A column devoted to understanding monetary policy issues for the long run.

**Inverted Yield Curve, But No Danger of Recession**

Some economists are worried that the U.S. economy could fall into a recession soon. The crumbling housing market has been cause for concern for the past year and does not yet show signs of stabilizing. GDP growth in the first quarter was a paltry 1.3%. Finally, the yield curve is inverted, which means the term spread between long-term and short-term interest rates is negative, as the figure shows.

![The Term Spread and Recessions](image)

This figure shows the term spread, which is the difference between the interest rate on ten-year U.S. Treasury securities and the interest rate on three-month Treasury bills. Some economists believe that it is one of the best indicators of the likelihood of recession. The figure shows that the yield curve was low or negative before every recession (note that the recession dates are indicated by the gray bars in the figure). Today’s negative term spread of –0.4% means that the interest rate on three-month Treasury bills is about 0.4 percentage point higher than the interest rate on ten-year Treasury securities.
Despite the seemingly good predictive power of the term spread for recessions, there is good reason to think that no recession is in sight for the United States right now. First, the yield curve often becomes very low or negative without a recession arriving. From 1956 to 1958, from 1966 to 1967, from 1988 to 1989, and in 1999, the term spread was less than 0.5%, yet no recession materialized. So, having a low term spread is not a guarantee of recession.

Perhaps more importantly, the reason we do not expect a recession now is a belief that the term spread does not mean the same thing now as it did in the past because investors have changed their views of several key macroeconomic variables.

One change by investors is that their outlook for inflation over the next ten years is much lower and much more stable than it was in the past. With less inflation and a lower volatility to inflation, the risk to long-term bonds declines relative to the risk to short-term bonds, and thus the term spread should be smaller than before. For more details on this mechanism, see the speech by Federal Reserve Bank of Philadelphia president Charles Plosser, “What Can We Expect from the Yield Curve?,” which can be found online at http://www.phil.frb.org/publicaffairs/speeches/plosser/2007/03-23-07_yield-curve.cfm.

Another change by investors is that their increased demand for long-term bonds has caused the real interest rate on long-term bonds to decline relative to the real interest rate on short-term bonds. For a number of reasons, investors today are demanding less of a term premium than before for the risk to holding long-term bonds. In part, overall macroeconomic stability may have led to a decline in that risk, because when the overall economy is stable, interest rates are stable. This and other reasons for changes in demand relative to supply were cited by Fed chairman Ben Bernanke in his speech on “Reflections on the Yield Curve and Monetary Policy,” which can be found online at http://www.federalreserve.gov/boarddocs/speeches/2006/20060320/default.htm.

The final, and perhaps most surprising, change in investor behavior is that occurring in foreign economies. Investors in foreign countries have increased their appetite for bonds and the global savings glut has greatly increased both demand and supply of long-term bonds all over the world. The global decline in long-term real interest rates has occurred for many of the same reasons as in the United States. Suffice it to say that the entire international financial system is much more sound than ever before. But with the United States still the safest haven for investment, U.S. yields on long-term bonds have been reduced even more than yields in foreign countries. For more details, see Federal Reserve Governor Randall Kroszner’s speech, “Why Are Yield Curves So Flat and Long Rates So Low Globally?” which is available online at http://www.federalreserve.gov/boarddocs/speeches/2006/20060615/default.htm.

Overall, the negative term spread in the United States is a result of changes in the market for long-term securities that reflect low rates of inflation, low real interest rates, and the global savings glut. As a result, we should not compare today’s situation to previous periods when a negative term spread was associated with a recession.