The term structure of credit spreads and business cycle in Japan

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Abstract

This paper investigates the usefulness of the term structure of credit spreads to predict the business cycle in Japan. Our bench-mark model using the government bond yield curve information shows that the short-term rate is significantly useful, despite the extremely low short-term rate over the last 15 years in Japan. Furthermore, our extended models incorporating the information in the term structure of credit spreads indicate a sensible improvement of predictability. Specifically, the results suggest that the credit spread curve of medium grade corporate bonds with A or BBB grade has more useful information than the government bond yield curve to predict the business cycle in Japan. By introducing the Markov-switching, the results show the existence of two distinct regimes; one for the usual period and another for the global financial crisis regime, and demonstrate that both the 1 year government bond yield and the term spread of A-rated credit spread information have significant predictive power for the business cycle in Japan regardless of the economic state.

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