

The Effect of Central Bank Independence on Stock Market Volatility in Tehran Stock Exchange

*Zeinab Yazdani Charati **

*Mahdi Shahrazi***

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Abstract

Nowadays, the capital market is one of the key economic sectors closely linked to other sectors, especially the monetary and banking. On the other hand, maintaining the stability of the capital market is a major concern for any economy. The financial crisis of 2008 has challenged the role of the central bank on financial stability. In this regard, the present research examines the effect of central bank independence on stock market volatility as a measure of financial instability in Tehran Stock Exchange from 1991 to 2019. In this regard, the stock market volatility series are generated utilizing the GARCH model and then the Autoregressive Distributed Lag (ARDL) model is estimated. Next, ARDL bounds testing for co-integration is employed and finally, the long-run relationship is estimated. The research findings show that the Central Bank Independence has a positive and significant effect on the volatility in Tehran Stock Exchange. However, the move towards the reduction of the central bank independence does not seem reasonable due to its inflationary consequences. In this context, by maintaining the central bank independence on one hand, and trying to increase the central bank transparency, on the other hand, the two goals of price stability and financial stability can be achieved simultaneously.

Keywords: central bank independence; stock market; volatility; Autoregressive Distributed Lag model; Iran.

JEL Classification: C22, G01, G10.

* Ph.D. Student, Department of Economics, Faculty of Administrative Sciences and Economics, Mazandaran University, Babolsar, Iran.

Email: yazdany_86@yahoo.com

** Assistant Professor, Department of Management, Faculty of Humanities and Social Sciences, Golestan University, Gorgan, Iran.

Email: m.m.shahrazi@gu.ac.ir



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