

The Yield Curve as a Leading Indicator: Frequently Asked Questions

Arturo Estrella
Updated November 2008*

A broad literature originating in the late 1980s documents the empirical regularity that the slope of the yield curve is a reliable predictor of future real economic activity. Today, there exists a substantial body of evidence from which various useful stylized facts have emerged. This catalogue of some of the salient findings takes the form of answers to frequently asked questions. An extensive [bibliography](#) is also included.

Click on a question from the following list to go to the page containing the answer.

- [Q. What does the evidence say, in short?](#)
- [Q. How and when were the relationships first identified?](#)
- [Q. How long have these relationships existed, and do they still hold?](#)
- [Q. Are formal models needed to extract the information content in the yield curve, or are there also rules of thumb?](#)
- [Q. What statistical models have been formulated?](#)
- [Q. Which interest rates to use: Treasuries, fed funds, Eurodollar, swap, corporate?](#)
- [Q. What maturity combinations work best?](#)
- [Q. Is it the level or the change in the spread that matters?](#)
- [Q. Does it matter if changes are driven by the short or the long end?](#)
- [Q. Is an inversion required for a signal?](#)
- [Q. Does the signal have to be persistent?](#)
- [Q. Is the evidence robust over time?](#)
- [Q. How do binary models that predict recessions compare with models that forecast continuous dependent variables \(e.g., real GDP, industrial production growth\)?](#)
- [Q. How does the yield curve compare with other indicators?](#)
- [Q. How does the yield curve perform out of sample, and can it be supplemented with other indicators?](#)
- [Q. How are predictions related to monetary policy?](#)
- [Q. How are predictions related to market expectations of the economy?](#)
- [Q. Is there causality from economic activity to the yield curve?](#)
- [Q. Should we expect the predictive power of the term spread for real activity to persist?](#)
- [Q. What reaction has the model received from policymakers?](#)

* Originally posted on the Federal Reserve Bank of New York web site, October 2005.

Questions & Answers

Q. What does the evidence say, in short?

A. The difference between long-term and short-term interest rates (“the slope of the yield curve” or “the term spread”) has borne a consistent negative relationship with subsequent real economic activity in the United States, with a lead time of about four to six quarters. The measures of the yield curve most frequently employed are based on differences between interest rates on Treasury securities of contrasting maturities, for instance, ten years minus three months. The measures of real activity for which predictive power has been found include GNP and GDP growth, growth in consumption, investment and industrial production, and economic recessions as dated by the National Bureau of Economic Research (NBER). The specific accuracy of these predictions depends on the particular measures employed, as well as on the estimation and prediction periods. However, the results are generally statistically significant and compare favorably with other variables employed as leading indicators. For instance, models that predict real GDP growth or recessions tend to explain 30 percent or more of the variation in the measure of real activity. See Estrella and Hardouvelis (1991). The yield curve has predicted essentially every U.S. recession since 1950 with only one “false” signal, which preceded the credit crunch and slowdown in production in 1967. There is also evidence that the predictive relationships exist in other countries, notably Germany, Canada, and the United Kingdom. See Estrella and Mishkin (1997) and Bernard and Gerlach (1998). [See also [Box 1.](#)] [Back to questions.](#)

Q. How and when were the relationships first identified?

A. Analysis of the behavior of interest rates of different maturities over the business cycle goes back at least to Mitchell (1913). However, Kessel (1965) may have been the first to make specific reference, verbal if not quantitative, to the behavior of term spreads. He pointed out that various spreads between long- and short-term rates tend to be low at the start of recessions – the business cycle peak – and high as expansions get under way after a cyclical trough. Butler (1978) made a connection between the yield curve as a predictor of short-term interest rates and the implications of declining short-term rates for contemporaneous economic activity, foreshadowing some of the later logic. In his view, the market predicted that short-term rates would peak by mid-1979, with “the yield curve reaching the classic recessionary *inverted* shape.” The late 1980s saw a spurt in research on the yield curve as a leading indicator. Laurent (1988, 1989) used the term spread to predict GNP growth. Harvey (1988), based on his 1986 dissertation, developed a theoretical relationship between the real term spread and subsequent real consumption growth and presented some confirming empirical evidence. Furlong (1989) noted some predictive power for recessions, but expressed skepticism about the yield curve’s reliability as a leading indicator at that time. Estrella

and Hardouvelis (1989, 1990, 1991) showed empirically that the yield curve may be used to predict real growth in consumption, investment, and aggregate GNP, as well as NBER-dated recessions. Stock and Watson (1989) developed a sophisticated model of coincident and leading indicators, with the term spread forming part of the latter. Chen (1991) looked at the predictive relationship from the point of view of financial market investors. [See also [Box 2.](#)] [Back to questions.](#)

Q. How long have these relationships existed, and do they still hold?

A. Kessel (1965) presents graphical evidence that shows that the term spread tends to be negative at cyclical peaks, using data that go back as far as 1858. He finds some evidence of the leading indicator properties of the spread in time periods from 1914 to 1933 and from 1954 to 1961. Bordo and Haubrich (2004) provide regression-based statistical evidence using U.S. data from 1875 to 1997 and Baltzer and Kling (2005) perform a similar exercise with German data from 1870 to 2003. Both papers conclude that predictability varies over time and that it seems to be related to monetary policy credibility. Most other studies use data since the 1950s. The most recent data suggest that some of the statistical models from which forecasts based on the term structure are constructed have undergone structural changes, particularly with regard to parameter values. The predictive power may still be there, but the values of the parameters that record the sensitivity to movements in the term spread may be somewhat changed from earlier periods. However, the simple rule of thumb that the difference between ten-year and three-month Treasury rates turns negative in advance of recessions is still reliable, with negative values observed before both the 1990-1991 and 2001 recessions. [See also [Box 4.](#)] [Back to questions.](#)

Q. Are formal models needed to extract the information content in the yield curve, or are there also rules of thumb?

A. Much of the research on this topic has been based on formal statistical models, such as linear regressions and non-linear statistical equations. These models are useful in that they provide quantitative guidelines about the sensitivity of output growth to changes in the term spread and about the precise lead-lag relationships exhibited by the data series, as well as recession probabilities. Nevertheless, simple rules of thumb are available, such as the fact that yield curve inversions (negative term spreads) are followed by recessions. Estrella and Mishkin (1996b) and Estrella (2005b) show that this approach may be made a bit more precise, though still simple, by presenting the relationship in tabular or graphical form. [See also [Box 3.](#)] [Back to questions.](#)

Q. What statistical models have been formulated?

A. Much of the analysis in the literature has focused on “continuous variables,” data series whose values can in principle be any real numbers. Examples of these series are

growth rates in GNP, GDP, industrial production, consumption, and investment. To predict these series, analysts have generally relied on relatively standard regression equations, taking care to deal with some important statistical issues. The most common issue results from the presence of overlapping observations in many of the applications. For example, suppose that we are interested in forecasting GDP growth over the next year using quarterly data. Then, two consecutive observations of the variable being forecasted correspond to time periods that have three quarters in common. Standard measures of statistical significance are in general inconsistent, and must be adjusted by using, for instance, the generalized method of moments estimators of Hansen (1982) or Newey and West (1987). When the objective is to predict recessions, the methodology used is typically a probit or logit equation, in which the forecasted variable only assumes the values one and zero (either the economy is in a recession or it is not). Note, however, that special techniques are also required in these models if the forecast horizon produces overlapping observations. See Estrella and Rodrigues (1998). [Back to questions.](#)

