



Yield Curve and Predicted GDP Growth

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The Yield Curve as a Predictor of Economic Growth

The slope of the yield curve—the difference between the yields on short- and long-term maturity bonds—has achieved some notoriety as a simple forecaster of economic growth. The rule of thumb is that an inverted yield curve (short rates above long rates) indicates a recession in about a year, and yield curve inversions have preceded each of the last seven recessions (as defined by the NBER [↗](#)). One of the recessions predicted by the yield curve was the most recent one: The yield curve inverted in August 2006, a bit more than a year before the most recent recession started in December 2007. There have been two notable false positives: an inversion in late 1966 and a very flat curve in late 1998.

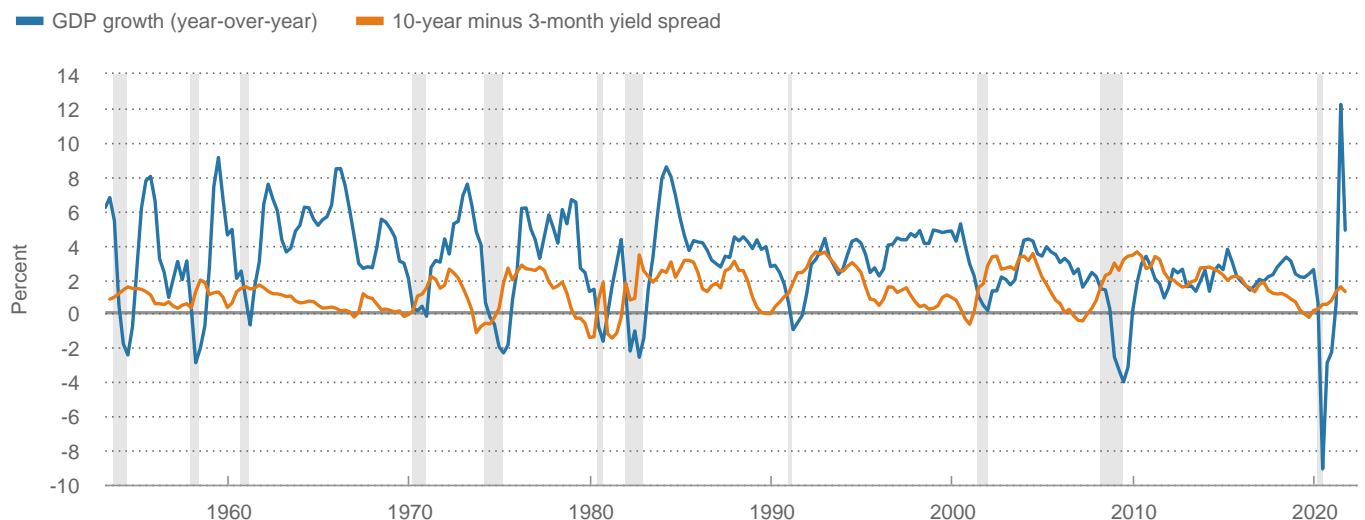
More generally, a flat curve indicates weak growth and, conversely, a steep curve indicates strong growth. One measure of slope, the spread between 10-year Treasury bonds and 3-month Treasury bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

[Yield Curve Spread and Real GDP Growth](#)
[Yield Curve Spread and Lagged Real GDP Growth](#)

Yield Curve Spread and Real GDP Growth



Click/drag to zoom



Note: Shaded bars indicate recessions.

Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics

Predicting GDP Growth

We use past values of the yield spread and GDP growth to project what real GDP will be in the future. We typically calculate and post the prediction for real GDP growth one year forward.

Predicting the Probability of Recession

While we can use the yield curve to predict whether future GDP growth will be above or below average, it does not do so well in predicting an actual number, especially in the case of recessions. Alternatively, we can employ features of the yield curve to predict whether or not the economy will be in a recession at a given point in the future. Typically, we calculate and post the probability of recession one year forward.

Of course, it might not be advisable to take these numbers quite so literally, for two reasons. First, this probability is itself subject to error, as is the case with all statistical estimates. Second, other researchers have postulated that the underlying determinants of the yield spread today are materially different from the determinants that generated yield spreads during prior decades. (For a recent example, see [“Recession Probabilities.”](#)) Differences could arise from changes in international capital flows and inflation expectations, for example. The

bottom line is that yield curves contain important information for business cycle analysis, but, like other indicators, should be interpreted with caution.

Research on the Yield Curve's Ability to Signal Recessions

- [“Does the Yield Curve Signal Recession?”](#) This article provides more detail on issues related to using the yield curve to predict recessions.

Additional Resources

- [“The Yield Curve, Recessions, and the Credibility of the Monetary Regime.”](#) This working paper examines yield curves based on securities other than Treasury security and their ability to predict recessions.
- [“Recession Probabilities.”](#) This article discusses the question of whether the underlying determinants of the yield spread today are materially different from the determinants that generated yield spreads during prior decade.
- The New York Fed's estimate of the probability of recession. ➔ This website contains much useful information along with an estimate of the probability of a recession in the United States 12 months ahead.

Contact Us

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