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Does central bank transparency affect stock market volatility?



Stephanos Papadamou^{a,*}, Moïse Sidiropoulos^b,
Eleftherios Spyromitros^c

^a University of Thessaly, Department of Economics, Korai 43, 38333 Volos, Greece

^b Aristotle University of Thessaloniki, Department of Economics, 54124 Thessaloniki, Greece

^c Democritus University of Thrace, Department of Economics, University Campus, 69100 Komotini, Greece

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ABSTRACT

This paper addresses the issue of impacts of central banks' transparency on stock market volatility. Using a simple theoretical macroeconomic model, we analytically find a negative link between stock prices volatility and central bank transparency. By applying panel data analysis on a set of 40 countries from 1998 to 2005, sufficient evidence for this negative relationship is provided, using three different measures of stock market volatility. Therefore, moving towards monetary policy transparency is recommended as stock market volatility can be reduced considerably, implying significant benefits for financial stability.

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1. Introduction

The conduct of monetary policy has moved during the last two decades to a new paradigm, which gives accent to central banks' independence and transparency. Recently, [Klomp and de Haan \(2009\)](#)

* Corresponding author. Tel.: +30 2421074963; fax: +30 2421074772.

E-mail addresses: stpapada@uth.gr, stefpap3@yahoo.com (S. Papadamou), msidiro@econ.auth.gr (M. Sidiropoulos), espyromi@ierd.duth.gr (E. Spyromitros).

have argued that central bank independence (CBI) may not only be beneficial for reaching the objective of price stability, but also for maintaining financial stability. In effect, as central banks became independent, being transparent gained importance based on accountability arguments. Moreover, since the pioneer work of Cukierman and Meltzer (1986), a large body of literature on the economic desirability of central bank transparency has been developed, mostly for the case of developed countries and limited to the interaction between monetary authorities and private agents.¹ Most economists are instinctually of the view that more information is better than less and hence agree that openness and communication with the public are crucial for the effectiveness of monetary policy in allowing the private sector and financial operators to improve expectations and therefore their decisions (Blinder, 1998; Van der Crujisen and Demertzis, 2007; Crowe and Meade, 2008).²

Among studies on the effects of transparency on macroeconomic variables, Chortareas et al. (2002) indicate that the disclosure of inflation forecasts reduces inflation, but is not necessarily associated with higher output volatility. Demertzis and Hughes-Hallett (2007) have found that greater transparency reduces inflation volatility but has a less clear effect on output volatility and no effects on the average level of inflation and output. The analysis of Dincer and Eichengreen (2007) suggests broadly favourable but relatively weak impacts on inflation and output volatility.

Theoretical research on the effects of central bank transparency on financial markets yields mixed results. On the one hand, Cukierman (2001), Geraats (2006) and Rhee and Turdaliev (2013), among others, argue that the opaque regime dominates the transparent regime. On the other hand, Laskar (2010), using an explicit way to model the private sector's behaviour, shows that the transparency regime prevails. Along the same line, Eijffinger et al. (2006) show that greater transparency should enhance central bank credibility, flexibility and reputation. These effects of transparency should influence the level of interest rates. In particular, enhanced flexibility would allow a reduction in policy and short-term interest rates without increasing long-term nominal interest rates. In addition, improved reputation would reduce inflation expectations and thereby long-term nominal interest rates. Furthermore, the role of interest rates is crucial in the equity valuation, implying a link between equity market and central bank transparency.

A large strand of the empirical literature examines the effects that monetary policy actions can have on financial assets. As far as the foreign exchange market is concerned, Evans and Speight (2010) and Rosa (2011) focusing on developed countries show that the surprise component part of monetary policy statements is accountable for most of the explainable variation of volatility in exchange rate returns in response to monetary policy. According to Fratzscher (2006) for G3 countries, central bank communication can reduce exchange rate volatility and uncertainty whereas actual interventions tend to raise it. Gnabo et al. (2009) argued that oral intervention by Bank of Japan increases exchange rate volatility while statements aimed at confirming or providing some details about the operation the day it was carried out tend to decrease the probability of false reports. In cases of emerging economies evidence that verbal interventions by central banks tend to reduce exchange rate volatility have been provided among others by Égert (2007), Fišer and Horvath (2010), Goyal and Arora (2012). Recently, Égert and Kočenda (2014), argued that the responsiveness to central bank verbal interventions of the exchange rates of three Central and Eastern European currencies against the euro becomes important only during the crisis period.

By examining the impact of monetary policy announcements on bond return volatility, de Goeij and Marquering (2006), Rinaldo and Rossi (2010), show that the bond market is highly responsive to central bank communication. Additionally, studies analysing the role of transparency concerning the reaction of bond markets to news related to monetary policy show that greater transparency (particularly political, policy and economic)³ improves the predictability of central banks' decisions. In this line, Neuenkirch (2012) provides evidence that transparency reduces the bias in money market expectations and dampens their variation.

¹ For a survey, see Geraats (2002) and Eijffinger and Van der Crujisen (2007).

² It should be noticed that Van der Crujisen et al. (2010) have shown that there is likely to be an optimal intermediate degree of central bank transparency. Moreover, an interesting theoretical study of Berardi and Duffy (2007) provides conditions under which we can assess the value of central bank transparency when agents are learning.

³ See for a survey Eijffinger and Van der Crujisen (2007).

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