Money and Financial Markets

One reason the federal funds rate gets such intense scrutiny, even though few people directly borrow and lend at that rate, is that Federal Reserve policy affects other rates as well. But the connection is not as tight as is often supposed. Since 1989, lowering the fed funds target has usually been accompanied by lower interest rates in other markets, but not always. Even the three-month Treasury bill, thought to be quite sensitive to monetary policy, increased 20% of the time when the target rate fell 25 basis points (bp). The 10-year rate shows an even higher proportion of such opposite moves. Digging deeper into the data may reveal more consistent patterns, depending on whether the change was anticipated or unanticipated, which part of business cycle the economy is in, or the slope of the yield curve.

Since March, an already steep yield curve has gotten even steeper. The bellwether 10-year, three-month spread has increased from 281 bp to 346 bp, well above the historical average of 120 bp. This rise has been driven almost exclusively by increases in long rates because short rates have been restrained by the steady fed funds rate. Historically, such a steep yield curve has foretold robust economic growth for the following year. Supporting that, the spread between Treasury bonds and eurodollar deposits (the TED spread), which is often thought to reflect concern over international tensions, remains low by recent historical standards.

Some observers believe inflation fears caused the increase in long rates. 

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rates, but more direct measures of inflationary expectations give a different view. The “break-even” inflation rate, defined as the difference between a 10-year nominal Treasury bond and a 10-year TIIS bond (which is protected against inflation), stands at 2.38%, almost exactly where it stood in January. But because of tax, liquidity, and different risk characteristics (particularly regarding inflation) this may overstate expectations by anywhere from 35 bp to 120 bp. Still, the lack of an upward trend this year is encouraging.

The Pennacchi model, which combines Treasury-bill rates and survey measures of inflation, has also stayed relatively flat in 2004.

Inflation expectations can be inferred from the recently introduced CPI futures contracts. With a shorter maturity than TIIS, these contracts help fill out an overview of the “term structure” of inflation expectations because people may have different views of inflation in the short versus the long term. Because the market is new, (trading in CPI futures at the Chicago Mercantile Exchange only began in February), the inflation numbers look quite volatile.

Perhaps inflationary expectations have held steady because monetary policy has found the right balance between ease and tightness. In fact, some real rates have been increasing lately. The Berk rate, which measures the real rate with an adjustment for a firm’s ability to delay investment, has risen almost 70 bp since mid-March.

**Sources:** Chicago Mercantile Exchange; Bloomberg Financial Information Services; and Wall Street Journal.