Interest rates fell across the entire maturity spectrum last winter, when incoming data revealed an abrupt weakening in economic conditions. Initially, the yield curve remained inverted at the low end because investors anticipated an attenuated response from the FOMC. This was evident in the spread between the intended federal funds rate and the 2-year Treasury rate, which exceeded 1 percentage point in early March. But when the FOMC responded aggressively in early spring, this spread fell precipitously.

Over the past two months, the Treasury yield curve—which depicts yields on various Treasury securities at different maturities—has steepened dramatically, largely because of a fall in short-term interest rates. Mounting signs of economic weakness fostered expectations that the FOMC would engineer a more concentrated series of fed funds rate cuts over the course of the spring, driving down short-term yields.

The yield curve is widely viewed as a useful economic indicator. Historically, a steep yield curve has been associated with a strong economy, while an inverted yield curve often presages a recession.

The recent period, however, is somewhat unusual. Budget surplus projections began to reveal that the federal government could retire its entire debt within the next decade. Because Treasury debt is uniquely desired as a benchmark risk-free asset, the prospect of a diminished supply probably distorted yields on Treasury bonds, keeping them artificially low relative to private debt. More recent projections of the deficit (continued on next page)
suggest that debt retirement is less imminent. Nonetheless, the rise in long-term Treasury rates since January has created some concern about whether policy actions have become too stimulatory. In particular, the spread between the 10-year Treasury bond and the Treasury inflation-indexed bond suggests that inflationary pressures may be intensifying.

On the other hand, yields on corporate bonds and mortgages have not risen as dramatically, despite robust borrowing in these markets. Mortgage rates have stayed relatively low, inducing a substantial volume of refinancing. For many households, refinancing has provided liquidity, helping to sustain moderate consumer spending despite the economic slowdown.

The fall in short-term interest rates has lowered the opportunity cost of holding monetary instruments, enhancing their attractiveness relative to other financial assets. Increased demand for monetary aggregates such as M2 and MZM is reflected in their acceleration this year.

MZM includes all instruments with zero maturity such as checking accounts, savings deposits, and money market mutual funds, both retail and institutional. The sharp rise in savings deposits over the past year occurred largely at the expense of retail money funds, as several mutual fund providers initiated sweep arrangements. This arrangement—which provides FDIC insurance on such funds—involves regular transfers from money funds into savings deposits at affiliated banks. It thus reduces retail mutual fund balances and increases savings deposits by a like amount, but washes out in MZM and M2.

This year’s surge in liquid assets also reflects equity market condi-

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tions. During periods of heightened uncertainty, investors often park their balances in liquid assets, which make up MZM and M2. Many analysts believe this “money on the sidelines” has great potential for financing an equity market recovery should the economic outlook become more favorable.

Although S&P 500 firms’ earnings are expected to decline this year relative to 2000, analysts forecast sharply accelerated earnings beginning in late 2001 and continuing through 2002. “By all evidence,” Federal Reserve Chairman Alan Greenspan recently noted, “we are not yet dealing with maturing technologies that, after having sparkled for a half decade, are now in the process of fizzling out.” Equity prices have strengthened somewhat since March, suggesting that investors are still confident about longer-term profitability in the corporate sector. Also, consumer expectations stabilized in late winter and appear to be drifting up modestly.

Stock prices’ sharp fall since early 2000 was contained largely within the technology sector. The S&P 500 price/earnings ratio now stands near its 1990s average of 22.2.

Asset price bubbles, like those in the tech stocks, can be recognized only after they burst. Nevertheless, policymakers can and often do lean against the economic winds that generally accompany speculative excesses. When stock prices correct abruptly, policymakers may act aggressively to keep asset-price deflation from threatening economic stability. But monetary policy takes effect only after long and variable lags. Given the concentration of policy rate reductions already taken in 2001, one might expect that future cuts, if needed, will be more attenuated.