The Conquest of U.S. Inflation: Its Implications for the Fisher Hypothesis and the Term Structure of Nominal Interest Rates

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ABSTRACT

A regime shift in the inflation process is the collective outcome of shifts in individual agents' rational expectations resulting from an important policy initiative. Taking this view, we find decisive evidence of a shift in the inflation process during the Volcker experiment reflecting the Federal Reserve's enforcement of an anti-inflationary interest rate policy consistent with the Taylor (1993) rule. Subsequent to the regime shift, inflation and real interest rates move together, especially in the long run, contradicting both the Fisher hypothesis and the presence of Mundell-Tobin effects. Contrary to conventional wisdom, today's yield curve is not informative about expected inflation and yields now command a significant inflation risk premium suggesting yet another violation of the Fisher hypothesis.

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