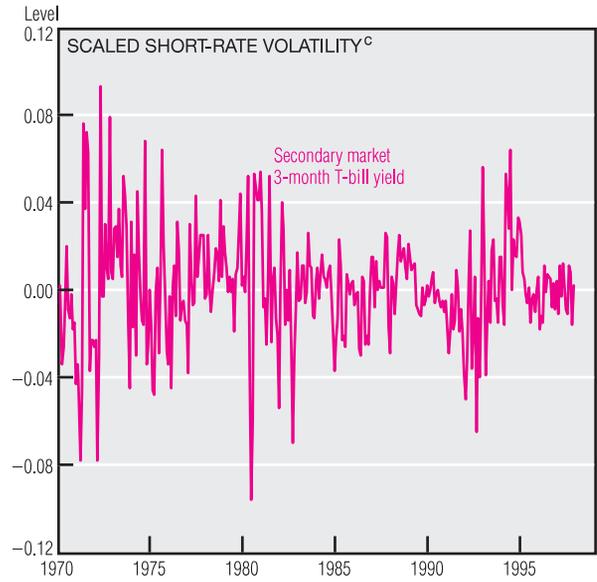
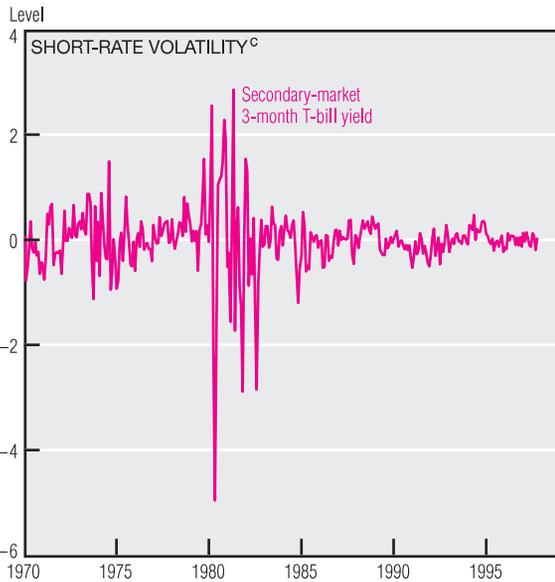
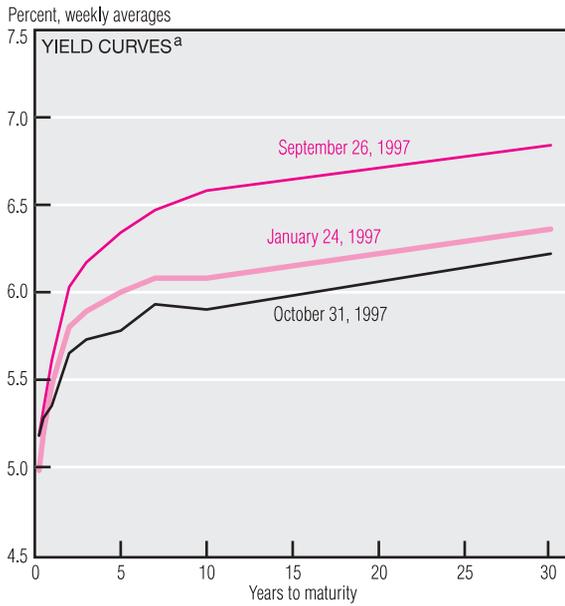


Interest Rates



a. All instruments are constant-maturity series.
b. 10-year Treasury bond constant-maturity yield minus the yield quote for the Treasury Inflation-Protection Securities given by the Bloomberg Information Service.
c. Volatility measures the day-to-day change in the Treasury rate. Scaling compensates for volatility's propensity to increase and decrease as rates rise and fall and for the tendency of this relationship to be nonlinear.
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Information Service.

The yield curve has flattened since last month, with rates falling for Treasuries with maturities of one year or longer, and rising for those of less than a year. The most closely watched spreads have both dropped well below their long-run averages: The 3-year, 3-month spread declined from 91 basis points to 55 basis points, and the 10-year, 3-month spread from 110 to 72 points. Such a fall often predicts slower future economic growth. The middle of the yield curve has taken on a rather bumpy appear-

ance because the complicated interplay between expected rates and risk has generated some unusual movements in the wake of the stock market correction in late October.

Treasury Inflation-Protection Securities (TIPS) have declined slightly to 3.54% since last month, but real yields have not deviated much since reaching 3.6% in April. A more striking change is the drop to 2.3% in the spread between 10-year Treasury bonds and TIPS (a basis-point decrease of 28 since mid-October and 100 since March), which may indicate lower inflation expectations.

It is a truism that the only constant is change, but for interest rates the change is not constant. By one measure—month-to-month changes in the 3-month Treasury bill yield—the volatility of interest rates has varied markedly in the past several decades. Some theories ascribe these differences to monetary policy shifts, and the high volatility in 1979–82 seems to bear this out. Other theories suggest that higher volatility—perhaps because it produces a risk premium—naturally accompanies higher interest rates.