ABSTRACT

There is considerable interest in identifying any factor that would predict economic activity, especially downturns. Internationally there are several academic papers examining the predictive content of various economic indicators with regard to real economic activity. Yield spread, the difference in yield between a short term t-bill and long term bond, is one such significant economic indicator. The extent to which the yield curve is tilted away from its normal slope is identified by many researchers as a valuable indicator of future state of the economy. The main objective of this study is to study the power of yield spread in predicting the timing of recession, in the Indian context, and compare the results with the results of Standard & Poor CRISIL NSE Index, non-food credit, M1 money stock. The study uses secondary data, of monthly frequency, of the explanatory variables from Reserve Bank of India's Database on Indian Economy. Monthly data of the variables from April 1996 till September 2012 is used in this study. The study tries to find out the predictive power of yield spread and other economic variables by using probit regression with the dependent variable as recession dummy obtained from business cycle analysis. The results suggest that yield spread outperforms other economic variables in its prediction, especially when predictive horizon is more than six months. Also, for horizons less than six months yield spread is as good as the best predictor. The results corroborate to similar studies done earlier for various countries, wherein yield spread was found to be the best predictor of timing of recessions.