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The Yield Curve and Real Activity

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Abstract

This paper attempts to formalize the link between the yield curve and real economic activity. A closed-form formula for the term structure of interest rates is derived. The paper then documents the use of bond market data for predicting GDP growth in the G-7 industrial countries. The results suggest that a simple measure of the slope of the yield curve, namely the yield spread, serves as a good predictor of future economic growth. The out-of-sample forecasting performance of the yield spread compares favorably with that of the alternative stock price-based model and a univariate time series (ARMA) model.

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