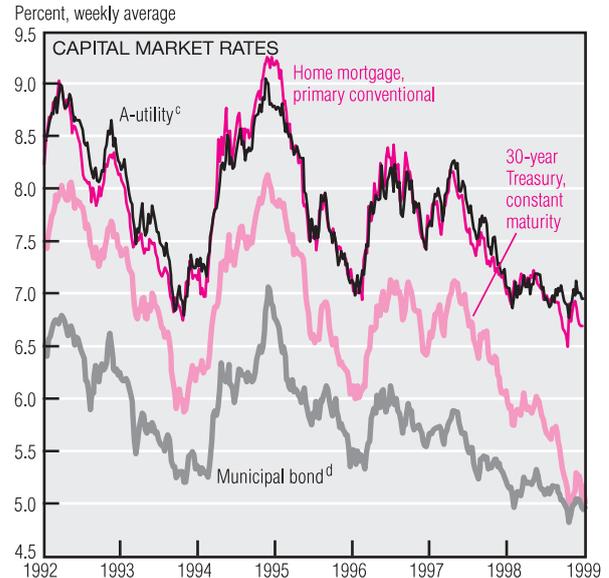
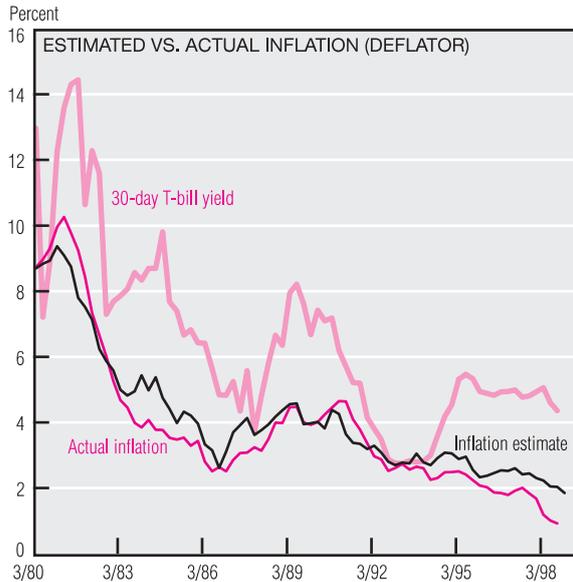
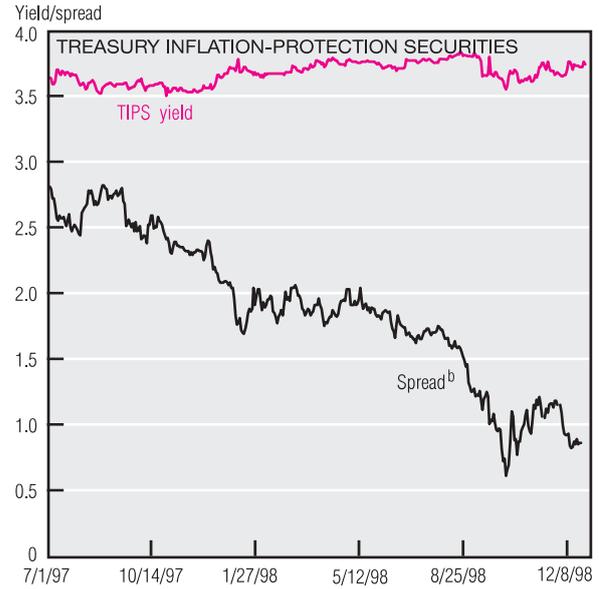
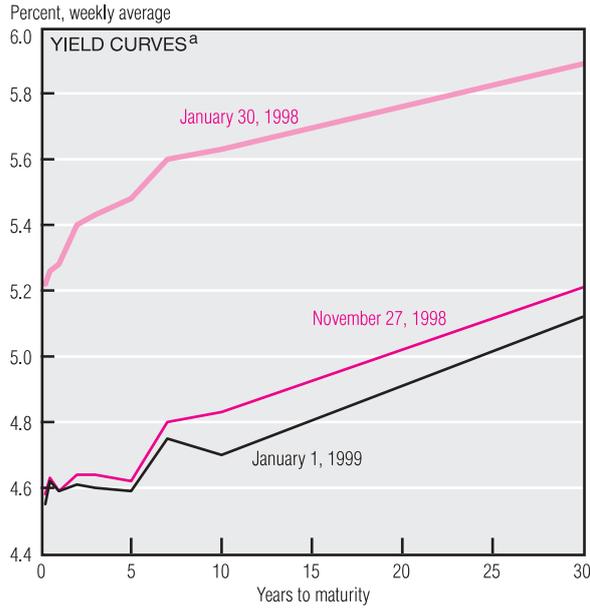


Interest Rates



a. All instruments are constant-maturity series.

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

c. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.

d. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.

SOURCES: Board of Governors of the Federal Reserve System, "Statistical Releases, H15: Selected Interest Rates"; Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*, <http://www.phil.frb.org/econ/spf/median.dat>; Bloomberg information services; and *The Wall Street Journal*.

The new year begins with interest rates noticeably below their levels at the start of 1998. The Treasury yield curve has shifted lower by about 60 basis points. It has also flattened out, with the 3-year, 3-month spread decreasing from 21 to five basis points, and the 10-year, 3-month spread decreasing from 20 to 15 basis points. The yield curve has also taken on a more jagged appearance, showing inversions between six and 12 months, two and five years, and seven and 10 years. It would be difficult to concoct a simple story that

would justify such a curve; quite possibly it reflects some combination of short-term confidence, uncertainty over the medium run, and long-run confidence about price stability. Rates on long-term corporate bonds and mortgages have seen less of a decrease because those securities did not benefit from the flight to quality after the Asian crises and Russian default.

A key question is always how to apportion the change in nominal interest rates between real rates and expected inflation. By one measure, the underlying real interest rate has

not shifted much over the year: The 10-year Treasury inflation-protection securities (TIPS) yield, which started the year at 3.71%, has moved to 3.74%, with highs and lows for the year of 3.84% and 3.55%. The spread between nominal 10-year Treasuries and 10-year TIPS, a rough gauge of expected inflation, has dropped from 2.04 to 0.86. A more direct estimate of inflationary expectations, from the *Survey of Professional Forecasters*, confirms that expectations of inflation have come down over the year, from 2.23% to 1.85%.