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Jens Christensen

Jose Lopez

Glenn Rudebusch

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Jens H. E. Christensen, Jose A. Lopez & Glenn D. Rudebusch

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Abstract

In response to the global financial crisis that started in August 2007, central banks provided extraordinary amounts of liquidity to the financial system. To investigate the effect of central bank liquidity facilities on term interbank lending rates near the start of the crisis, we estimate a six-factor arbitrage-free model of U.S. Treasury yields, financial corporate bond yields, and term interbank rates. This model can account for fluctuations in the term structure of credit and liquidity spreads observed in the data. A significant shift in model estimates after the announcement of the liquidity facilities suggests that these central bank actions did help lower the liquidity premium in term interbank rates.

KEY WORDS: Arbitrage-free yield curve modeling, Financial crisis, Kalman filter, LIBOR



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