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Inverted Yield Curves and Recessions

As forward-looking institutions, credit markets often provide useful glimpses of future economic developments. The spread between long-term and short-term interest rates (called the slope of the yield curve) has garnered particular attention as an indicator of recessions. The accompanying chart shows that short-term rates (e.g., the rate on 3-month Eurodollar deposits) exceeded long-term rates, that is, the yield curve became inverted, prior to each of the recessions since 1972. Should we worry today about the possibility of a recession because of a yield curve that recently has flattened and may yet invert?

Past yield-curve inversions resulted from sharp increases in short-term rates that coincided with surges in inflation. In 1974, 1980 and 1981, upswings in short-term interest rates boosted them above long-term interest rates by several hundred basis points. A marked inversion of the yield curve is, to some extent, a passive indicator of coming weakness in the economy, but also directly curtails economic activity through a bank lending channel. Because bank deposits generally are shorter in maturity than bank loans, inversions of the yield curve can squeeze bank profit margins and discourage new lending. When interest rates on bank deposits had legal ceilings prior to the mid-1980s, periods of high short-term interest rates led to disintermediation and a shortage of loanable funds in the banking system.

Recently, the yield-curve slope has decreased because of falling long-term rates, rather than rising short-term rates. If short-term rates remain fairly steady in the near term, it is highly unlikely that long-term rates would fall enough to cause more than a mild inversion of the yield curve. Yet, is there a danger that even a mild inversion of the yield curve could foreshadow a recession, as in 1989? Possibly not, because two special factors pervaded the 1990-91 recession. First, the 1986 Tax Act removed in phases key tax breaks for commercial real estate that had been instituted only a few years earlier. This whipsawing in tax treatment caused an overbuilding followed by a severe downturn in the market for commercial real estate, which negatively impacted bank balance sheets. Second, base closings and other cutbacks in defense spending caused downturns in areas of the country that had remained largely immune to recessions for most of the Cold-War era. Today, American businesses, especially banks, have stronger balance sheets than in 1989. Hence, if the yield curve were to become mildly inverted today, the business-cycle effect probably would be minor. Moreover, a slight, temporary inversion of the yield curve could well reflect a positive long-run development: a permanent disinflation.

—Michael J. Dueker

The Yield Curve, Inflation, and Bank Lending Growth