Q. Which interest rates to use: Treasuries, fed funds, Eurodollar, swap, corporate?

A. Research on the United States business cycle has relied mostly on interest rates for U.S. Treasury securities. One reason is convenience: data for many maturities are available continuously from the 1950s to the present in a consistent format. Another reason is that the pricing of these securities is not subject to significant credit risk premiums that, at least in principle, may change with maturity and over time. For similar reasons, studies of other countries tend to use data on national government debt securities. Rates on coupon bonds and notes are most easily accessible, but researchers in many countries have also produced zero-coupon rates, which may be directly matched with the timing of the forecasts. Some analysts have also used, as short-term rates, the U.S. federal funds rate and rates closely controlled by central banks in other countries. These are useful for some purposes, but the control exercised by the central bank implies that these rates are not fully reflective of the expectations of financial market participants. The spread between ten-year Treasuries and fed funds is a very accurate predictor of U.S. recessions during some time periods, but less so in others. At certain times, concerns have been voiced that special factors, such as the federal budget surpluses of 1999-2000, might affect the supply or demand of Treasury securities and distort the signals incorporated in their prices. Attempts have been made to use other interest rates for which a yield curve may be constructed, like Eurodollar, swap or corporate rates. An important drawback to the use of such data, however, is their limited availability with regard to the length of historical time series, the number of points along the yield curve, or both. [Back to questions.](#)

Q. What maturity combinations work best?

A. When the yield curve is used to predict inflation (e.g., as in Mishkin (1990a, 1990b), interest rate maturities are matched precisely with the forecast horizons for inflation. For instance, to predict the difference between inflation expected in the next five years and inflation expected in the next year, the difference between five-year and one-year Treasury yields is used. When forecasting real activity, in contrast, the best results are obtained empirically by taking the difference between two Treasury yields whose maturities are far apart. At the long end, the clear choice seems to be a ten-year rate, which is the longest maturity available in most countries on a consistent basis over a long sample period. At the short end, there is a wider variety of choices. An overnight rate, such as the fed funds rate, is close to the extreme of the maturity spectrum. However, its usefulness as an indicator of market expectations is confounded by its fairly direct control by the Federal Reserve. A common choice currently is the two-year Treasury rate, perhaps because of the liquidity of the associated instruments. Background research in connection with Estrella and Mishkin (1998) suggested that the three-month Treasury rate, when used in combination with the ten-year Treasury rate to predict U.S. recessions, provides a reasonable combination of accuracy and robustness over long time periods. In the end, most term spreads are highly correlated and provide similar information about the real economy, so the particular choices with regard to maturity amount mainly to fine tuning and not to reversal of results. The caveat is that a benchmark that works for one spread may not work for another. For instance, the ten-year minus two-year spread may invert earlier than the ten-year minus three-month spread, which tends to be larger. [Back to questions.](#)

Q. Is it the level or the change in the spread that matters?

A. With many leading economic indicators, either individual variables or indices, analysts focus on the change or growth rate in the variable as a forecaster of future real economic conditions. In contrast, it is the level of the term spread – not the change – that helps forecast both recessions and changes in real economic activity. For recessions, it is clearly the level that matters. In a probit model of the probability of recession, a given change in the spread can have a very different impact, depending on the initial level of the spread. When the curve is very steep, say the spread is above 300 basis points, a change of 50 basis points in the spread hardly changes the probability of recession. However, if the spread starts out at 50 basis points, a decrease of that magnitude may raise the implied probability by 10 percentage points or more. Theoretical explanations of these empirical results are not easily formulated. A suggestive heuristic argument is that the term spread, being a difference between interest rates of different maturities, incorporates an element of expected changes in rates and is thus indicative of future changes in real activity. In 1996, the Conference Board added the yield curve spread to its index of leading indicators, focusing on monthly changes in the spread. Note,

however, that it announced in June 2005 that it would adjust its procedures so as to focus on the level of the spread and not on the change. [See also [Box 3.](#)] [Back to questions.](#)

Q. Does it matter if changes are driven by the short or the long end?

A. The best forecast of future real activity is provided by the level of the term spread, not the change in the spread, nor even the source of the change in the spread. Thus, if a low or negative value of the spread is reached via an increase in the short-term rate or a decrease in the long-term rate, it is only the low level that matters. In the six months preceding the trough of each yield curve inversion in the United States since 1960, we see a decline in the ten-year Treasury rate in two of seven cases (before the 1990-1991 and 2001 recessions) and an increase in the other cases. The direction of the change in the ten-year rate at the time of the signal does not appear to be indicative of the strength or duration of the subsequent recession. It is clear, however, that each recessionary episode is preceded (with varying lead times) by a substantial increase in the short-term rate. [Back to questions.](#)

Q. Is an inversion required for a signal?

A. Although economic theory suggests that the yield curve should help forecast real output, no theory establishes a clear connection specifically between yield curve inversions and recessions. However, since 1960, a yield curve inversion (as measured by the difference between ten-year and three-month Treasury rates) has preceded every recession on record. In fact, in terms of monthly averages, the ten-year rate was at least 12 basis points below the three-month rate before every recession in that period. In contrast, very low positive levels of the spread have been observed without a subsequent recession. Specifically, there were two episodes in the 1990s in which the term spread attained very low positive levels (42 and 12 basis points respectively), but did not invert. In both of those cases, economic activity continued unabated after the troughs or low points for the spread. Thus, using inversion as a benchmark, there were no “false positives” during the period. While inversions and recessions may not be inevitably connected by theory, they correspond to extreme values of the term spread and output growth, respectively, which are in fact theoretically linked. [See also [Box 5.](#)] [Back to questions.](#)

Q. Does the signal have to be persistent?

A. Daily or even intraday changes in the term spread can be substantial. For example, for the spread between ten-year and 3-month rates, one-day changes of over 25 basis points occur about 2½ percent of the time. In some cases, these changes may be driven by market expectations of economic fundamentals and consequently may be persistent. In many instances, though, high-frequency changes in the spread may result from

temporary demand or supply imbalances in the markets for Treasury securities, which may be quickly reversed and thus may not be truly reflective of changes in expectations about real economic conditions. One way to distinguish between perceived changes in fundamentals and temporary market phenomena is to trace the persistence of yield curve signals. A signal that lasts only one day may be dismissed, but a signal that persists for a month or more should be looked at carefully. Statistically, these distinctions may be captured by using data averaged over one month or more, which is quite common in the literature, or by including lagged effects in the model, as in Chauvet and Potter (2005). [Back to questions.](#)

Q. Is the evidence robust over time?

A. An informal way to assess the robustness of yield curve forecasts of real activity is to examine visually the ex post accuracy of the results. In some cases, as with the regularity that yield curve inversions precede recessions, the evidence is immediate and quite consistent, as in the United States since 1960. The only apparent miss was in 1967, when the economy experienced a “credit crunch” that the NBER did not classify as a recession, despite a marked decline in industrial production. In other cases, such as with forecasts of real GDP growth, it is not altogether obvious whether the forecasting performance is consistent in different subperiods. Thus, it is helpful to apply formal statistical tests of model stability to the forecasting equations. Stock and Watson (2003) find instability in a large proportion of the models that are frequently used to forecast output growth. Their results stress the need to look for changes in parameter values that may result, for instance, from changes in monetary policy regime. Estrella, Rodrigues and Schich (2003) find modest evidence of instability in models used to forecast growth in industrial production, which suggests a similar caveat. However, the latter find no evidence of instability in models used to forecast recessions in Germany and the United States, suggesting that models with qualitative dependent variables may be more robust to changes in policy or other economic conditions. [Back to questions.](#)

Q. How do binary models that predict recessions compare with models that forecast continuous dependent variables (e.g., real GDP or industrial production growth)?

