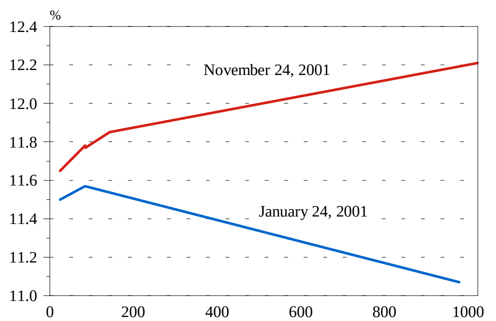
Box 1 Reading expectations from interest rates

Interest rates can provide an indication of the market's view of economic developments. For example, the yield curve can give an impression of the vision that the market has about the future inflation trend. The yield curve maps the relationship of interest rates to the length of a specific class of bonds. Examples are the yield curves of T-bills and T-notes shown in Chart 1. The chart shows two different interest rate trends where market expectations have changed. It is unwise to read too much into the calibration of the vertical axis, however, since an interest rate incorporates a specific return, risk premium and expected rate of inflation. The process since November 24, 2000 shows the market expecting a considerable degree of inflation over the following months. The process since January 24, 2001 shows different expectations, because the assumption seems to be that after a relatively short time inflation will be lower than at present. However, this is not an absolute indicator and other explanations could exist. For example, the bond class used for measuring the longest lifetime is known to be widely used as collateral for repurchase agreements with the Central Bank, so that credit institutions have small exposures in it and may opt to price it in a way that makes it unattractive to investors. Another factor at work may be the great difference in length between the bonds forming the last two segments of the yield curve.

Chart 1

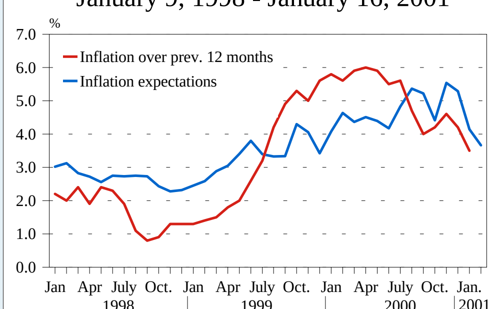
Yield curve of non-indexed rates, November 24, 2000 and January 24, 2001



Another method of forecasting inflation is to examine the spread between indexed and unindexed securities. While this method provides certain indications, it is important to keep the lifetimes of the securities being compared as similar as possible, besides which the market always calculates a certain risk premium on unindexed interest rates to meet unforeseen swings in inflation. This premium is difficult to assess but probably varies somewhat depending on the economic outlook. Differences in how active the markets for indexed and unindexed bonds are may also distort the comparison. Chart 2 maps expected and real inflation as measured by the CPI for the past three years. It apparently reveals inertia towards changes in expectations, although this may be explained to some extent by interest rate formation embodying not only future expectations but also a retrospective inflation measurement.

Chart 2

CPI inflation and inflation expectations[1], January 9, 1998 - January 16, 2001



1. Inflation premium measured as spread between yield on indexed and non-indexed treasury paper of similar maturity.