

**Abstract: A test of the Expectations Hypothesis in the Icelandic Bond Market**

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This thesis is a part of the master's program in Economics in the Faculty of Economics and Business Administration at the University of Iceland. It accounts for 30 ECTS credits and is written under the supervision of Assistant Professor, Hersir Sigurgeirsson.

In the thesis we tested the Expectations Hypothesis of the term structure in the Icelandic bond market from 1998 to 2006. The theory claims that the long term interest rates on bonds is the simple average of the current and expected short term interest rates over the lifetime of the bond and a constant term premium.

We used two methodologies to test the EH, first using two regression based tests and second using a VAR-based test method. The test results were in many ways interesting, as we conclude that the EH holds considerable information about future changes in short term interest rate changes.

In the regression based tests, the results were inconclusive. The interest rate spread; the difference between the long term and short term interest rates predicts the wrong direction for short term changes in long term bonds. However, when predicting the changes in the shorter term interest rates, the spread gave results that supported the EH. This tells us that agents on the Icelandic bond market can up to a certain degree use the interest rate spread to predict future short term interest rates.

The VAR-based tests of the EH also gave us positive results for the EH, that however were not statistically significant. The predicted theoretical spread was more volatile than

the actual spread which can be explained partially by the underreaction of news by agents on the Icelandic bond market.