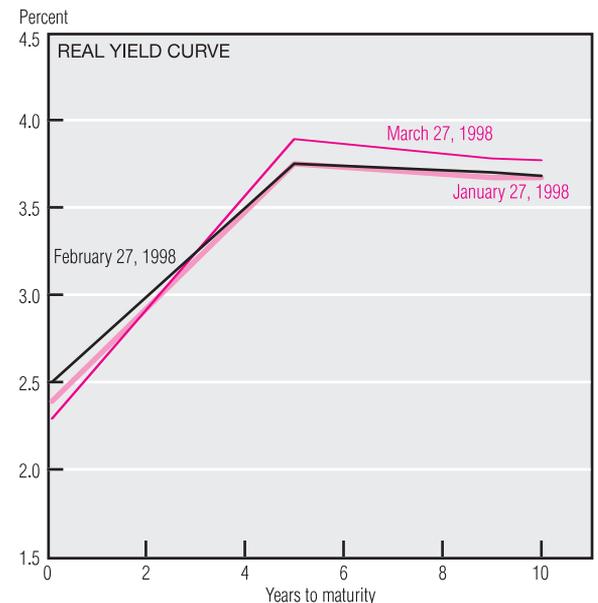
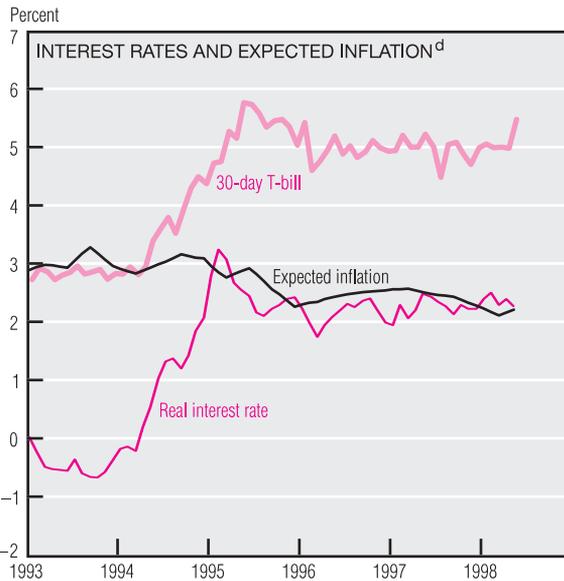
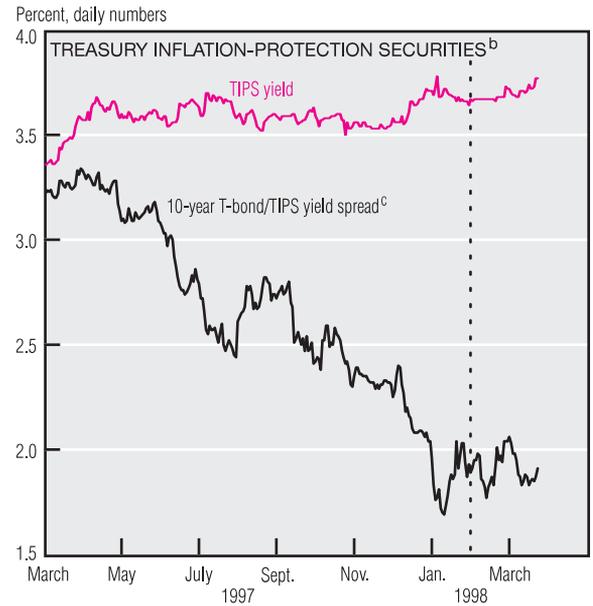
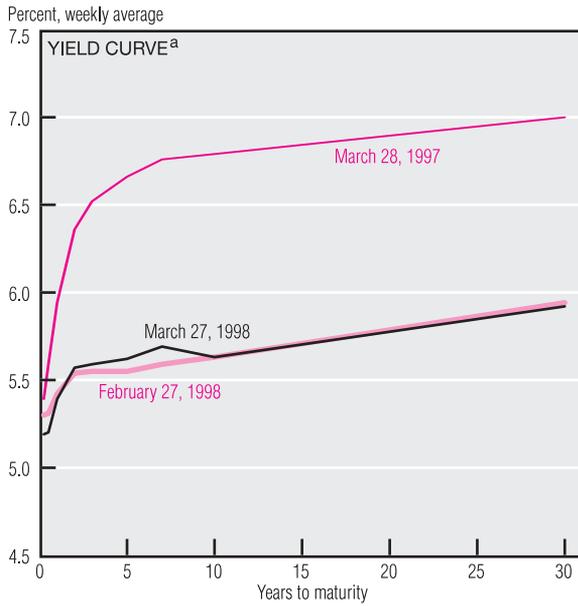


# Interest Rates



a. All instruments are constant-maturity series.

b. Vertical line marks the change from the TIPS series that is due to mature in 2007 to the series due to mature in 2008.

c. 10-year Treasury bond constant-maturity yield minus the yield quote for the TIPS-adjusted series.

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

SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; Bloomberg information services; and *The Wall Street Journal*, various issues.

The yield curve remains flat relative to its historical shape, with the benchmark 3-year, 3-month and 10-year, 3-month spreads at 40 and 44 basis points, respectively. The flatness is particularly noticeable at the long end. Since last month, the curve has steepened slightly because of lower 3-month rates and higher rates on maturities of two to 10 years. The yield curve continues to show a rather bumpy shape over those years.

The recent introduction of Treasury Inflation-Protection Securities (TIPS) makes it easier to use the

yield curve to discern future inflation trends. One simple measure of expected inflation subtracts the interest rate on TIPS from the standard nominal (not inflation-protected) Treasury. This assumes that the nominal interest rate is the sum of the real rate and expected inflation—ignoring risk premiums, liquidity differences, and tax effects—but it probably suffices for a first look. The resulting measure of expected inflation has fluctuated, but has shown no discernible trend since January and now stands at 1.9%. A more sophisticated procedure using short-term rates and a survey of profes-

sional forecasters yields 2.16% expected inflation for the month of April, with a 1-month real interest rate of 2.39%.

The final chart combines the 1-month results with TIPS bonds of five, nine, and 10 years to construct a yield curve of real interest rates. It clearly indicates that the slope of the yield curve depends on more than inflationary expectations; in fact, at the short end, the real yield curve is steeper than the nominal curve, with a 5-year, 1-month spread of 160 basis points. This exceeds the nominal curve's spread of 62 basis points.