A. These two types of models may be compared in two dimensions: accuracy and robustness. There is evidence that the most accurate binary models perform about as well as the most accurate continuous models. For example, Estrella and Hardouvelis (1991) and Estrella and Mishkin (1997) find that the R-squared in models of cumulative GNP growth is similar in magnitude to the pseudo R-squared in probit models of recession. The sample period may influence the results somewhat, particularly in the case of the continuous models. Stock and Watson (2003) find substantial evidence of instability over time in various models of output growth, and Estrella, Rodrigues and Schich (2003) find some instability in models of industrial production growth. However,

the latter paper suggests that binary models of recessions are quite robust over time, both in Germany and in the United States. [Back to questions.](#)

Q. How does the yield curve compare with other indicators?

A. In general, the yield curve tends to perform quite well in comparisons with other leading indicators, including the traditional leading indexes and their components, and other variables with potential predictive power. Indicators such as stock prices and interest rates may have similar performance to the yield curve at some horizons, but none seem to dominate the yield curve as a predictor. For instance, Dueker (1997) and Dotsey (1998) compare the yield curve with a few other variables as a leading indicator of recessions, and find generally supportive statistical evidence. Estrella and Mishkin (1998) compare the term structure as a predictor of recessions with a large number of alternative indicators, and find that it is among the best in tests of statistical significance, particularly at horizons of about one year. Stock and Watson (2003) examine a large number of competing indicators in forecasts of output growth and find that all of them fall short of ideal properties, but that within these limitations the term structure “comes closest” to achieving those goals. [Back to questions.](#)

Q. How does the yield curve perform out of sample, and can it be supplemented with other indicators?

A. The yield curve performs quite well in out of sample tests of predictive accuracy, and it is not clear that, in general, supplementary information can improve its predictive performance. Estrella and Mishkin (1998) find that, at predictive horizons beyond one quarter, there is no match for the term structure as a predictor of recessions. Not only do a large number of other indicators fall short, but predictions deteriorate as those other indicators are added to the term spread in out of sample forecasting exercises. Stock and Watson (2003) similarly examine a large number of competing indicators, but focus on forecasts of output growth rather than recessions. They find that the term spread works best, but that it exhibits some instability. The nature of this instability seems sufficiently idiosyncratic that combining the term spread with some other indicators may improve performance in their equations. [Back to questions.](#)

Q. How are predictions related to monetary policy?

A. Although there are different views of the instruments and channels of monetary policy, a tightening of monetary policy usually means a rise in short-term interest rates, typically intended in the end to lead to a reduction in inflationary pressures. When those pressures subside, it is expected that a policy easing will follow. Expected future short-term rates are important determinants of current long-term rates. Thus, long rates tend to respond to a monetary tightening by increasing, though given that a policy reversal is expected, they tend not to increase by as much as short-term rates. Thus, a

simple explanation of the predictive power of the yield curve for future output growth is that a monetary tightening both slows down the economy and flattens (or even inverts) the yield curve. Monetary policy is therefore an important determinant of the predictive power of the yield curve. However, given that private-sector expectations are incorporated in interest rates, and given that those expectations are based on some concept of the structure of the economy, monetary policy is not likely to be the single determinant of the predictive power. Formal models with these properties are presented in Eijffinger, Schaling and Verhagen (2000), Hardouvelis and Malliaropoulos (2004), and Estrella (2005a). Adrian and Estrella (2008) find that the yield curve discriminates almost perfectly between monetary tightening episodes that lead to an economic slowdown and those that do not. [Back to questions.](#)

Q. How are predictions related to market expectations of the economy?

A. One of the most pervasive theories of the determinants of the yield curve is the expectations hypothesis, which posits that long-term interest rates are averages of expected future short-term rates. In the “pure” version of the hypothesis, this is the whole story. That version has been repeatedly rejected in econometric tests [see Campbell (1995)], so it is likely that there are other important determinants as well, such as risk or liquidity premiums. Nevertheless, it is difficult to dispute that interest rate expectations play an important role, and that those expectations are related to future real demand for credit and to future inflation. A rise in short-term interest rates induced by monetary policy may lead to a future slowdown in real economic activity and demand for credit, putting downward pressure on future real interest rates. At the same time, slowing activity may result in lower expected inflation. By the expectations hypothesis, these expected declines in future short-term rates would tend to reduce current long-term rates and flatten the yield curve. Clearly, this scenario is consistent with the observed correlation between the yield curve and recessions. A formal model with these properties is presented in Estrella (2005a), and alternative specifications are considered in Eijffinger, Schaling and Verhagen (2000), Rendu de Lint and Stolin (2003), Malliaropoulos (2003) and Hardouvelis and Malliaropoulos (2004). [Back to questions.](#)

Q. Is there causality from economic activity to the yield curve?

A. Most of the literature in this field deals with the yield curve as a predictor of future activity, but in principle there could be influences in the opposite direction, from economic activity to the yield curve. In a dynamic theoretical model with rational expectations, such as Estrella (2005a), both directions play a role. The term spread contains expectations of future activity, and it is affected by current monetary policy, which is influenced in turn by current economic activity. Empirically, Estrella and Hardouvelis (1990) use U.S. data to examine the effect of monetary policy on the yield curve, and Estrella and Mishkin (1997) perform a similar analysis for a panel of

European economies. Evans and Marshall (2001) find consistent evidence that monetary policy shocks affect the nominal yield curve. In the context of a vector autoregression, Diebold, Rudebusch and Aruoba (2004) find that the influence in the direction from activity to the term structure is even stronger than the predictive relationships (though Stock and Watson (2003) warn about overinterpretation of such results). In general, theory and evidence are both supportive of a bidirectional relationship. [Back to questions.](#)

Q. Should we expect the predictive power of the term spread for real activity to persist?

A. Accumulated experience with the forecasting power of the yield curve suggests that it is much more than a passing phenomenon. Warnings of its actual or possible demise are often voiced, as in Butler (1978), Furlong (1989), Watson (1991) and – to some extent – Dotsey (1998), but the fact remains that recessions still seem to follow inversions quite inevitably, as recently as in 2000-2001. Like many empirical models, some formal predictive models that forecast output growth based on the term spread seem to have a structural break around 1979-1980. Stock and Watson (2003) find substantial evidence of a break for models that predict output growth and Estrella, Rodrigues and Schich (2003) find more modest evidence for models that predict industrial production. However, this evidence does not necessarily imply that the predictive power of the yield curve has disappeared altogether, only that the values of the parameters in the formal models may have changed. Models of a more qualitative nature, such as those that predict recessions, seem to be affected much less or not at all, as documented by Estrella, Rodrigues and Schich (2003). Theory suggests (e.g., Estrella (2005a)) that there is a persistent predictive relationship between term spreads and future real output, though the precise parameters may change over time. Since yield curve inversions and economic recessions correspond to extreme values of those variables, a connection between inversions and recessions may be systematically detectable even if parameters change over time within reasonable bounds. Thus, although yield curve inversions may not be followed by recessions as a matter of universal mathematical principle, they should definitely raise warning flags about future output growth. [Back to questions.](#)

