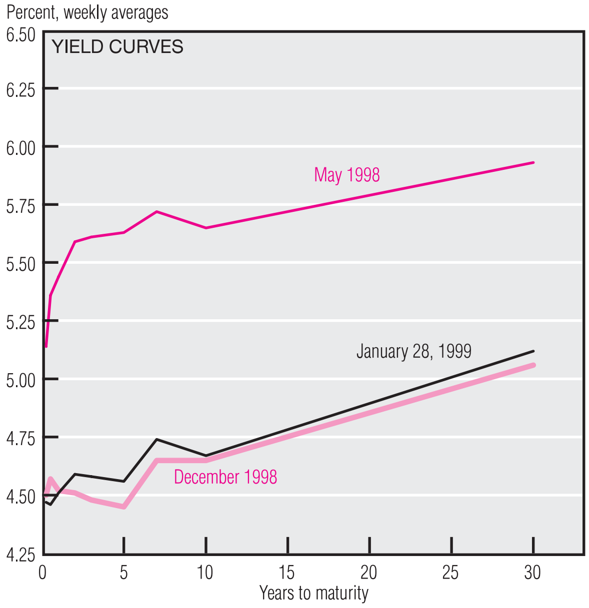
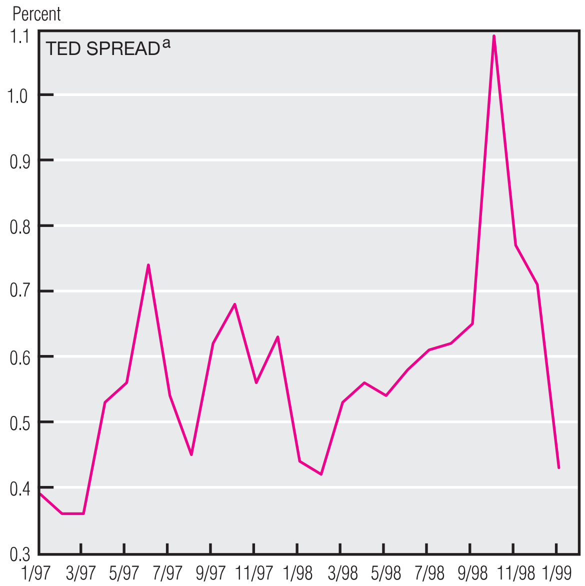
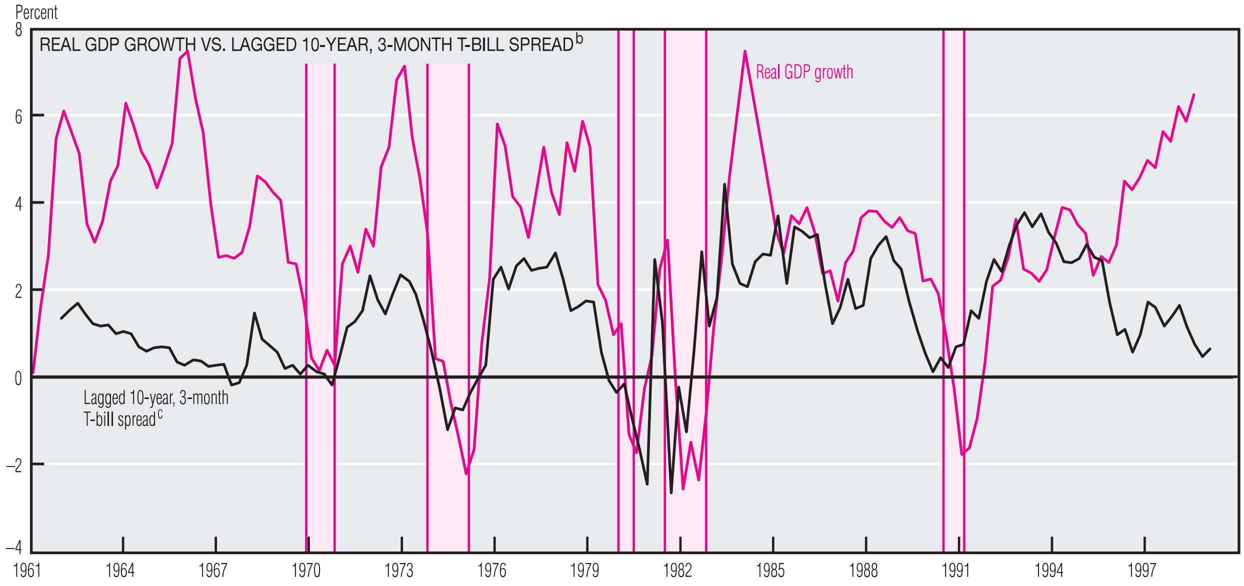
Interest Rates







a. The spread between the 3-month Eurodollar deposit rate and the 3-month Treasury-bill rate.
b. Shaded areas indicate recessions.
c. 10-year, 3-month spread lagged four quarters.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, statistical releases.

The yield curve remains rather flat, having shown little movement since last month. At the long end, rates on 30-year bonds increased a scant six basis points; at the short end, three-month rates dropped three basis points.

The introduction of the euro, heralded by some as the dawn of a new era, was decried by others as a doomed experiment. By one measure, the Treasury-to-Eurodollar (TED) spread, the experiment seems a success. The spread continued its downward trend from its peak of 109 basis points in October, a sign that the flight to quality, so evident after the turmoil in Russia and East Asia, was slowing. Now, at 44 basis points, the spread has returned to its pre-crisis level. This seems to indicate that the market, at least, did not believe that the euro placed any unbearable strains upon the European banking system.

One classic application uses spreads in the yield curve to predict future economic activity. In the simplest approach, a yield-curve inversion signals a recession; more generally, the size of the spread provides information about future growth. The standard story here is that the 10-year, 3-month spread predicts growth over the next four quarters. Since late 1995, however, this relationship has become suspect because a relatively flat yield curve has persisted in the face of robust growth. The spread currently stands at 20 basis points, historically a rather low number, though recent experience suggests it may not be a cause for great concern.