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Title: Interest rate dynamic effect on stock returns and Central Bank Transparency: Evidence from Emerging markets

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Interest rate dynamic effect on stock returns and Central Bank Transparency: Evidence from Emerging markets

Abstract: Interest rate dynamic effect on stock returns is examined under different levels of central bank transparency under an asset pricing context. Using a large set of emerging countries in a panel data framework, we provide evidence for a negative link between stock returns and interest rate differences. However, this negative effect is reduced significantly under a transparent central bank, underlying a non-linear impact on stock returns. Our study is focused on a period from 1998 to 2008 where fundamental changes in the level of central banks' transparency were occurred. Our findings imply that restrictive monetary policies under high levels of transparency lead to smoother reductions on stock returns with significant benefits for financial stability.

Key words: Central bank transparency, stock markets, asset pricing, panel data.

JEL classification numbers: E52, E58, G1

1. Introduction

The effectiveness of the transmission mechanisms of monetary policy has been examined under different scenarios regarding the economic shocks hitting the economy and/or conditions affecting the efficiency of the markets (see among others, Gunji et al., 2009; Jeon et al., 2011; Aastveit et al., 2013). However, a recent literature (Liu et al., 2008; Papadamou, 2013; Papadamou et al., 2015) highlights the role of central bank behavior in the transmission mechanism of policy actions. The main argument behind these studies is that there is an important role of monetary policy characteristics such as transparency in the effective transmission of monetary policy through the interest rate channel. In effect, the new paradigm in monetary policymaking gives accent to two important characteristics of central banks, namely independence and transparency. The apparent move towards more independent and transparent central banks has been supported by the fact that this policy behavior is