Q. What reaction has the model received from policymakers?

A. Some policymakers have acknowledged the historical predictive power of the yield curve, but in general have played down its usefulness in predicting future economic downturns. For example, when the yield curve flattened in March 1989, Fed Chairman Greenspan told the Wall Street Journal that “circumstances differ today” and that “recent movements in nominal interest rates are not a reliable predictor of economic activity.” In late November 2005, when the yield curve had again flattened, he told Congress that “markets have become far more complex and the simple relationships that that yield curve slope indicated no longer work.” In March 2006, Chairman

Bernanke said in a speech that “I would not interpret the currently very flat yield curve as indicating a significant economic slowdown to come.” In each of these cases, the flatness in the yield curve was soon followed by an inversion and later by a recession or sharp economic slowdown. In a recent research paper, Rudebusch and Williams (Forthcoming) note that “signals from the yield curve have often been dismissed because of supposed changes in the economy or special factors influencing interest rates. This paper, however, shows that the puzzling power of the yield curve to predict recessions relative to that of professional forecasters appears to have endured, despite the wide dissemination of knowledge about the yield curve's predictive power.” [Back to questions.](#)

Bibliography

Additional references are welcome at estrea@rpi.edu.

- [1] Adrian, Tobias and Arturo Estrella (2008) "Monetary tightening and the predictability of economic activity." *Economics Letters* 99: 260-264.
- [2] Ahrens, Ralf (2002) "Predicting recessions with interest rate spreads: A multicountry regime-switching analysis." *Journal of International Money and Finance* 21: 519-537.
- [3] Alles, Lakshman (1995) "The Australian term structure as a predictor of real economic activity." *Australian Economic Review* 0(112): 71-85.
- [4] Anderson, Heather M. and Farshid Vahid (2001) "Predicting the probability of a recession with nonlinear autoregressive leading-indicator models." *Macroeconomic Dynamics* 5: 482-505.
- [5] Ang, Andrew and Monika Piazzesi (2003) "A no-arbitrage vector autoregression of term structure dynamics with macroeconomic and latent variables." *Journal of Monetary Economics* 50: 745-787.
- [6] Ang, Andrew, Monika Piazzesi and Min Wei (2005) "What does the yield curve tell us about GDP growth?" *Journal of Econometrics*, Forthcoming.
- [7] Athanasopoulos, George, Heather M. Anderson and Farshid Vahid (2001) "Capturing the shape of business cycles with nonlinear autoregressive leading indicator models." Monash University Working Paper No. 7/2001.
- [8] Attah-Mensah, Joseph and Greg Tkacz (2001) "Predicting recessions and booms using financial variables." *Canadian Business Economics*, February, 30-36.
- [9] Baltzer, Markus and Gerhard Kling (2005) "Predictability of future economic growth and the credibility of different monetary regimes in Germany, 1870-2003." Unpublished paper, University of Tübingen.
- [10] Bange, Mary M. (1996) "Capital market forecasts of economic growth: New tests for Germany, Japan, and the United States." *Quarterly Journal of Business and Economics* 35: 3-17.
- [11] Berk, Jan Marc (1998) "The information content of the yield curve for monetary policy: A survey." *De Economist* 146: 303-320.
- [12] Berk, Jan Marc and Peter Van Bergeijk (2001) "On the information content of the yield curve: Lessons from the Eurosystem?" *Kredit und Kapital* 34: 28-47.
- [13] Bernanke, Ben (2004) "The information in financial markets." Speech delivered at conference on "Monetary Policy and Interest Rates," sponsored jointly by the Stanford Institute for Economic Policy Research and the Federal Reserve Bank of San Francisco.
- [14] Bernanke, Ben S. (2006) "Reflections on the yield curve and monetary policy." Remarks before the Economic Club of New York, March 20.

- [15] Bernard, Henri and Stefan Gerlach (1998) "Does the term structure predict recessions? The international evidence." *International Journal of Finance and Economics* 3: 195-215; Bank for International Settlements Working Paper No. 37, September 1996.
- [16] Bomhoff, Eduard J. (1994) *Financial Forecasting for Business and Economics*. London: Academic Press.
- [17] Bonser-Neal, Catherine and Timothy R. Morley (1997) "Does the yield spread predict real economic activity? A multicountry analysis." *Federal Reserve Bank of Kansas City Economic Review* 82: 37-53.
- [18] Bordo, Michael D. and Joseph G. Haubrich (2004) "The yield curve, recessions and the credibility of the monetary regime: Long run evidence 1875-1997." NBER Working Paper 10431.
- [19] Boulier, Bryan L. and H.O. Stekler (2001) "The term spread as a cyclical indicator: A forecasting evaluation." *Applied Financial Economics* 11: 403-409.
- [20] Brown, William S. and Douglas E. Goodman (1991) "A yield curve model for predicting turning points in industrial production." *Business Economics* 26: 55-58.
- [21] Butler, Larry (1978) "Recession? – A Market View." *Federal Reserve Bank of San Francisco Weekly Letter*, December 15.
- [22] Campbell, John Y. (1995) "Some lessons from the yield curve." *Journal of Economic Perspectives* 9: 129-152.
- [23] Canova, Fabio and Gianni De Nicolò (2000) "Stock returns, term structure, inflation, and real activity: An international perspective." *Macroeconomic Dynamics* 4: 343-372.
- [24] Castellanos, Sara G. and Eduardo Camero (2003) "La estructura temporal de tasas de interés en México: ¿Puede ésta predecir la actividad económica futura?" *Revista de Análisis Económico* 18: 33-66.
- [25] Chauvet, Marcelle and Simon Potter (2002) "Predicting a recession: Evidence from the yield curve in the presence of structural breaks." *Economics Letters* 77: 245-253.
- [26] Chauvet, Marcelle and Simon Potter (2005) "Forecasting recessions using the yield curve." *Journal of Forecasting* 24: 77-103.
- [27] Chen, Nai-Fu (1991) "Financial investment opportunities and the macroeconomy." *Journal of Finance* 46: 529-554.
- [28] Clinton, Kevin (1995) "The term structure of interest rates as a leading indicator of economic activity: A technical note." *Bank of Canada Review* 1995: 23-40.
- [29] Davis, E. Philip and Gabriel Fagan (1994) "Indicator properties of financial spreads in the EU: Evidence from aggregate Union data." *European Monetary Institute Working Paper*.

