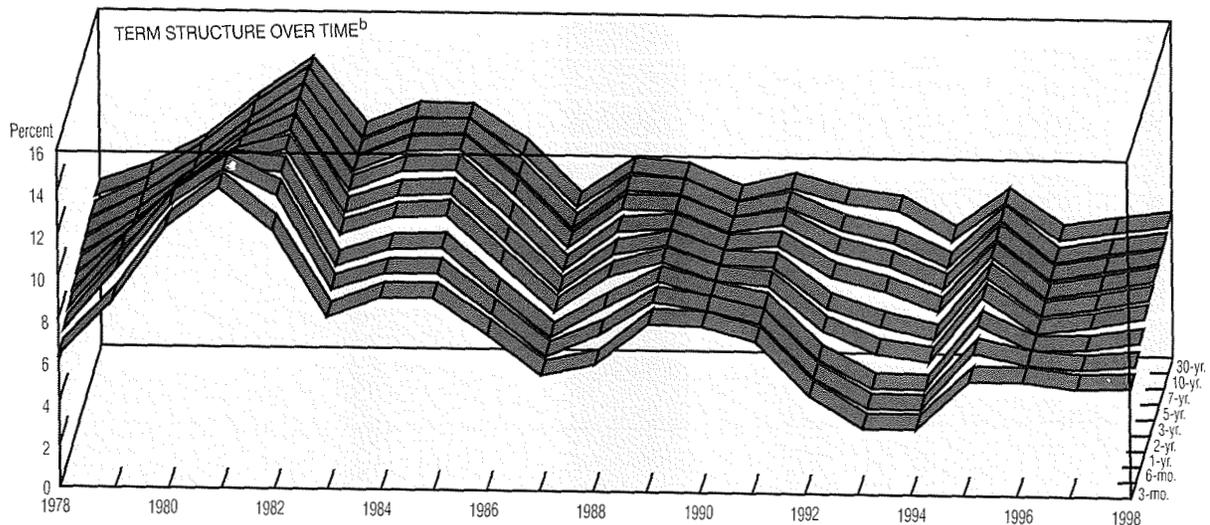
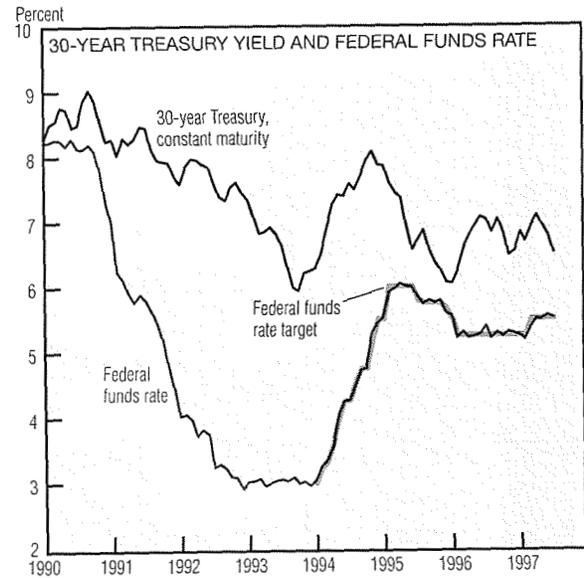
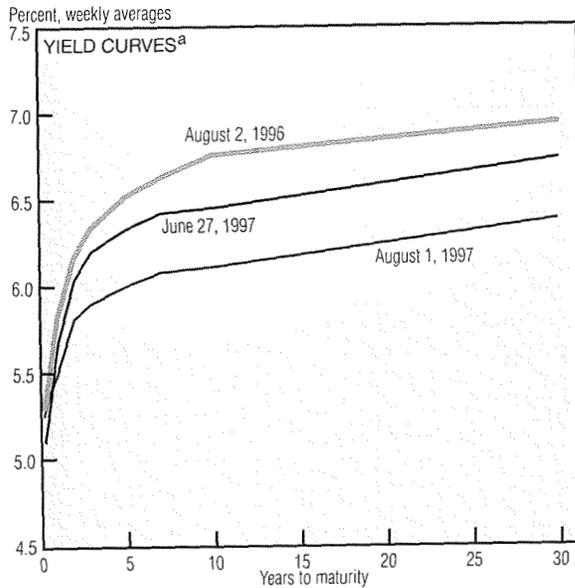


Interest Rates



a. All instruments are constant-maturity series.
 b. End-of-period quarterly averages of daily data. All observations are fourth-quarter data except the final one, which is for 1997:1Q.
 SOURCE: Board of Governors of the Federal Reserve System.

The yield curve has flattened since last month, with long rates falling and short rates rising. The often-watched 3-year, 3-month spread and 10-year, 3-month spread stand at 65 and 86 basis points, below their historical averages of 80 and 125. This flattening suggests a slowdown of real economic growth over the next year, although the yield curve is still far from an inversion (short rates above long rates), which would signal recession. A look at the very long and very short rates confirms a pattern—that long

rates account for most of the change in the spread. Continuing the trend begun in April, the federal funds rate remains slightly above its target value of 5.50%.

Tracking spreads is convenient, but it fails to capture the true three-dimensional nature of the yield curve over time. Shifts in the curve are rarely parallel: They also involve twists, because maturities rise and fall at different rates. Did interest rates peak in 1981 or 1982? It depends on whether one looks at long rates or short. The inversion of 1981

occurred when all rates were rising rapidly, but the 1989 inversion saw long and short rates moving in opposite directions.

Finance experts disagree on how best to characterize the twists and turns of the yield curve. Most think that three numbers are needed: level, steepness, and curvature. This three-dimensional perspective emphasizes the relative tranquility of rates since 1994, with twists and turns that look tame compared to the gyrations of more turbulent times.