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Peso problem explanations for term structure anomalies â˜†

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Abstract

We investigate whether term structure anomalies in U.S. data may be due to a generalized peso problem, in which a high-interest-rate regime occurred less frequently in the U.S. sample than was rationally anticipated. We formalize this idea by estimating a regime-switching model of short-term interest rates with data from seven countries. Under the small-sample distributions generated by the model, the expectations hypothesis is rejected. When we allow moderate time variation in term premiums, the term-premium dynamics interact with peso-problem effects to generate small-sample distributions more consistent with the data. Nonetheless, our model cannot fully account for U.S. term structure anomalies.

JEL classification

E43; C22; G15

Keywords

Term structure; Regime switching; Expectations hypothesis

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