- [30] Davis, E. Philip and Gabriel Fagan (1997) "Are financial spreads useful indicators of future inflation and output growth in EU countries?" *Journal of Applied Econometrics* 6: 701-714.
- [31] Davis, E. Philip and S.G.B. Henry (1994) "The use of financial spreads as indicator variables: Evidence for the United Kingdom and Germany." *IMF Staff Papers* 41: 517-525.
- [32] Diebold, Francis X., Glenn D. Rudebusch and S. Boragan Aruoba (2004) "The macroeconomy and the yield curve: A dynamic latent factor approach." *Journal of Econometrics*, Forthcoming.
- [33] Dotsey, Michael (1998) "The predictive content of the interest rate term spread for future economic growth." *Federal Reserve Bank of Richmond Quarterly Review* 84: 31-51.
- [34] Duarte, Agustín, Ioannis A. Venetis and Iván Payá (2005) "Predicting real growth and the probability of recession in the Euro area using the yield spread." *International Journal of Forecasting* 21: 261-277.
- [35] Dueker, Michael J. (1997) "Strengthening the case for the yield curve as a predictor of U.S. recessions." *Federal Reserve Bank of St. Louis Review* 79: 41-51.
- [36] Dueker, Michael J. (2005) "Dynamic forecasts of qualitative variables: A Qual VAR model of U.S. recessions" *Journal of Business and Economics Statistics* 23: 96-104.
- [37] Dueker, Michael J. and Katrin Wesche (1999) "European business cycles: New indices and analysis of their synchronicity." *Federal Reserve Bank of St. Louis Working Paper* 1999-019B.
- [38] Eijffinger, Sylvester, Eric Schaling and Willem Verhagen (2000) "The term structure of interest rates and inflation forecast targeting." *CEPR Discussion Paper* No. 2375.
- [39] Estrella, Arturo (2005a) "Why does the yield curve predict output and inflation?" *The Economic Journal* 115: 722-744.
- [40] Estrella, Arturo (2005b) "The yield curve and recessions." *The International Economy*, Summer.
- [41] Estrella, Arturo (2005c) "The yield curve as a leading indicator: Frequently asked questions." *Federal Reserve Bank of New York Working Paper*.
- [42] Estrella, Arturo and Gikas Hardouvelis (1989) "The term structure as a predictor of real economic activity." *Federal Reserve Bank of New York Research Paper*, May.
- [43] Estrella, Arturo and Gikas Hardouvelis (1990) "Possible roles of the yield curve in monetary analysis." In *Intermediate Targets and Indicators for Monetary Policy: A Critical Survey*. New York: Federal Reserve Bank of New York.
- [44] Estrella, Arturo and Gikas Hardouvelis (1991) "The term structure as a predictor of real economic activity." *Journal of Finance* 46: 555-576.

- [45] Estrella, Arturo and Frederic S. Mishkin (1996a) "The yield curve as a predictor of recessions in the United States and Europe," In *The Determination of Long-Term Interest Rates and Exchange Rates and the Role of Expectations*. Basel: Bank for International Settlements.
- [46] Estrella, Arturo and Frederic S. Mishkin (1996b) "The yield curve as a predictor of U.S. recessions." *Federal Reserve Bank of New York Current Issues in Economics and Finance*.
- [47] Estrella, Arturo and Frederic S. Mishkin (1997) "The predictive power of the term structure of interest rates in Europe and the United States: Implications for the European Central Bank." *European Economic Review* 41: 1375-1401.
- [48] Estrella, Arturo and Frederic S. Mishkin (1998) "Predicting U.S. recessions: Financial variables as leading indicators." *Review of Economics and Statistics*, 80: 45-61.
- [49] Estrella, Arturo and Anthony P. Rodrigues (1998) "Consistent covariance matrix estimation in probit models with autocorrelated errors." *Federal Reserve Bank of New York Staff Reports* No. 39.
- [50] Estrella, Arturo, Anthony P. Rodrigues and Sebastian Schich (2003) "How stable is the predictive power of the yield curve? Evidence from Germany and the United States." *Review of Economics and Statistics* 85: 629-644.
- [51] Estrella, Arturo and Mary R. Trubin (2006) "The yield curve as a leading indicator: Some practical issues," *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, July/August.
- [52] Estrella, Arturo and Hao Wu (2008) "Term premiums and the predictability of recessions." *Working Paper*, August.
- [53] Evans, Charles L. and David A. Marshall (1998) "Monetary policy and the term structure of nominal interest rates: Evidence and theory." *Carnegie-Rochester Conference Series on Public Policy* 49: 53-111.
- [54] Evans, Charles L. and David Marshall (2001) "Economic determinants of the nominal Treasury yield curve." *Unpublished paper*, Federal Reserve Bank of Chicago.
- [55] Fama, Eugene (1990) "Term structure forecasts of interest rates, inflation, and real returns." *Journal of Monetary Economics* 25: 59-76.
- [56] Favero, Carlo A., Iryna Kaminska and Ulf Söderström (2005) "The predictive power of the yield spread: Further evidence and a structural interpretation." *CEPR Discussion Paper* No. 4910.
- [57] Feroli, Michael (2004) "Monetary policy and the information content of the yield spread." *Topics in Macroeconomics* 4: Article 13.
- [58] Filardo, Andrew J. (1999) "How reliable are recession prediction models?" *Federal Reserve Bank of Kansas City Economic Review* 84: 35-55.

- [59] Frankel, Jeffrey A. and Cara S. Lown (1994) "An indicator of future inflation extracted from the steepness of the interest rate yield curve along its entire length." *Quarterly Journal of Economics* 109: 517-30.
- [60] Frumkin, Norman (2004) *Tracking America's Economy*. Armonk, New York: M.E. Sharpe.
- [61] Fuhrer, Jeffrey C. and George R. Moore (1992) "Monetary policy rules and the indicator properties of asset prices." *Journal of Monetary Economics* 29: 303-336.
- [62] Fuhrer, Jeffrey C. and George R. Moore (1995) "Monetary policy trade-offs and the correlation between nominal interest rates and real output." *American Economic Review* 85: 219-239.
- [63] Furlong, Frederick T. (1989) "The yield curve and recessions." *Federal Reserve Bank of San Francisco Weekly Letter*, March 10.
- [64] Funke, Norbert (1997) "Yield spreads as predictors of recessions in a core European economic area." *Applied Economics Letters* 4: 695-697.
- [65] Furlong, Frederick T. (1989) "The yield curve and recessions." *Federal Reserve Bank of San Francisco Weekly Letter*, March 10.
- [66] Galbraith, John W. and Greg Tkacz (2004) "Testing for asymmetry in the link between the yield spread and output in the G-7 countries." Unpublished paper, Bank of Canada.
- [67] Galvão, Ana Beatriz (2006) "Structural break threshold VARs for predicting US recessions using the spread." *Journal of Applied Econometrics* 21: 463-487.
- [68] Gerlach, Stefan (1997) "The information content of the term structure: Evidence for Germany." *Empirical Economics* 22: 161-179.
- [69] Gertler, Mark and Cara S. Lown (2000) "The information in the high yield bond spread for the business cycle: Evidence and some implications." NBER Working Paper 7549.
- [70] González, Jorge G., Roger W. Spencer and Daniel T. Walz (2000) "The term structure of interest rates and the Mexican economy." *Contemporary Economic Policy* 18: 284-294.
- [71] Greenspan, Alan (2005) Testimony before the Joint Economic Committee of Congress, November 3.
- [72] Hamilton, James D. and Dong Heon Kim (2002) "A reexamination of the predictability of economic activity using the yield spread." *Journal of Money, Credit, and Banking* 34: 340-360.
- [73] Hansen, Lars P. (1982) "Large sample properties of generalized method of moments estimators." *Econometrica* 50: 1029-1054.
- [74] Hardouvelis, Gikas and Dimitrios Malliaropoulos (2004) "The yield spread as a symmetric predictor of output and inflation." CEPR Discussion Paper No. 4314.
- [75] Harvey, Campbell R. (1988) "The real term structure and consumption growth." *Journal of Financial Economics* 22 (December): 305-333.

