

MASTER'S THESIS

The importance of interest rate spreads in the international financial market

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**The Importance of Interest Rate Spreads in the
International Financial Market**

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Abstract

Over the past decades, interest rate volatility has raised a number of issues about the functioning of bond markets and its implications. Some indicators derived from the bond markets, i.e. bond yield or interest rate spreads, seem to provide good predictions or a benchmark on macroeconomic condition, especially inflation, risk premia of exchange rate and even policy action of the central bank. First, this study focuses on the predictability of bond yield spreads in future inflation because the problems of inflation almost dominate the direction of policies for most of the developed countries over the last two decades. The empirical results support that the bond yield spread is a good predictor of future inflation in the United States and Germany, and the forecasting power of the model, with a time-varying real interest rate, is superior to the conventional version with a constant real interest rate. Second, an issue about the dynamic interaction between long-term bond yields and the U.S. monetary policy is examined by Johansen's cointegration in order to more clearly understand the relationship between the financial market and the implementation of the central bank's policy. The result indicates that a close relationship was manifested in the post-1979 period. Finally, another issue is to study the interest rate spread as one of the macroeconomic factors that can help for the proxy of the time-varying risk premium of exchange rates. Testing the model of exchange rate movements shows that risk premia to be significant in explaining the failure of interest rate parities. The test also supports the market efficiency hypothesis after considering the risk premia.

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