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The Term Structure of Government Bond Yields in an Emerging Market: Empirical Evidence from Pakistan Bond Market

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Abstract : The study investigates the extent to which the so called Nelson-Siegel model (DNS) and its extended version that accounts for time varying volatility (DNS-EGARCH) can optimally fit the yield curve and predict its future path in the context of an emerging economy. For the in-sample fit, both models fit the curve remarkably well even in the emerging markets. However, the DNS-EGARCH model fits the curve slightly better than the DNS. Moreover, both specifications of yield curve that are based on the Nelson-Siegel functional form outperform the benchmark VAR forecasts at all forecast horizons. The DNS-EGARCH comes with more precise forecasts than the DNS for the 6- and 12-month ahead forecasts, while the two have almost similar performance in terms of RMSE for the very short forecast horizons.

Keywords : yield curve, forecasting, emerging markets, Kalman filter, EGARCH
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