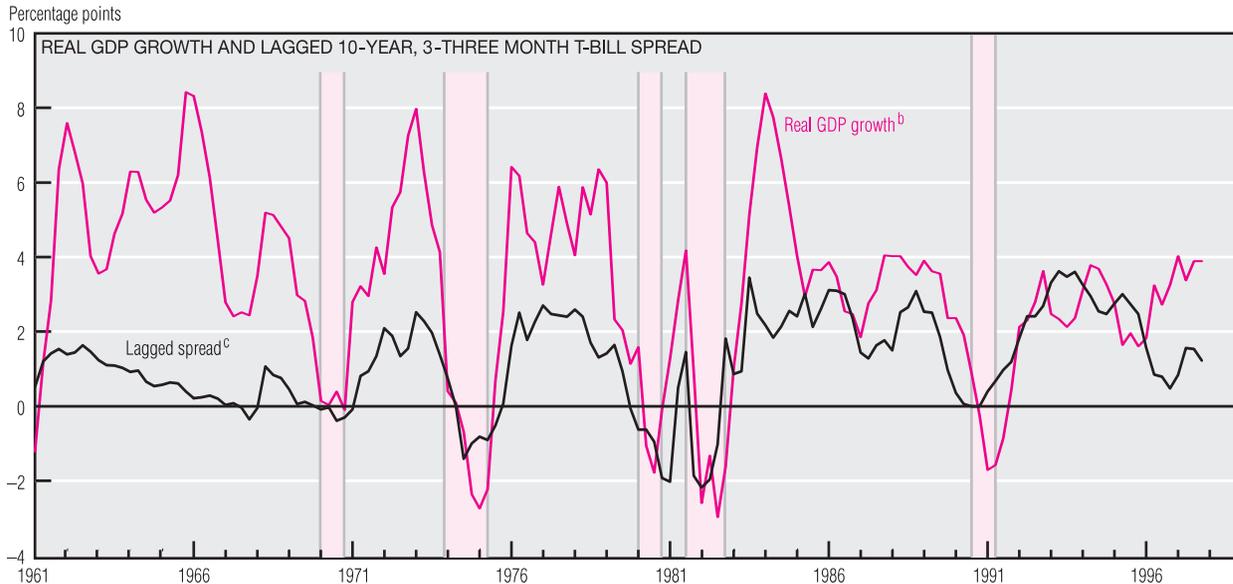
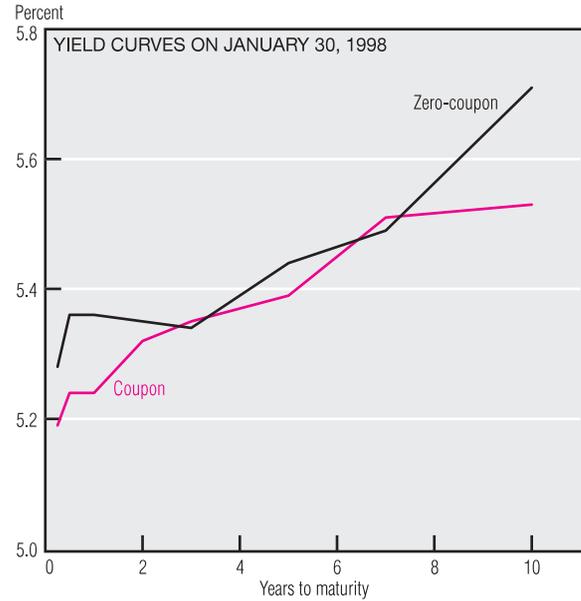
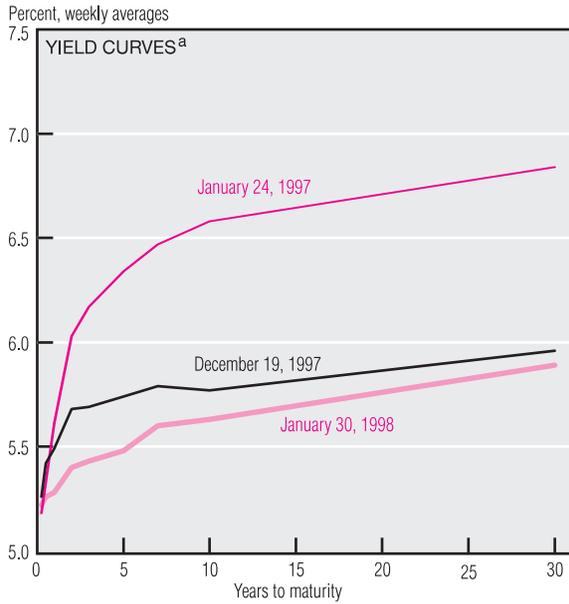


Interest Rates



a. All instruments are constant-maturity series.

b. Percent change from corresponding quarter of previous year.

c. Constant-maturity 10-year Treasury bond yield minus constant-maturity 3-month Treasury bill yield, lagged four quarters.

NOTE: Shaded areas indicate recessions.

SOURCES: Board of Governors of the Federal Reserve System; DRI/McGraw-Hill; and *The Wall Street Journal*, various issues.

Since last month, the yield curve has flattened and shifted downward. The spread between the 3-year Treasury note and the 3-month T-bill narrowed from 43 basis points to 21 basis points, and the spread between the 10-year Treasury bond and the 3-month T-bill went from 51 to 41 basis points. Especially conspicuous flattening has occurred since this time last year, when the 10-year, 3-month spread stood at 140 basis points. The coupon yield curve remains close to the zero-coupon yield curve. As expected, the 10-year zero rate exceeds the

10-year coupon rate because the coupons give the bond a shorter effective duration than the zero. This is less important in shorter rates, where the yield on zeros exceeds that on coupons.

One classic application of the yield curve—predicting future economic activity—works particularly well for real GDP growth over the next year. Its excellent predictive ability is obvious in the comparison of real GDP growth with the 10-year, 3-month spread lagged a year. The aspect most often remarked on is that inversions, where the spread turns negative (that is, where short

rates exceed long ones), indicate declines, and the data bear this out. A feature that gets less attention is that the size of the spread also indicates the amount of growth. Steep yield curves and the associated large spreads mean high growth; conversely, the more negative the spread, the deeper the recession. This relationship generally holds, although exceptions still abound. A flat yield curve belied the high growth of the early 1960s. Since 1996, strong growth has accompanied a yield curve that is flat by recent standards.