Output, Stock Volatility and Political Uncertainty: Evidence from Sri Lanka

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The purpose of this study is to investigate the relationship between stock return volatility, political uncertainty, macroeconomic variables and output. Why does stock volatility increase when output declines? Theory of investment under uncertainty implies that political uncertainty may simultaneously increase volatility and reduce output. Though the basic facts are well-established, the causal link between volatility and business slumps is unclear. Slumps may cause volatility, volatility may cause slumps, or both may be the consequence of some other more clearly exogenous factors.

The study examines the explanatory power of the selected variables to explain the output over a period from 1998 to 2003 using multiple regression approach. Monthly secondary data are gathered from Colombo Stock Exchange, Central Bank of Sri Lanka, Elections Department and Department of Police. Eight important variables have been identified for the study namely, stock return volatility, changes in share price, political uncertainty, inflation rate, exchange rate and treasury bill rate. Descriptive statistics and regression analysis were carried out to analyze the data. Regression analysis was carried out for the periods before and after the peace process.

The results of the study show that three variables indicate a significant impact on the output. Study indicates two general conclusions. First, the existence of stock return volatility, share price changes and political uncertainty affect the output. Second, the existence of such environments i.e., politically uncertain and volatile stock market reveals that some unexplained factors affect the output. However, political uncertainty hypothesis is not statistically significant but the coefficients are negative as assumed in the valuation model. However, taking all the variables together in the model explains more than moderate level change in output.

Key Words: Output; Stock volatility; Political uncertainty; Macroeconomic variables; Industrial production.

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