The yield curve for U.S. government debt has recently become inverted. The interest rate on 5-year debt, for example, exceeds that on 30-year debt. This is an unusual phenomenon. More typically, investors who are committing their funds for longer periods of time require a higher return to compensate for lost liquidity.

The conventional wisdom is that yield-curve inversions precede recessions. Is the U.S. indeed on the brink of a recession? There are several reasons to think not. First, if this country is about to enter a recession, then so are Canada, the U.K., and Norway, which also have inverted yield curves. Inversion in so many countries at once might be attributed to the tendency of business cycles to be international phenomena, due perhaps to common shocks (for example, high oil prices) or to international trade (which transmits shocks across countries). But if a world recession is in the offing, why do Germany, France, Belgium, and Japan, among others, have typical, upward-sloping yield curves?

Second, some analysts have used supply factors in the government-debt market to explain inverted yield curves. As follows: Countries with inversions are also running budget surpluses that reduce the need for debt financing of government spending and so reduce the supply of long-term government debt. This reduction in the debt supply drives up the price of government bonds, thus reducing the yield. Furthermore, in the U.S. at least, the Treasury Department may also shift the mix of

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government debt from long- to short-term, which can be expected to contribute further to the inversion of U.S. Treasury yields. Yet government surpluses seem to provide only a partial explanation for yield-curve inversions. In particular, they cannot account for the absence of inversions in Denmark, New Zealand, and Australia, countries that are running government surpluses.

Third, in the U.S., only the yield curve for government debt is now inverted. The yield curves for high-quality corporate debt slope upward. The same is true for Canada. The U.K. alone shows inversion in both the government and corporate yield curves. (Data for Norwegian corporate yields were not available.) It might at first seem odd that government and high-quality corporate debt would have such different yields, but there is an important distinction between the two: Government debt is default-free. Consequently, corporate yields will incorporate a risk premium in excess of government yields. If this premium rises with maturity, then the gap between corporate and government yields will become larger at longer horizons. Such a risk premium may explain the different shapes of yield curves in both Canada and the U.S. (where inversion in government yields is fairly modest) relative to the U.K. (where risk premiums are comparable but the inversion is far more pronounced and is apparent in both corporate and government yield curves).