



# International Economic Trends



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## EMU: A Credibility Gap?

Expectations of increased inflation raise interest rates because higher prices reduce the real value of the payoff that lenders receive. As a result, lenders demand higher interest rates to compensate for the reduction in their purchasing power.

The Bundesbank, Germany's central bank, has consistently delivered one of the lowest and most stable rates of inflation. This stability has permitted the German government and businesses to borrow money over the long term—10 years or more—at relatively low interest rates. Some researchers have credited much of Germany's robust post-war economic performance to this steady environment.

The Maastricht Treaty, signed in December 1991, provides the conditions for European Monetary Union (EMU). If the terms of this treaty are implemented, German inflation will be determined by the new European Central Bank after 1999. Doubts about the bank's commitment to price stability will be reflected in higher German long-term interest rates.

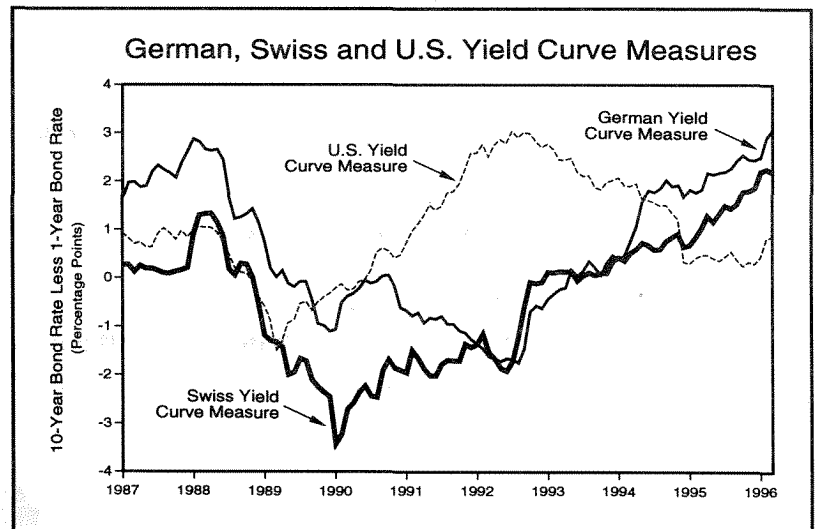
A number of market observers attribute the current steep slope of the German yield curve to just such a phenomenon. A yield curve is the plot of the relation of interest rates paid by bonds of different maturities. If long-term bonds pay much more than short-term bonds, the yield curve is said to be steep. If they pay about the same, the yield curve is said to be flat. If they pay less, the yield curve is said to be inverted. If market participants expect future inflation to exceed near-term inflation, then the yield curve should be steep.

A crude measure of the slope of the German yield curve is shown in the chart. Switzerland and the United States are shown for comparison

because they are also low inflation countries, but will not enter monetary union. By this measure, the German yield curve has been getting progressively steeper since 1992—shortly after the Maastricht Treaty was concluded—and is now steeper than it has been in the last nine years. Investors may anticipate higher German inflation several years from now because the European Central Bank lacks the anti-inflation credibility of the Bundesbank.

This is not the only interpretation, however. For example, an Organization for Economic Cooperation and Development publication suggested that, given the current level of short-term interest rates, the German yield curve is normally sloped and the U.S. yield curve is abnormally flat. Further casting doubt on the EMU explanation, the slope of the Swiss yield curve has been climbing since 1990 and is also now quite high. Could the same factors contributing to the steepness of the Swiss yield curve also be driving Germany's? The data do not permit us to distinguish easily between these explanations.

—Christopher J. Neely



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