Economic Scene | Leonard Silk

Encouraging Clue Points to Recovery

CHANGES in the spread between short-term and long-term interest rates may be the best means of forecasting business-cycle turning points. When short rates are lower than long — as they are now — the economy tends to grow. But when long rates drop below short, recession looms.

Over the last 25 years, movements in the "term structure" of interest rates, or yield curve, have correctly predicted all the major peaks and troughs in the United States business cycle, according to Prof. Campbell R. Harvey of Duke University's Fuqua School of Business.

Unlike other indicators, the yield curve has put out no false signals. In the third quarter of 1968, the curve began an inversion, changing its slope from positive to negative, and correctly signaled the recession of 1969-70, which started five months after long rates dropped below short rates.

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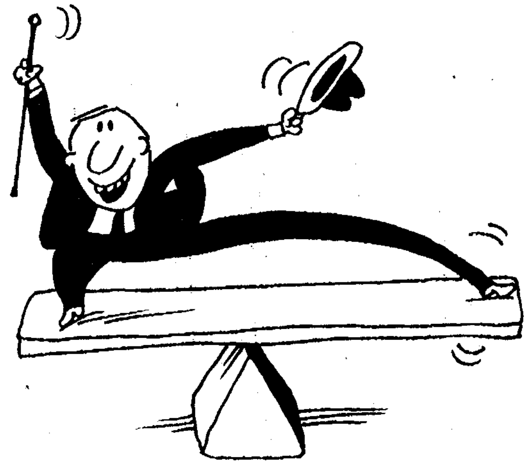
The yield curve inverted two months before the 1973-75 recession began. In the fourth quarter of 1978 and in the fourth quarter of 1980, the yield curve inverted, recovered and inverted again, correctly predicting the double-dip recessions of 1980 and 1981-82, which some economists see as one recession.

How about the latest recession, which may or may not be over? The Administration attributed the onset of the recession to the outbreak of the Persian Gulf crisis in August 1990. But the inversion of the yield curve in the second quarter of 1989 had predicted the downturn that began five months later — the average lag between inversions and recessions.

But so slight was the inversion in the last three quarters of 1989 that it was unclear whether the economy was facing recession or just a spell of sluggish growth. The inversion in the third quarter of 1989 was only 30 basis points (with long-term rates just three-tenths of 1 percent below short-term rates). By comparison, the inversion in the fourth quarter of 1980 was 340 basis points (3.4 percent), correctly predicting the deep recession of 1981-82.



Niculae Asciu

In July 1990, with the yield curve positive again, Professor Harvey correctly predicted that the economy would begin its recovery about the middle of 1991. That forecast now appears to be on target. The index of leading indicators posted a sharp increase of 1.2 percent in July.

But the downward revision by the Commerce Department of the preliminary estimate of the growth of gross national product, corrected for inflation, in the second quarter to minus three-tenths of 1 percent from positive four-tenths of 1 percent has made some economists dubious about the end of the recession.

For his part, Mr. Harvey holds that the present upward sloping yield curve signals a robust recovery, not a weak or moderate one, as most economists are forecasting. Using a model based on the yield curve, he forecasts real growth of 3.5 percent from the second quarter of this year through the second quarter of 1992. But he concedes that his model is better at forecasting turning points than rates of growth. He underestimated the degree of the current recession. But it was still milder than earlier recessions. From the third quarter of 1990 to the second quarter of 1991, real G.N.P. declined 1.1 percent, compared with the 3.3 percent in the recession of 1981-82, 2.3 percent in 1980 and 4.4 percent in 1974-75.

Expectations of a stronger recovery can now be based on the steepening slope of the yield curve. Measured by the spread between three-month Treasury bills and 10-year Treasury notes, the yield curve has grown more positive in the last 12 months: Long-term rates were 80 basis points higher than short rates in the third quarter of 1990, 90 in the fourth quarter of 1990, 160 in the first quarter of 1991 and 230 in the second quarter. This week the spread between three-month T-bills and 10-year notes was 244 basis points. This steepening curve gives no sign of a double-dip recession ahead, in contrast with the correct anticipation of the double-dip recessions of 1980 and 1981-82.

What explains the ability of the yield curve to call business cycle turning points? Most people are risk averse: if they expect hard times, they will try to even out their future income flows by shifting money into secure, longer-term assets, thereby bidding up their prices and reducing their yields. To finance such purchases, they will sell short-term assets, reducing their prices and raising their yields. Thus, the normally positive yield curve goes negative in advance of recessions.

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But the typical yield curve was not always positive. The new addition of Sidney Homer's classic "History of Interest Rates," revised and updated by Richard Sylla, reveals that during the 19th century and the first three decades of the 20th century, short-term paper rates averaged far higher than did prime long-term bond yields. The yield curve went positive during the Depression of the 1930's, when short-term yields plunged, and has stayed positive most years since.

On the statistical record of the last quarter century, the yield curve has been a good forecaster of economic growth and recessions. But borrowers and lenders cannot really see the future or the shocks that will change it. So no economic forecasting model can be perfectly reliable, not even one based on interest rates.