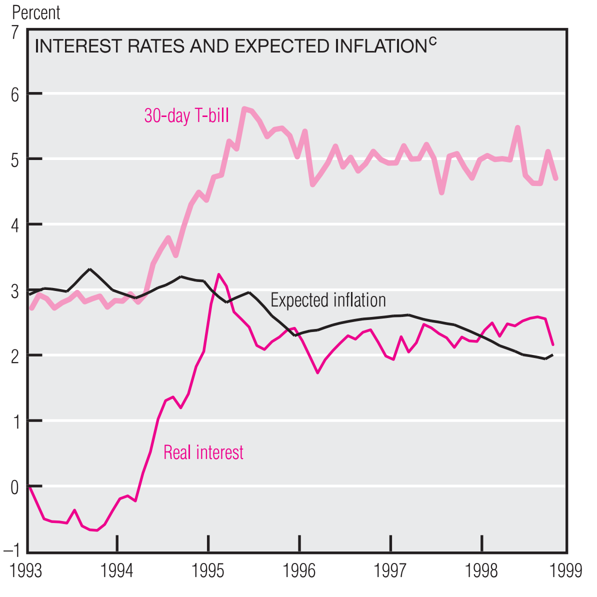
Interest Rates









a. All instruments are constant-maturity series.
b. 10-year Treasury constant-maturity bond yield minus market yield on 10-year TIPS bond.
c. The real interest rate and the expected inflation rate, from the Survey of Professional Forecasters, are calculated using the 30-day T-bill rate.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; Bloomberg information services; and *Wall Street Journal*, various issues.

The yield curve has continued to move down and flatten, showing an inversion at some rates. The shift is quite noticeable in comparison to the yield curve of one year ago, which was itself slightly flat by historical standards. The closely watched 3-year, 3-month and 10-year, 3-month spreads stand at –16 and zero basis points. Such a flat yield curve traditionally has indicated either slow economic growth or low expectations of inflation. Certainly in the 1990–92 period, real factors proved more important, and the spread widened despite a sustained fall in inflation. Inflation has dominated more recently, although in 1998 inflation and the spread have again moved in opposite directions.

The spread between nominal 10-year Treasury bonds and 10-year Treasury inflation-protection securities (TIPS) provides a more direct measure of inflationary expectations than does the yield spread. TIPS yields have declined slightly in September, but the steeper drop in Treasuries has decreased the spread from 175 basis points in July to 101 basis points in late September. This may indicate a reduced fear of inflation, but it may also reflect a flight to quality in safe, liquid Treasuries, which do not include the relatively illiquid TIPS.

A shorter-term measure of real rates and expected inflation can be uncovered by combining nominal rates with professional forecasts of inflation. Such results (which must be used cautiously) show a steady decline in expected inflation since early 1997, with a barely noticeable upturn in the most recent month.