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A NOTE ON THE (CONTINUED) ABILITY OF THE YIELD CURVE TO FORECAST ECONOMIC DOWNTURNS IN SOUTH AFRICA

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Abstract
In 2002-2003, the South African yield spread falsely signalled a downswing that never materialised. This paper provides two reasons for this false signal. First, while the Reserve Bank never actually officially declared the start of a downswing, by alternative measures a downswing did actually occur. It is this severe weakness in economic activity at that time that the yield curve pointed to. Second, short-term interest rates in 2003 were higher than they should have been because of a mistake made in measuring consumer price inflation. Because South Africa had recently introduced an inflation-targeting regime, policy interest rates were, as a result of this error, kept too high for too long. This policy mistake was rectified as soon as the error in the Consumer Price Index was discovered. Thus, the yield curve in 2003 pointed to the reality that short-term interest rates were too high and risked pushing the economy into full blown recession. This is demonstrated by the fact that it was a fall in long bond interest rates that caused the yield spread to turn negative, indicating expectations that short-term interest rates would need to be cut – as indeed they were.
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1. INTRODUCTION

The ability of the yield spread to accurately forecast economic downswings is well established in the literature (*cf.* Estrella and Hardouvelis, 1991; Hu, 1993; Dombrosky and Haubrich, 1996; Estrella and Mishkin, 1996, 1997; Dueker, 1997; Moneta, 2003; Estrella and Trubin, 2006; Khomo and Aziakpono, 2007; Chinn and Kucko, 2009). It is not the intention to repeat here the well-known theoretical explanations for this relationship or the substantial empirical evidence of its accuracy globally.

For South Africa, Nel (1996) found that the yield curve is positively related to gross domestic product (GDP) growth and is a successful indicator of current and expected monetary policy. Moolman (2002, 2003), Khomo and Aziakpono (2007), and Clay and Keeton (2011) all found that the yield spread successfully predicts turning points in the South African business cycle two quarters ahead. However, Khomo and Aziakpono (2007) reported that the yield curve had falsely predicted a downswing in South Africa in 2002-2003, which suggested that the yield curve might be losing its predictive powers. This false signal was in line with international evidence that the yield curve may be losing its predictive powers (*cf.*

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