**Overconfidence and the Rational Expectations Model of the**

**Term Structure of Interest Rates**

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**Abstract**

We propose a behavioral explanation for the widely reported rejection of the rational

expectations model of the term structure of interest rates. We distinguish between public and

private information and show that overconfidence among investors about the precision of private

information can account for the empirical failure of the rational expectations model. Using a

simulation experiment calibrated with data on US interest rates, we demonstrate that only a

small degree of investor overconfidence is needed to replicate the principle features of the

rejections of the rational expectations model that have been documented in different tests in the

empirical literature.

**Keywords**: Rational expectations hypothesis; Term structure of interest rates; Behavioural bias;

Overconfidence; Monte Carlo simulation.

**JEL**: C11, G14.

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