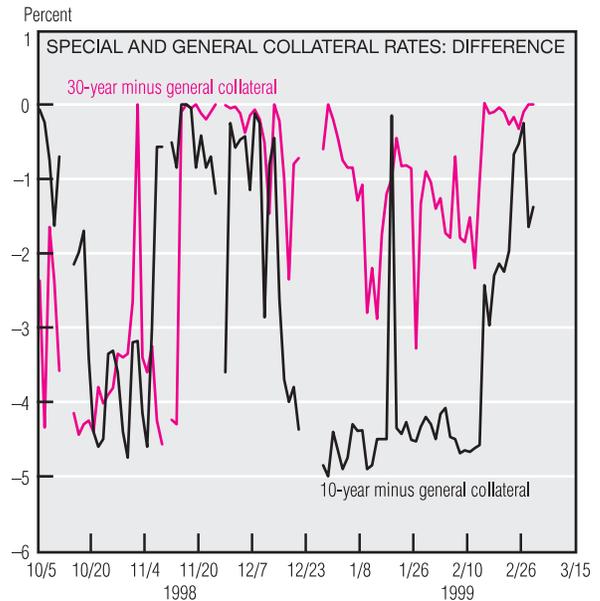
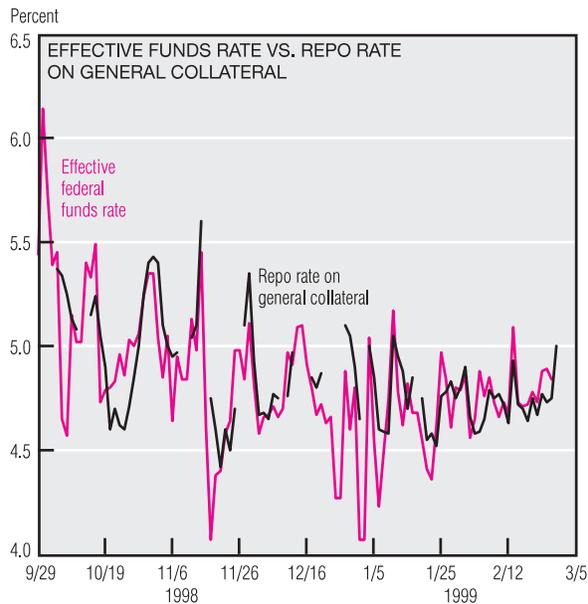
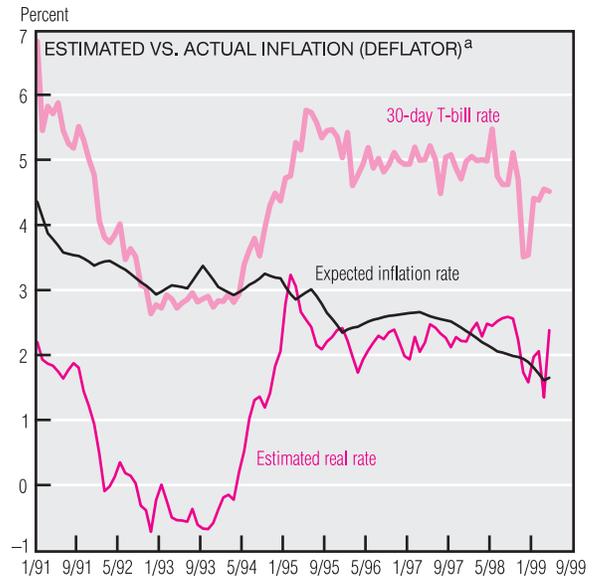
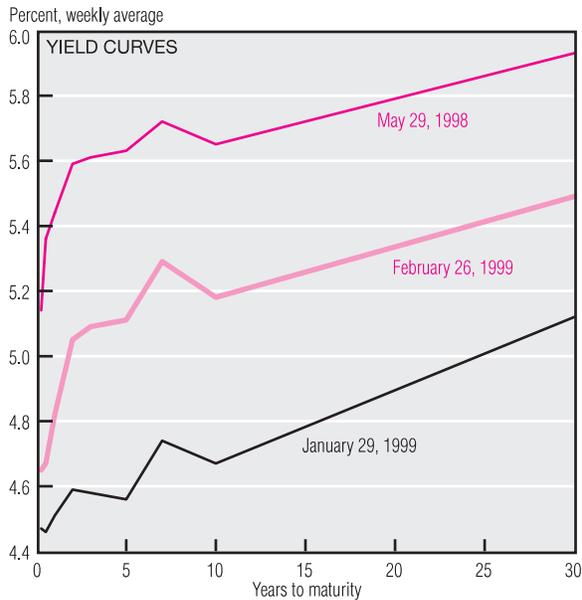


Interest Rates



a. The expected inflation rate and the estimated real rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; and *Dow Jones Capital Markets Report*.

Interest rates at all maturities have moved up sharply since last month. Some of the increase can be traced to speculation that the Federal Reserve will increase the federal funds rate. If the market expects such an increase to be delayed several months, this may explain the pronounced steepening at the short end of the yield curve—the 3-year, 3-month spread increased from 11 to 44 basis points. But such short-term expectations about policy should not have a pronounced effect on longer rates, which also increased substantially. A greater

worry might be the possibility of higher inflation. One admittedly short-term measure, however, which combines nominal rates with professional forecasts of inflation, indicates only a minuscule upturn in inflationary expectations.

The market for repurchase agreements ("repos" or RPs) is an important arena for short-term borrowing and lending. It is also the market most frequently used by the Open Market Desk of the Federal Reserve Bank of New York to implement monetary policy directives from the FOMC. A bank will borrow money

by selling a Treasury security and agreeing to repurchase it later, usually the next day, at a given rate. This rate closely tracks the federal funds rate. The exact Treasury security that is repurchased generally doesn't matter, but often certain securities are in greater demand (or lesser supply) than the general collateral. This leads the repo to go "on special," allowing anyone owning such collateral to borrow at relatively low rates. Recently, both the 30-year and the 10-year bond have been on special by substantial amounts.