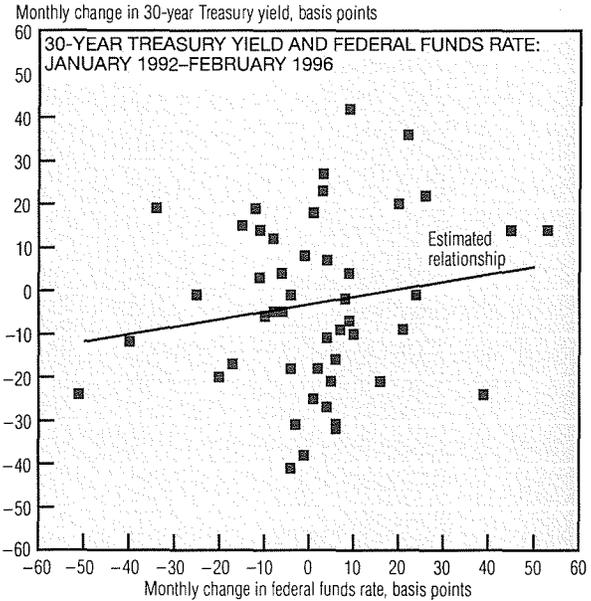
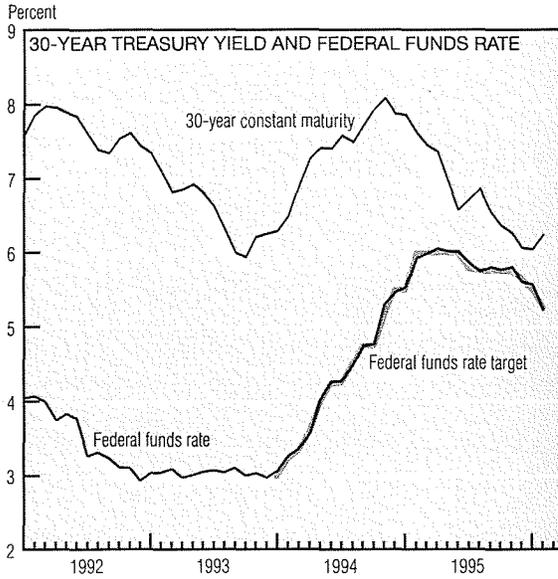
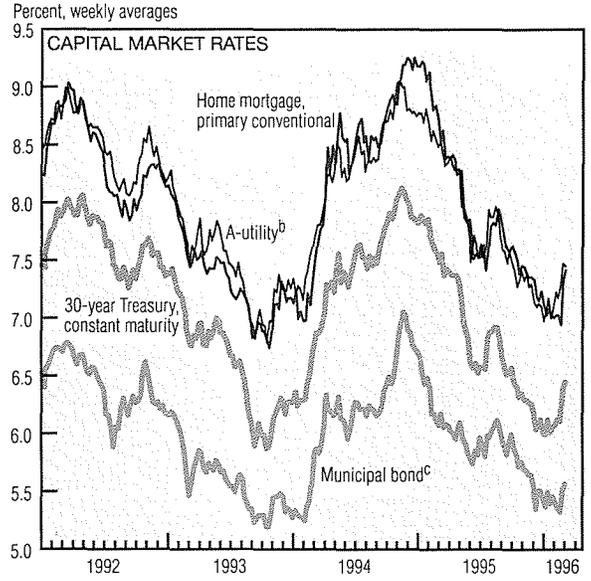
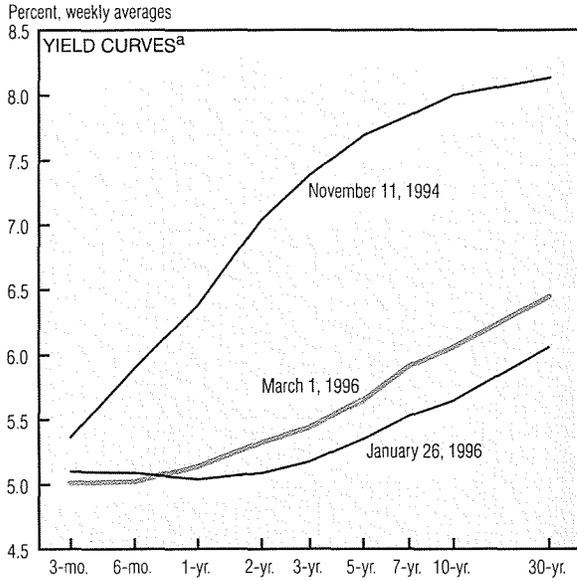


Interest Rates



a. Three-month, six-month, and one-year instruments are quoted from the secondary market on a yield basis; all other instruments are constant-maturity series.
 b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
 c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
 SOURCE: Board of Governors of the Federal Reserve System.

Long-term interest rates have increased in the past month, leading to a steepening in the Treasury yield curve. A slight drop in short-term rates also contributed to the rise. Popular explanations for this development vary. Some contend it reflects a stronger economy, while others fear rising inflation—whether tied to monetary policy or to the expressions of presidential hopefuls. In any case, the development shows that bond markets incorporate ex-

pectations about future economic activity and inflation.

When considering the influence of monetary policy on long-term interest rates, one should examine the historical relationship between the federal funds rate (the Federal Reserve's short-term target rate) and the 30-year Treasury bond rate (traditionally thought to be a bellwether of inflation). In 1993, the federal funds rate held steady but the long rate fell, narrowing the spread between the two from 450 to 300 basis

points. The spread continued to shrink through most of 1994 as both rates rose, but as the year came to an end, long rates headed down once again. Since December 1995, rates have diverged, and the spread has more than doubled.

In short, the Treasury yield spread can be affected by influences exerted at either end. A plot of monthly changes in both the federal funds rate and the 30-year Treasury rate illustrates a weak connection at best.