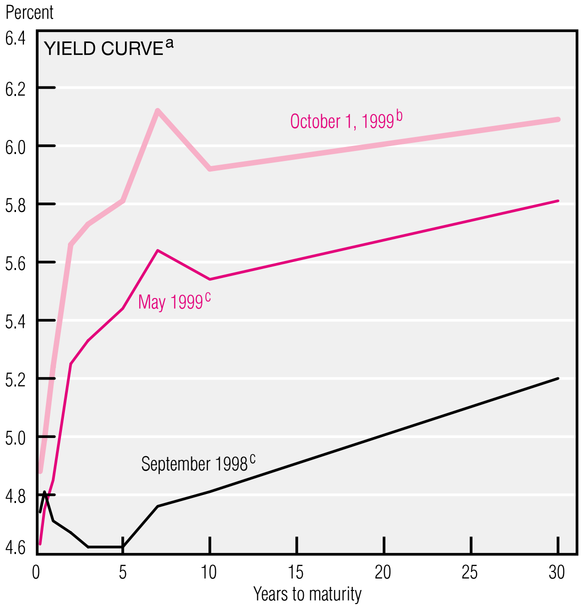
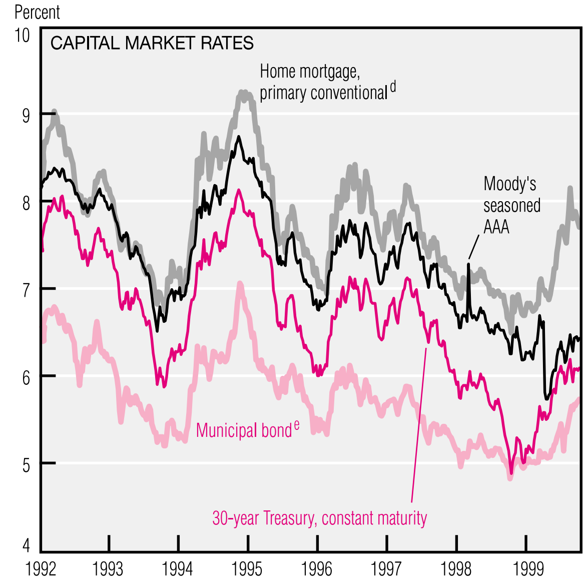
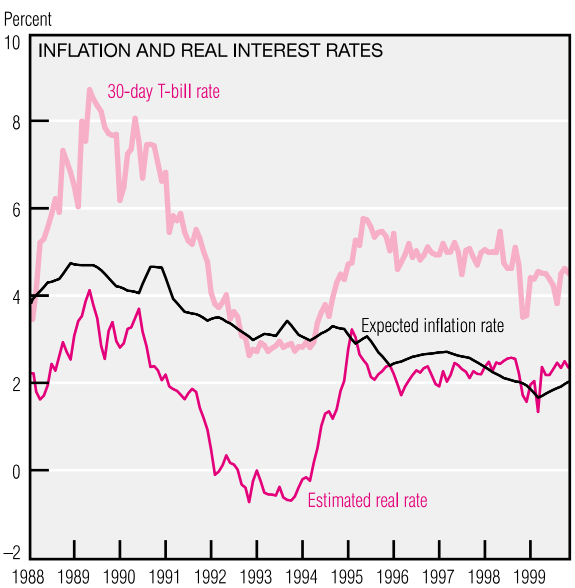
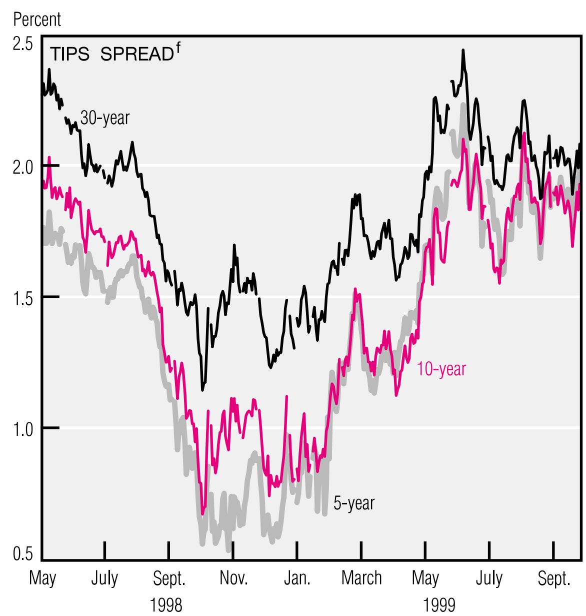
Interest Rates









a. All yields are from constant-maturity series.
b. Weekly averages.
c. Monthly averages.
d. Contract interest rates on commitments for fixed-rate first mortgages.
e. Bond Buyer Index general obligation, 20 years to maturity, mixed quality, Thursday quotations.
f. The spread between the interest rate on constant-maturity Treasury securities and the interest rate on Treasury inflation-protection securities with the same maturity.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases,* H.15; Bloomberg Financial Information Services; and the *Wall Street Journal.*

What a difference a year makes! One year ago, financial markets were still reeling from the Asian crisis, the Russian default, the collapse of Long Term Capital Management, and the associated flight to quality and liquidity. The Treasury yield curve has moved from a position of short-rate inversion with a 10-year, 3-month spread of only seven basis points (bp) to a more normal, upward-sloping shape with a 10-year, 3-month spread of 104 bp, just below the historical average of 120 bp.

An increase in long rates has contributed to the steepening of the yield curve, but not all long-term rates have increased by the same amount as 30-year Treasuries. Home mortgage rates have risen equally with Treasuries (87 bp since the beginning of the year). However, yields on municipal bonds and on seasoned (that is, not newly issued) corporate AAA bonds have not kept pace.

Long rates often vary with expectations of inflation, and there is some evidence that such expectations have increased over the past year. A procedure that uses 30-day T-bill rates in conjunction with survey forecasts shows that expectations of short-term inflation have increased from 1.66% in March 1999 to 1.98% in October 1999. Expectations of longer-term inflation, obtained by subtracting the yield on Treasury inflation-protection securities (TIPS) from the nominal bond yield, also show an increase. Only part of the increased spread represents a retreat from last year's flight to liquidity.