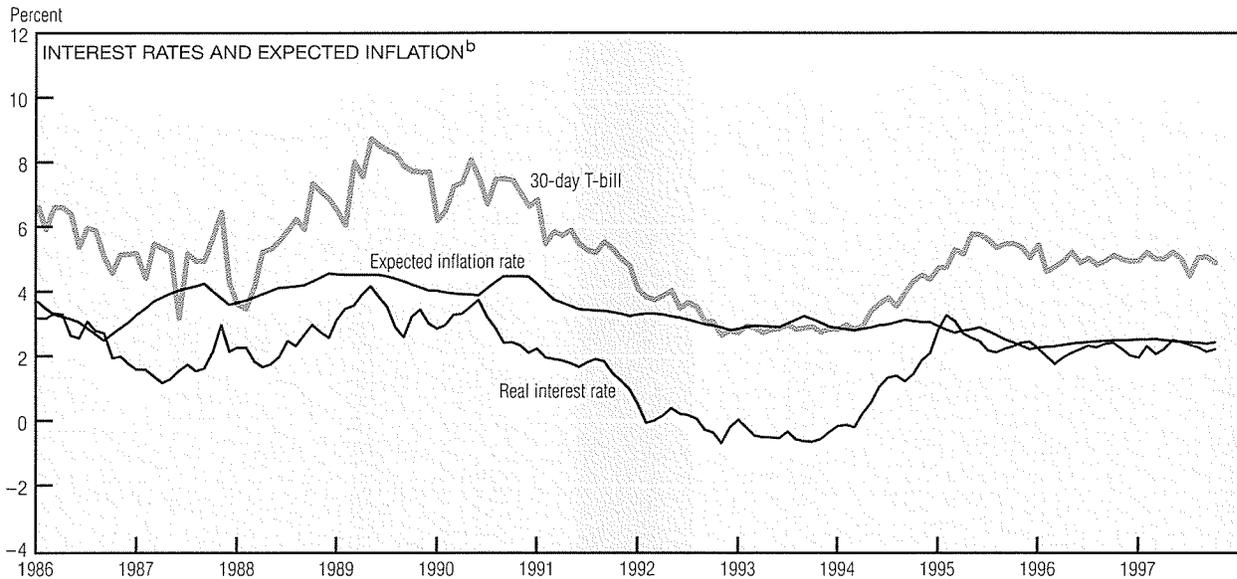
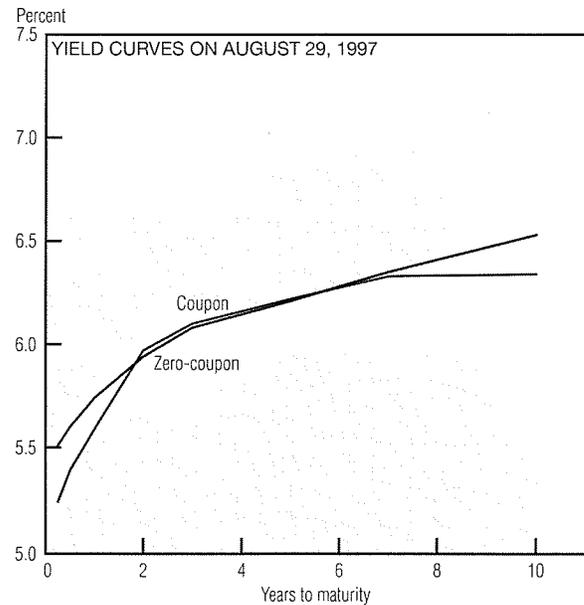
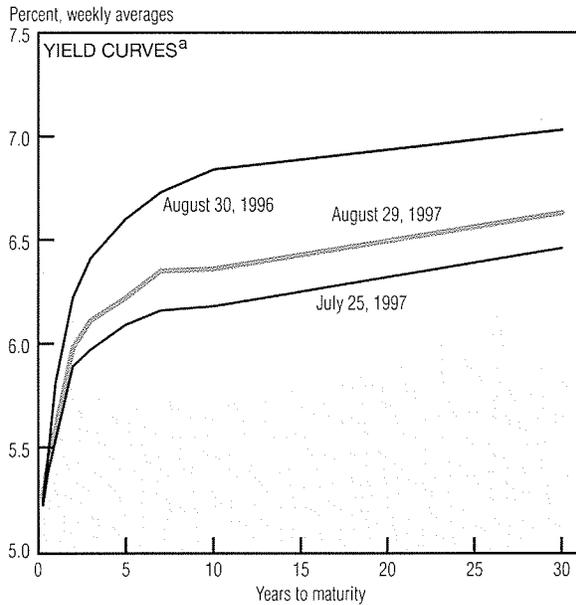


Interest Rates



a. All instruments are constant-maturity series.

b. The real and expected inflation rates are from the Survey of Professional Forecasters and are calculated using the 30-day T-bill rate.

SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia; and *The Wall Street Journal*, various issues.

The yield curve has steepened since the end of July, with long rates increasing about 20 basis points (b.p.) and the 3-month short rate inching up only four b.p. The closely watched spreads—the 3-year, 3-month and the 10-year, 3-month—have widened to 85 b.p. and 110 b.p., respectively, straddling their average values of 80 and 120. This suggests that the economy will grow at an average rate over the next four quarters.

The yield curve for zero-coupon Treasury securities is noticeably flat-

ter than the yield curve for coupon securities; however, since 3-month T-bills do not have coupons, this mainly reflects a market segmentation caused by liquidity differences.

Nominal interest rates depend on both expected inflation and real (inflation-adjusted) interest rates; uncertainty also has an effect. Before maturity, a bond's yield can be adjusted for expected inflation, providing an estimate of the real interest rate. Such a breakdown for the 30-day T-bill shows that compared to past years, 1997 has been fairly un-

eventful. The short-term real interest rate stands at 2.20%, well above the negative levels of 1993 but below the 4% posted in 1991. Short-term expected inflation has increased for the first time in six months, edging up from an annualized 2.38% to 2.41%. A close look at the bottom chart reveals the importance of accounting for uncertainty: Simply subtracting expected inflation from the nominal interest rate overstates the real rate by a quarter of a percentage point.