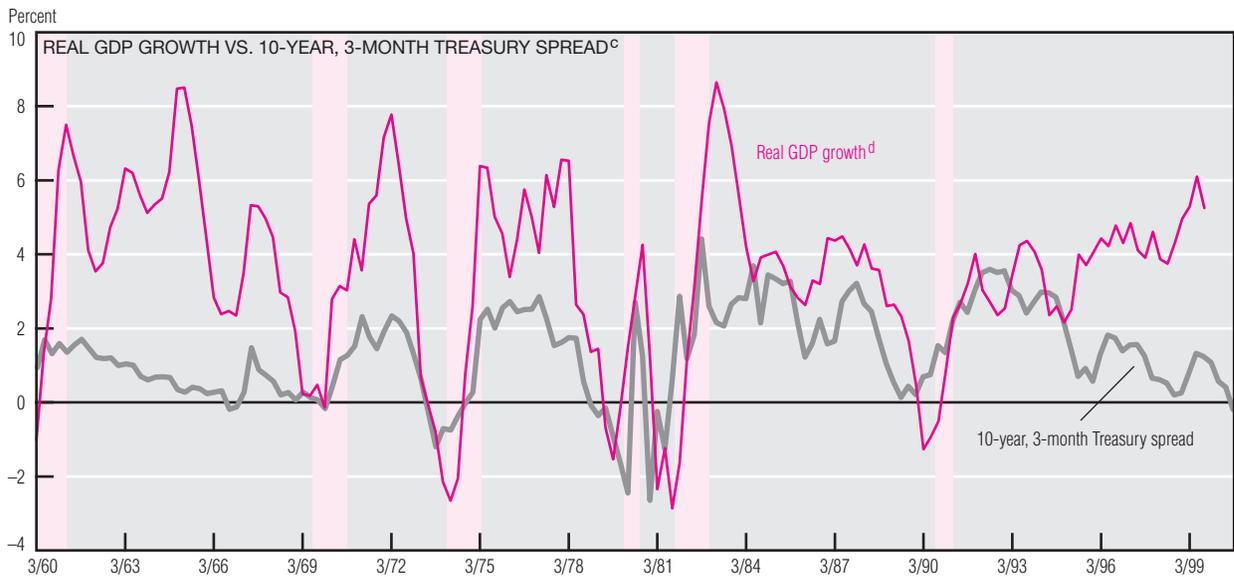
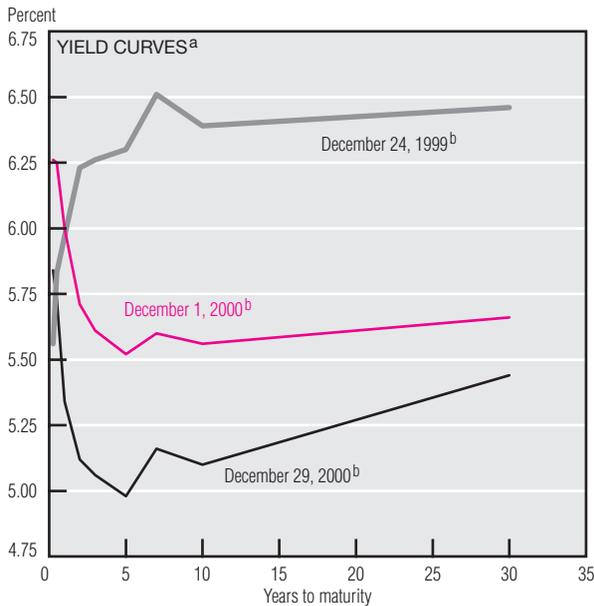


Interest Rates



- a. All yields are from constant-maturity series.
 b. Average for the week ending on this date.
 c. Shaded areas indicate recessions.
 d. Real GDP growth for the succeeding four quarters.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

As 2000 closed, the yield curve was inverted, with a 3-year, 3-month spread of -78 basis points (bp) and a 10-year, 3-month spread of -74 bp. The inversion's proximate cause was an increase in short rates combined with a decrease in long rates. The curve starts sloping upward again at five years, although 7-year yields continue to exceed adjacent maturities somewhat.

Long-term real interest rates—as measured by Treasury inflation-indexed securities (TIIS), which