- [76] Harvey, Campbell R. (1989) "Forecasts of economic growth from the bond and stock markets." *Financial Analysts Journal*, September/October: 38-45.
- [77] Harvey, Campbell R. (1991) "The term structure and world economic growth." *The Journal of Fixed Income* 1: 7-19.
- [78] Harvey, Campbell R. (1997) "The relation between the term structure of interest rates and Canadian economic growth." *Canadian Journal of Economics* 30: 169-193.
- [79] Haubrich, Joseph G. and Ann M. Dombrosky (1996) "Predicting real growth using the yield curve." *Federal Reserve Bank of Cleveland Economic Review* 32: 26-35.
- [80] Hejazi, Walid (1997) "Yield spreads as predictors of industrial production: Short rates or term premia?" University of Toronto Working Paper.
- [81] Hu, Zulu (1993) "The yield curve and real activity." *IMF Staff Papers* 40: 781-806.
- [82] Ivanova, Detelina, Kajal Lahiri and Frank Seitz (2000) "Interest rate spreads as predictors of German inflation and business cycles." *International Journal of Forecasting* 16: 39-58.
- [83] Kamara, Avraham (1997) "The relation between default-free interest rates and expected economic growth is stronger than you think." *Journal of Finance* 52: 1681-1694.
- [84] Kauppi, Heikki and Pentti Saikkonen (2005) "Predicting U.S. recessions with dynamic binary response models." Helsinki Center of Economic Research Discussion Paper No. 79.
- [85] Kessel, Reuben A. (1965) "The cyclical behavior of the term structure of interest rates." *National Bureau of Economic Research Occasional Paper* No. 91.
- [86] Kim, Kenneth A. and Piman Limpaphayom (1997) "The effect of economic regimes on the relation between term structure and real activity in Japan." *Journal of Economics and Business* 49: 379-392.
- [87] Kotlán, Viktor (2002) "Monetary policy and the term spread in a macro model of a small open economy." *Czech National Bank Working Paper* No. 1.
- [88] Kozicki, Sharon (1997) "Predicting real growth and inflation with the yield spread." *Federal Reserve Bank of Kansas City Economic Review* 82:39-57.
- [89] Labadie, Pamela (1994) "The term structure of interest rates over the business cycle." *Journal of Economic Dynamics and Control* 18: 671-697.
- [90] Lapp, John S. (1997) "Interest rates, rate spreads, and economic activity." *Contemporary Economic Policy* 15: 42-50.
- [91] Laurent, Robert (1988) "An interest rate-based indicator of monetary policy." *Federal Reserve Bank of Chicago Economic Perspectives* 12 (January): 3-14.
- [92] Laurent, Robert (1989) "Testing the spread." *Federal Reserve Bank of Chicago Economic Perspectives* 13 (July): 22-34.

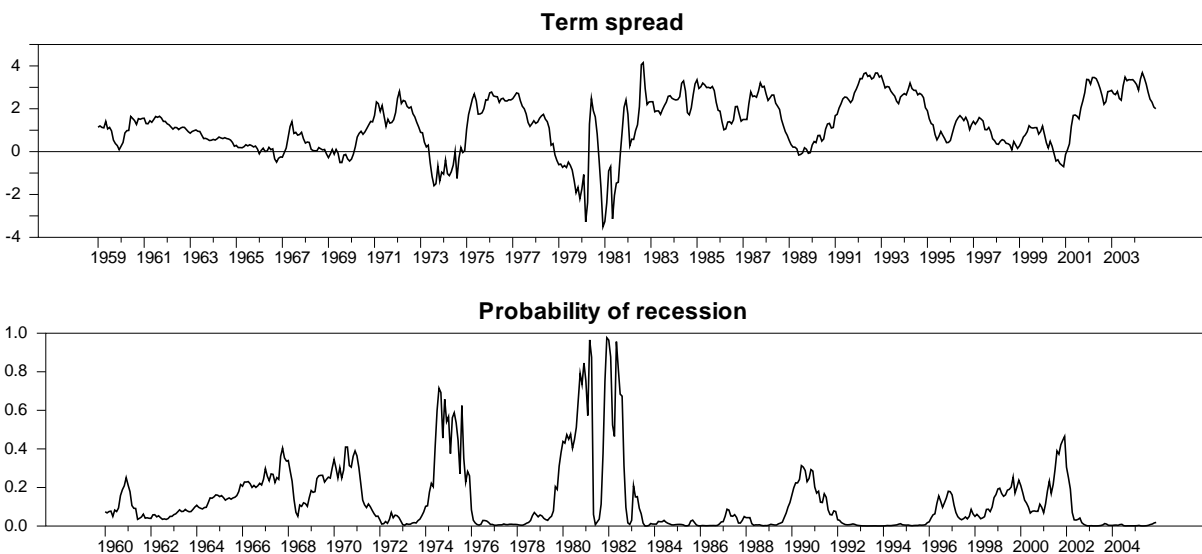
- [93] Li, Ning, David E. Ayling and Lynn Hodgkinson (2003) "An examination of the information role of the yield spread and stock returns for predicting future GDP." *Applied Financial Economics* 13: 593-597.
- [94] Malliaropulos, Dimitrios (2003) "Identifying the sources of the predictive ability of the yield spread." Unpublished paper, University of Piraeus.
- [95] McMillan, David G. (2002) "Interest rate spread and real activity: Evidence for the UK." *Applied Economics Letters* 9: 191-194.
- [96] Mishkin, Frederic S. (1990a) "What does the term structure tell us about future inflation?" *Journal of Monetary Economics* 25: 77-95.
- [97] Mishkin, Frederic S. (1990b) "The information in the longer-maturity term structure about future inflation." *Quarterly Journal of Economics* 55: 815-28.
- [98] Mitchell, Wesley C. (1913) *Business Cycles*. Berkeley: University of California Press.
- [99] Mody, Ashoka and Mark P. Taylor (2004) "Financial predictors of real activity and the financial accelerator." *Economics Letters* 82: 167-172.
- [100] Moneta, Fabio (2003) "Does the yield spread predict recessions in the Euro area?" *European Central Bank Working Paper No. 294*.
- [101] Murray, Alan (1989) "Fed's goal is to cut inflation to zero, Greenspan says." *Wall Street Journal*, March 28, p. A2.
- [102] Neeley, Christopher J. (2000) "What is the slope of the yield curve telling us?" *Federal Reserve Bank of St. Louis Monetary Trends*, August.
- [103] Newey, Whitney K. and Kenneth D. West (1987) "A simple, positive semi-definite, heteroskedasticity and autocorrelation consistent covariance matrix." *Econometrica* 55: 703-708.
- [104] Öncü, T. Sabri (2006) "A parametric estimator for multi-stage duration models with many transient and absorbing states with an application: The yield curve slope as a predictor of the US recessions." *Bilkent University Working Paper*.
- [105] Payá, Iván, Ioannis A. Venetis and David A. Peel (2000) "Asymmetry in the link between the yield spread and industrial production. Threshold effects and forecasting." Unpublished paper, Cardiff University Business School.
- [106] Peel, David A. and Christos Ioannidis (2003) "Empirical evidence on the relationship between the term structure of interest rates and future output changes when there are changes in policy regimes." *Economics Letters* 78: 147-152.
- [107] Peel, David A. and Mark P. Taylor (1998) "The slope of the yield curve and real economic activity: Tracing the transmission mechanism." *Economics Letters* 59: 353-360.
- [108] Plosser, Charles I. and K. Geert Rouwenhorst (1994) "International term structures and real economic growth." *Journal of Monetary Economics* 33: 133-155.
- [109] Reinhart, Carmen M. and Vincent R. Reinhart (1996) "Forecasting turning points in Canada." Unpublished paper, International Monetary Fund.

