

## Accepted Manuscript

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PII: S0927-5398(16)30030-5  
DOI: doi: [10.1016/j.jempfin.2016.03.003](https://doi.org/10.1016/j.jempfin.2016.03.003)  
Reference: EMPFIN 891

To appear in: *Journal of Empirical Finance*

Received date: 31 March 2015  
Revised date: 22 February 2016  
Accepted date: 6 March 2016



Please cite this article as: Levant, Jared, Ma, Jun, Investigating United Kingdom's Monetary Policy with Macro Factor-Augmented Dynamic Nelson-Siegel Models, *Journal of Empirical Finance* (2016), doi: [10.1016/j.jempfin.2016.03.003](https://doi.org/10.1016/j.jempfin.2016.03.003)

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## Investigating United Kingdom's Monetary Policy with Macro Factor-Augmented Dynamic Nelson-Siegel Models

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This Version: February 20, 2016

Abstract

We employ the Dynamic Nelson-Siegel (DNS) model augmented with macroeconomic factors to investigate interactions of yields, real economic activity, and monetary policy in the United Kingdom. By explicitly accounting for the structural break during the early 90s at the time the UK exited the Exchange Rate Mechanism of the European Monetary System, we document a number of interesting findings. Specifically, there is evidence of a great moderation in the volatility of the term structure post-1992. At the same time, there is a significant reduction of the loading parameter in the DNS model, which suggests a greater influence of the monetary policy and economic activity on the bond market. We find with others that the level and slope yield curve factors are related to inflation expectations and monetary policy, respectively. Interestingly, the curvature factor which has been elusive in its relationship to macroeconomic fundamentals is found to be more strongly related to economic activity post-1992.

JEL: C51, E43

Keywords: Monetary policy, Term Structure, Macroeconomic Fundamentals, Dynamic Nelson-Siegel model, Factor-augmented VAR, Structural Break

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