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REGIME-SWITCHING RISK IN THE TERM STRUCTURE OF INTEREST RATES

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ABSTRACT

This paper incorporates the systematic risk of regime shifts into a general equilibrium model of the term structure of interest rates. The regime-switching risk introduces a new source of time-variation in bond term premiums. A closed-form solution for the term structure of interest rates is obtained for an affine-type model under log-linear approximation. The model is estimated by Efficient Method of Moments. We find that the market price of the regime-switching risk is not only statistically significant, but also economically important, accounting for a significant portion of the term premiums for long-term bonds. Ignoring the regime-switching risk leads to underestimation of long-term interest rates and therefore flatter yield curves.

KEYWORD: The Term Structure, General Equilibrium, Markov Regime Shifts
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