- [110] Rendu de Lint, Christel and David Stolin (2003) "The predictive power of the yield curve: A theoretical assessment." *Journal of Monetary Economics* 50: 1603-1622.
- [111] Roma, Antonio and Walter Torous (1997) "The cyclical behavior of interest rates." *Journal of Finance* 52: 1519-1542.
- [112] Rosenberg, Joshua and Samuel Maurer (2008) "Signal or Noise? Implications of the Term Premium for Recession Forecasting." *Economic Policy Review*, Federal Reserve Bank of New York, July.
- [113] Rudebusch, Glenn D., Brian P. Sack and Eric T. Swanson (2007) "Macroeconomic implications of changes in the term premium." *Federal Reserve Bank of St. Louis Review* 89 (July/August): 241-269.
- [114] Rudebusch, Glenn D. and John C. Williams (Forthcoming) "Forecasting recessions: The puzzle of the enduring power of the yield curve." *Journal of Business and Economic Statistics*.
- [115] Rudebusch, Glenn D. and Tao Wu (2004) "A macro-finance model of the term structure, monetary policy, and the economy." *Federal Reserve Bank of San Francisco Working Paper* 2003-17.
- [116] Schich, Sebastian T. (1996) "Alternative specifications of the German term structure and its information content regarding inflation." *Discussion Paper* 8/96, Economic Research Group of the Deutsche Bundesbank.
- [117] Sédillot, Franck (2001) "La pente des taux contient-elle de l'information sur l'activité économique future?" *Économie et Prévision* 0(147): 141-157.
- [118] Shaaf, Mohamad (2000) "Predicting recession using the yield curve: An artificial intelligence and econometric comparison." *Eastern Economic Journal* 26:171-190.
- [119] Shoesmith, Gary L. (2003) "Predicting national and regional recessions using probit modeling and interest-rate spreads." *Journal of Regional Science* 43: 373-392.
- [120] Smets, Frank and Kostas Tsatsaronis (1997) "Why does the yield curve predict economic activity? Dissecting the evidence for Germany and the United States." *BIS Working Papers* No. 49.
- [121] Smith, Stephen D. (1999) "What do asset prices tell us about the future?" *Federal Reserve Bank of Atlanta Economic Review* 84: 4-13.
- [122] Stock, James and Mark Watson (1989) "New indexes of coincident and leading indicators." In Blanchard, Olivier and Stanley Fischer, eds. *NBER Macroeconomic Annual* 4 (November): 351-394.
- [123] Stock, James and Mark Watson (1993) "A procedure for predicting recessions with leading indicators: Econometric issues and recent performance." In Stock, James and Mark Watson, eds., *Business Cycles, Indicators, and Forecasting*. Chicago: University of Chicago Press.
- [124] Stock, James and Mark Watson (2003a) "Forecasting output and inflation: The role of asset prices." *Journal of Economic Literature* 41: 788-829.

- [125] Stock, James and Mark Watson (2003b) "How did leading indicator forecasts perform during the 2001 recession?" Federal Reserve Bank of Richmond Economic Quarterly 89: 71-90.
- [126] Stojanovic, Dusan and Mark D. Vaughn (1997) "Yielding clues about recessions: The yield curve as a forecasting tool." Federal Reserve Bank of St. Louis Regional Review 10-11.
- [127] Tkacz, Greg (2001) "Neural network forecasting of Canadian GDP growth." International Journal of Forecasting 17: 57-69.
- [128] Tse, Y.K. (1998) "Interest rate spreads and the prediction of real economic activity: The case of Singapore." Developing Economies 36: 289-304.
- [129] Venetis, Ioannis A., Iván Payá and David A. Peel (2003) "Re-examination of the predictability of economic activity using the yield spread: A nonlinear approach." International Review of Economics and Finance 12: 187-206.
- [130] Watson, Mark (1991) "Using econometric models to predict recessions." Federal Reserve Bank of Chicago Economic Perspectives 15: 14-25.
- [131] Wright, Jonathan (2006) "The yield curve and predicting recessions." Finance and Economics Discussion Series No. 2006-07, Federal Reserve Board, February 2006.

Box 1. *The term spread and recessions*

Yield curve inversions have preceded each of the last six recessions. To illustrate, the top figure shows the spread between ten-year and three-month Treasury securities from 1960 to 2005, with shading to indicate NBER-dated recessions. The bottom panel shows the probability of recession one year ahead, obtained by applying a probit model to the term spread as defined above. [See Estrella and Hardouvelis (1991) and [Box 3](#).]



Note that the probability of recession in month m is based on the spread from month $m-12$. The ten-year rate is the constant maturity rate and the three-month rate is calculated on a bond-equivalent basis. Both are monthly averages of daily rates from January 1960 to December 2005. The estimation sample period stops at the end of 2005 to avoid errors in recession dates, which are issues by the NBER with a fairly long lag. Source: Federal Reserve Board. [Back to questions](#).

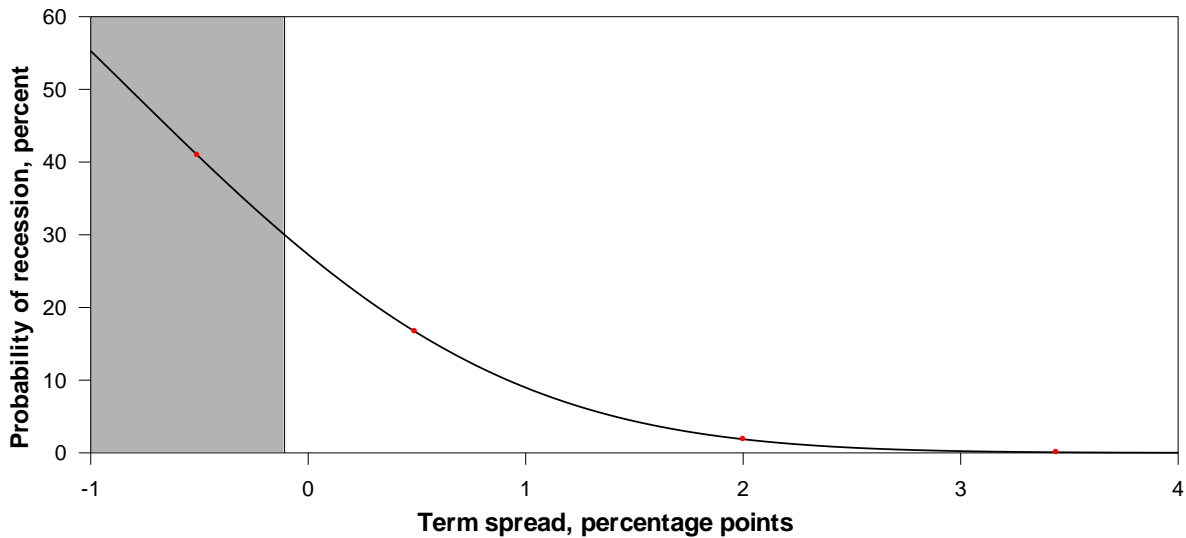
Box 2. Early works on the yield curve and real activity