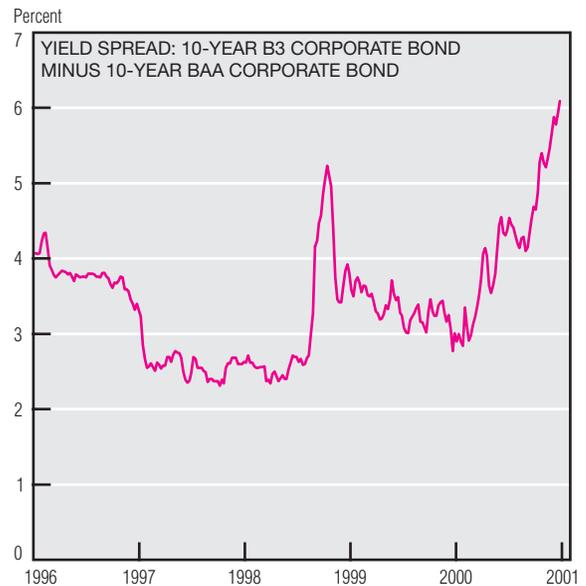
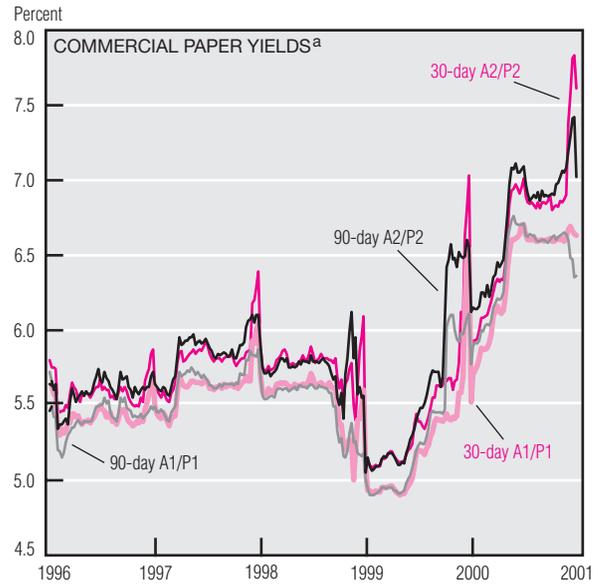
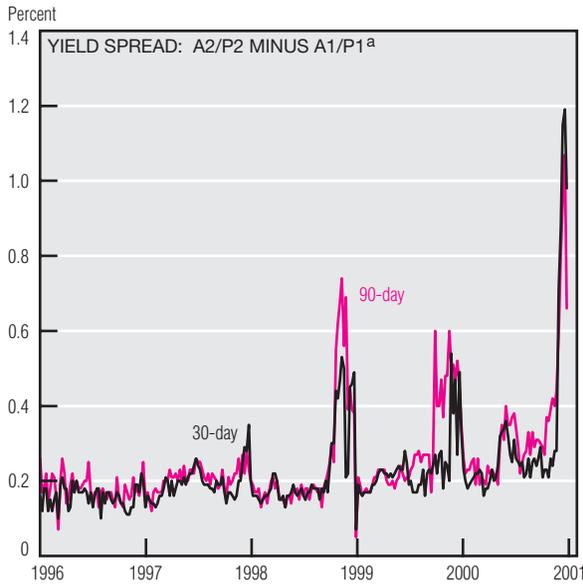
adjust both principal and interest payments for inflation—show a related pattern. Both 10-year and 30-year TIIS fell throughout most of 2000, although 30-year yields were generally lower. This is evidence of an inflation premium in nominal rates, for which the 30-year premium exceeds the 10-year.

An inverted yield curve is commonly thought to signal an incipient recession. How valid is this claim? One way to check is to plot the 10-year, 3-month spread (historically,

the best spread for predicting recessions) along with GDP growth for the year ahead. The spread was negative (even if only slightly) before the past five recessions, although the lag between inversion and recession varied, and at least once (in 1966) a negative spread was not followed closely by a recession. Generally, a wide spread indicates high growth and a narrow spread indicates low growth, but this relation was strained in two low-inflation eras, the 1960s and the 1990s. While

(continued on next page)

Interest Rates (cont.)



a. Bloomberg composite rate for dealer-placed commercial paper.
NOTE: For all charts on this page, the last data point is December 29, 2000.
SOURCE: Bloomberg Financial Information Services.

a cause for concern then, the current inversion should not be taken as a definitive indicator.

Another recent source of concern has been risk spreads—spreads between bonds of different riskiness. The commercial paper market has seen a particularly large spike in the spread between paper rated A1/P1 (the highest grade) and A2/P2. This spike tops levels that were reached in earlier times of financial concern, such as the Long Term Capital Management crisis and Russian default of late 1998 and the Y2K preparations of a year ago.

Although spreads on both 30- and 90-day commercial paper have risen, higher A2/P2 rates account for most of the rise in the 30-day spread, whereas declines in the safe A1/P1 rate also contribute to the 90-day spread. Perhaps less noticeable, both spreads have recently fallen as sharply as they had risen: From their peaks of 119 bp and 107 bp for the week of December 22, 2000, 30- and 90-day spreads dropped to 22 bp and 38 bp as of January 2, 2001.

Other sorts of risk spreads also have increased recently: The spread of BAA corporate bonds over Treasuries has reached high levels, as has the spread of B3 corporates over BAAs. Along with commercial paper rates, this may signal some tightness in the lending market: A decline in outstanding federal debt might account for the increasing spread over Treasuries, but it cannot explain the spread between different grades of corporate bonds.