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THE EFFECTS OF MACROECONOMIC VARIABLES ON STOCK PRICES IN AN EMERGING SRI LANKAN STOCK MARKET

By

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ABSTRACT

This study investigates the effects of macroeconomic variables on stock prices in emerging Sri Lankan stock market using monthly data for the period from September 1991 to December 2001. All the data were collected on monthly basis and these were supplied by various secondary sources. The study uses thirty four companies out of eight sectors in the CSE. The multivariate regression was run using eight macroeconomic variables for each individual stocks. Analysis was conducted for the full sample period as well as for sub periods. The null hypothesis which states that money supply, exchange rate, inflation rate, interest rate and other qualitative variables combinely do not accord any impact on equity prices is rejected at 0.15 level of significance in all stocks.

The results indicate that most of the companies report a higher R^2 which justifies that higher explanatory power of macroeconomic variables in explaining stock prices. Consistent with the similar results of the developed as well as emerging markets studies, inflation rate and exchange rate react mainly negatively to stock prices in the Colombo Stock Exchange (CSE). Compatible with the theory which states that an inverse relation with stock prices, the Treasury bill rate responds mainly negatively to stock prices while stock prices mainly positively impact with money supply consistent with the theory. The negative effect of Treasury bill rate implies that whenever the interest rate on Treasury securities rise investors tend to switch out of stocks, causing stock prices to fall. However, lagged money supply variables do not appear to have a strong prediction of movements of stock prices while stocks do not provide effective hedge against inflation specially in Manufacturing, Trading and Diversified sectors in the CSE.

On the other hand, the results of the sub-period reveal that the dummy variable which represents power crisis urban terrorism and foreign poor participation in investments have greater impact on equity prices in all sectors in the sample except for Trading and Hotels & Travel sectors. The most surprising evidence in sub-period analysis is the Treasury bill rate which signals a predominant negative impact on equity prices compatible with the theory. These findings hold practical implications for policy makers, stock market regulators, investors and stock market analysts.