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Int. Fin. Markets, Inst. and Money 14 (2004) 135–164

Journal of INTERNATIONAL FINANCIAL MARKETS, INSTITUTIONS & MONEY

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Monetary policy implications of comovements among long-term interest rates

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Received 22 October 2001; accepted 1 June 2003

Abstract

This paper examines the monetary policy implications from the greater integration of major capital markets using long-term interest rates. Proof that globalization has affected the behavior of interest rates and made them more synchronized across countries is provided from the way disturbances in a market transmit to other markets thereby affecting the conduct of monetary policy in all involved parties. The results also confirm greater convergence among countries in the European Union (EU) as Germany still retains its hegemonic status. The implications for monetary policy are that countries now will have to deal with more outside shocks and these shocks will be more diverse, intense and persistent. Thus, global monetary policy, at least among the major capital markets, henceforth will have to be played interactively, which may necessitate a greater financial supervision in order to ensure continued world stability and prosperity.

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JEL classification: F42; G15; C32

Keywords: Interest rates; VAR; Monetary policy

1. Introduction

Recent developments in the bond markets have raised serious concerns about the relationships among national long-term interest rates in globalized markets. For instance, since the 1990s long-term interest rates in major economies have moved together very closely

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doi:10.1016/j.intfin.2003.06.003

despite different economic policies and business cycles by those countries (e.g. Friedmann and Herrmann, 1989; Nambara and Fukao, 1989; Laopodis, 2000). Hence, it is suggested that interest rates have responded more to external factors than to domestic fundamentals and this might impair significantly the ability of monetary authorities to influence them much more than originally believed. Furthermore, the internationalization of financial markets has significantly changed the breadth and depth of the conduct of monetary policy. Specifically, although it has not changed the main objective of monetary policy (i.e. price level stability), it amplified the scope of real or nominal shocks that must be considered when applying domestic stabilization policies and impacted upon the policy transmission channels. Recent adverse developments in the Asian markets highlight this challenge since policymakers must now evaluate these new dangers and adjust monetary policies accordingly so as to avoid a serious economic exposure at home.

Secondly, given that global financial integration means diminished ability of policy makers to pursue domestic stabilization policies independently, a country's pledge to a pegged exchange-rate regime, under free capital flows, could produce economic malaise at home. Under a fixed exchange-rate regime, market integration means a high degree of convergence of (short- and) long-term interest rates and a greater synchronization in their movements over time. This implies that interest rates are not determined by a single country but by all parties in unison, such as in the European Monetary System (EMS), generating thus a limited scope for independent monetary policy by any individual country. By contrast, under flexible exchange rates (short- and) long-term interest rates are primarily determined by domestic conditions and monetary authorities retain their ability to influence the long-term rates. And third, knowledge of the linkages among national interest rates is important because the understanding of the extent to which interest rates in countries vary in relation to each other has serious practical implications for investors, who rely on international claims contingent on an interest rate in their search for a suitable pricing model, and policy-makers alike, who shape and evaluate regulatory proposals.

The above observations solicit several interesting questions regarding the effects of the relations among national interest rates. For example to what degree have the responses among long-term interest rates changed over time and to what extent have external disturbances to long-term interest rates affected the domestic long-term interest rates, given their traditional linkages? This issue is critical for countries, such as Germany, where long-term interest rates are especially important to monetary transmission within EMS. Moreover, turning to the future, better knowledge of the monetary transmission mechanism can (hopefully) provide some indication of the impact of the European Monetary Union (EMU) on the economies of prospective members. Also, has the volatility spillover mechanism manifested itself in a conditional (i.e. shock-specific) or in a general basis? Alternatively put, has there been a general increase in the tendency for interest rate changes in a major bond market to transmit to bond markets in other countries on a near term basis such as a week? This question seeks to find evidence of what is called 'shock contagion' among major capital markets. Lastly, has the ability of national central banks to implement monetary policy been increasingly constrained, given the prevalent perception of the market that interest-rate linkages have become more intense over the years?

The extant evidence on these questions suggests that, in general, there exists a greater co-movement among major long-term interest rates (e.g. Friedmann and Herrmann, 1989;

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