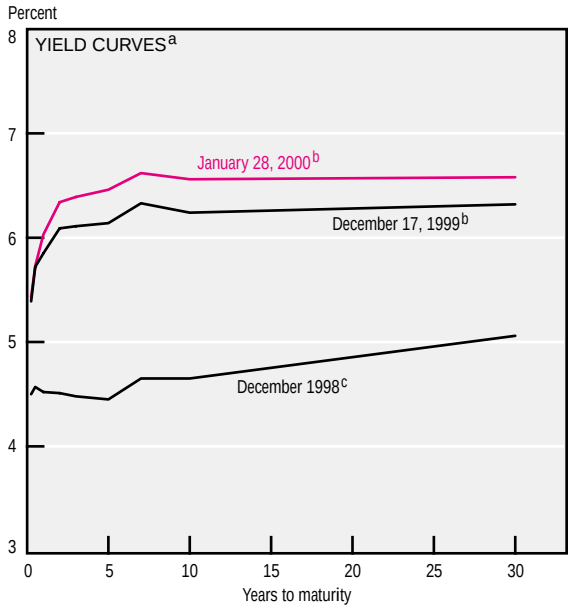
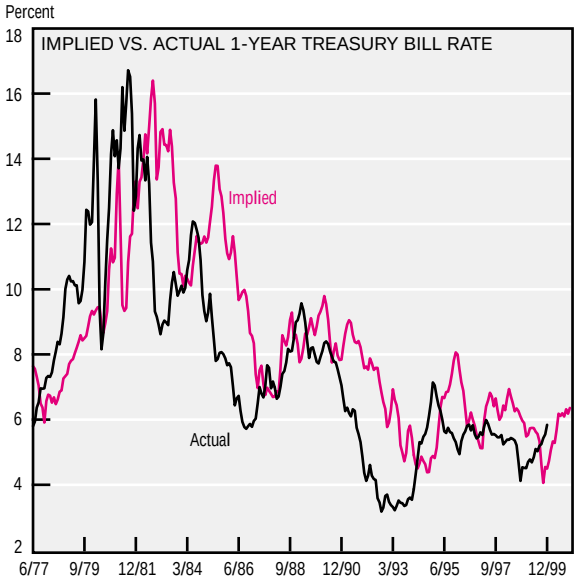
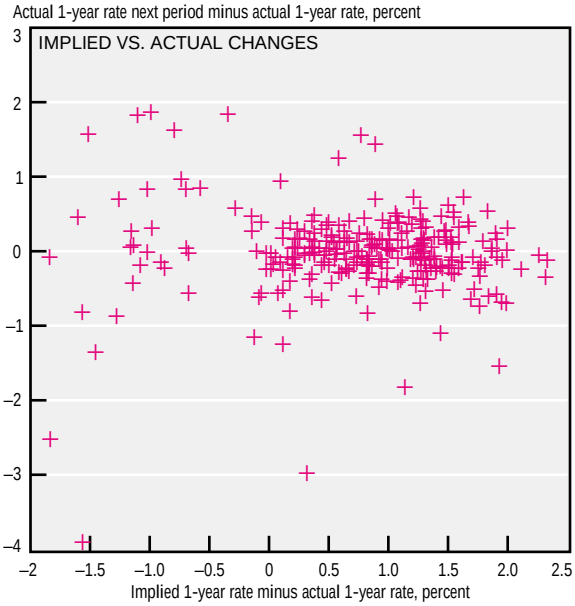
Interest Rates







a. All yields are from constant-maturity series.
b. Weekly averages.
c. Monthly averages.
SOURCE: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases,* H.15.

The yield curve has moved upward and steepened since last month. The 3-month rate moved up 20 basis points (bp); the 5-year rate increased fully 49 bp. The 10-year, 3-month spread now stands at 109 bp, up from 85 bp last month. Traditional factors such as expected inflation and future real activity may be influencing the yield curve. In addition, the supply of some maturities is declining as the Treasury Department begins to retire debt.

A common question regarding the term structure of interest rates is the extent to which implied forward rates predict future interest rates. This question arises from the expectations hypothesis of the term structure, which posits that long-term rates are the average of expected future short-term rates. A look at 1- and 2-year T-bond rates shows that the two move together closely. Plotting implied rates with actual rates apparently shows that a high implied rate reflects high current rates more often than it does high future rates. Extracting such information can be tricky, however, because interest rates have high serial correlation—that is, high rates today generally imply high rates tomorrow.

Another approach is to look at changes: If the implied future rate exceeds the current rate, it predicts that the rate will increase. If the implied future rate is below the current rate, it predicts that the rate will decrease. Plotting the actual change against the predicted change indicates how well the prediction does. In the case of 1-year T-bill rates, the prediction works poorly. At this time horizon, at least, the expectations hypothesis does not do so well.