Paper	Measure of yield curve	Measure of real activity
Mitchell (1913)	Individual rates on railroad bonds, commercial paper, and call loans	Ad hoc business cycle dating
Kessel (1965)	Rates on government and corporate securities, call money	NBER business cycle turning points
Butler (1978)	Rates on Federal agency securities of various maturities	NBER business cycle turning points
Laurent (1988, 1989)	Spread between 20-year Treasury and federal funds rate	Real GNP growth
Harvey (1988)	Spreads between 6-, 9- and 12-month real Treasury rates, respectively, and 3-month real Treasury rate	Real consumption growth
Furlong (1989)	Spread between 10-year and 3-month Treasury securities	NBER recessions
Estrella and Hardouvelis (1989, 1990, 1991)	Spread between 10-year and 3-month Treasury securities	Real GNP growth Real consumption growth Real growth in consumer durables Real investment growth NBER recessions
Stock and Watson (1989)	Spread between 10-year and 1-year Treasury securities	Computed experimental coincident index
Chen (1991)	Spread between 10-year and 1-month Treasury securities	Growth in GNP and per capita consumption

[Back to questions.](#)

Box 3. The term spread and the probability of recession twelve months later

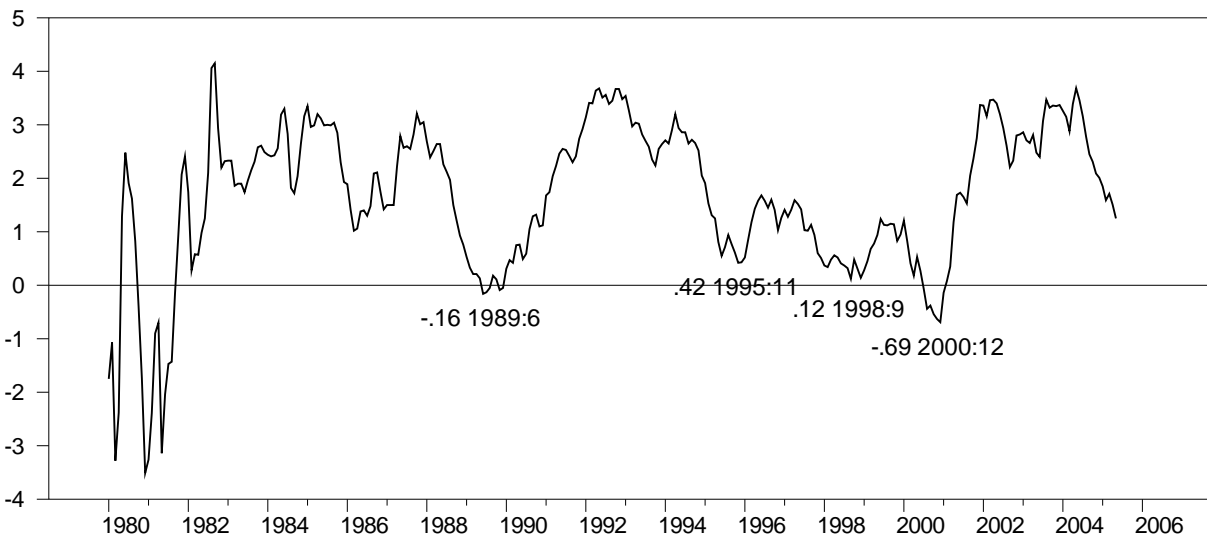
The term spread may be converted into a probability of recession twelve months later by using a probit model.* The figure below depicts the probability of recession associated with a range of levels of the term spread, the latter measured as the monthly average spread between ten-year and three-month Treasury rates. From 1960 to 2005, whenever this spread has entered the shaded region, a recession has followed about a year later.



*For a given value of the spread s_t at month t , the probability of recession at month $t+12$ is given by the probit model as $p_{t+12} = F(\alpha + \beta x_t)$, where F is the standard cumulative normal distribution and α and β are constants. The values of the constants are chosen to maximize a likelihood function whose value is higher as each probability in the sample period approaches the true value of the recession indicator in that month (1 for a recession month, 0 otherwise). For sample data from 1959 to 2005, the estimates are $\alpha = -0.6046$ and $\beta = -0.7374$. See Estrella and Trubin (2006). [Back to questions.](#)

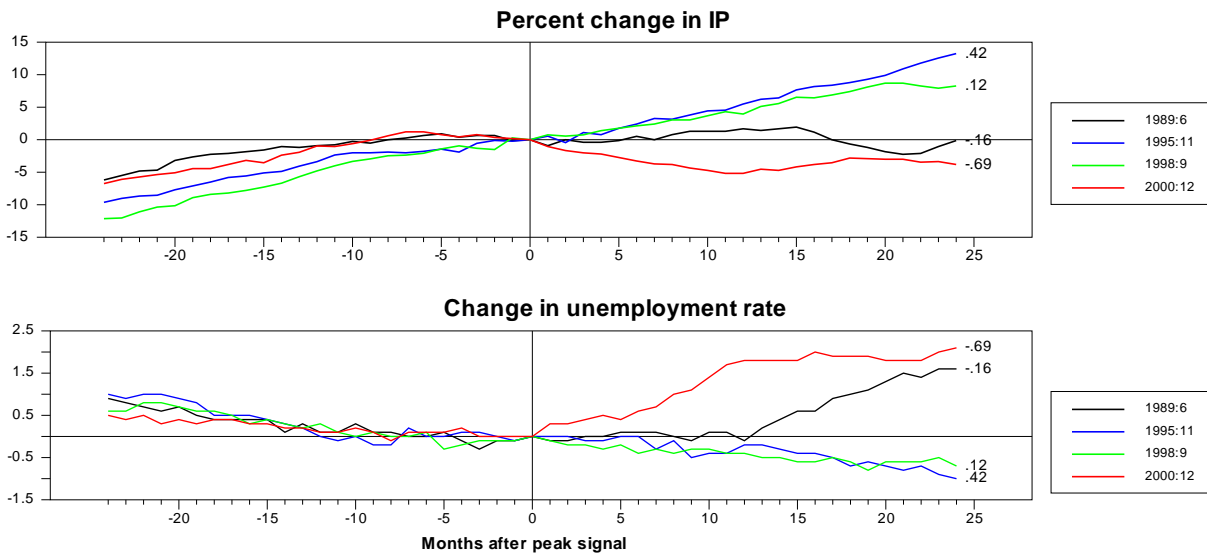
Box 4. Troughs in the term spread since 1989

After the “twin recessions” of the early 1980s, the term spread (ten year minus three month rates) has been negative twice, each time followed by a recession. See figure below, which shows low values of the yield spread (in percentage points) and the months in which they were observed. There were also two instances in the 1990s in which the value of the spread came very close to zero, but did not turn negative on a monthly average basis. In those two occasions, a recession did not ensue. [Back to questions.](#)



Box 5. Industrial production and unemployment around recent term spread signals

How different was the course of real economic activity around the four troughs identified in Box 4? The troughs correspond to the peak signals emitted by the term spread during particular periods. Two of the troughs, those with negative spreads, were followed by recessions and two, with positive spreads, were not. The figures below examine the behavior of industrial production and the unemployment rate around each of the troughs. There is one curve for each episode, representing the difference between the current value of the variable and its value at the trough. In the case of industrial production, the difference is proportional. The value of the term spread at the trough – the peak signal – is given at the tail end of each curve.



The month of the trough is denoted as 0 in the horizontal axis. As each trough approaches, the four episodes exhibit similar behavior, with trends consistent with a growing economy. After the positive troughs, these trends continue unabated. After the negative troughs, however, industrial production falters or decreases and unemployment stagnates or increases, both manifestations of the subsequent recessions.

[Back to questions.](#)