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CENTRAL BANK POLICY RATES: ARE THEY COINTEGRATED?*

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Abstract

This paper analyses the stochastic properties of and the bilateral linkages between the central bank policy rates of the US, the Eurozone, Australia, Canada, Japan and the UK using fractional integration and cointegration techniques respectively. The univariate analysis suggests a high degree of persistence in all cases: the fractional integration parameter d is estimated to be above 1, ranging from 1.26 (US) to 1.48 (UK), with the single exception of Japan, for which the unit root null cannot be rejected. Concerning the bivariate results, Australian interest rates are found to be cointegrated with the Eurozone and UK ones, Canadian rates with the UK and US ones, and Japanese rates with the UK ones. The increasing degree of integration of international financial markets and the coordinated monetary policy responses following the global financial crisis might both account for such linkages.

Keywords: Interest Rates; Long memory; Fractional integration and cointegration.**JEL Classification:** C22, C32, E47.**1. Introduction**

Interest rate linkages have been analysed in numerous empirical studies. There are two main ways to interpret them (see Barassiet al., 2005). If interest rates are viewed as similar to other asset prices, then financial flows should be their main determinant. In particular, the uncovered interest parity condition (or the open arbitrage condition) implies that interest rate differentials should equal the (expected) change in exchange rates. Therefore if exchange rates are at most $I(1)$ series (a common finding in the literature for the G-7), and if the risk premium is stationary, one should find that interest rates are cointegrated on a bilateral basis. It is noteworthy that in recent years many countries have liberalized their capital accounts, and there has been a shift in capital flows towards portfolio and other short-term flows. Cross-border capital flows have risen in search of higher yields given the low interest rates resulting from a global liquidity surplus. It has been

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