EM.SCI.1

THE RELATIONSHIP BETWEEN ALL SHARE PRICE INDEX AND MACROECONOMIC VARIABLES: EVIDENCE FROM SRI LANKA

R. M. I. P. Ratnayake, P. Wijekoon, Roshan D. Yapa

*Department of Statistics and Computer Science, Faculty of Science,
University of Peradeniya*

In modern economy the role of the stock exchange is very important. It can be very helpful to diversify the domestic funds and channels into productive investment. However to perform this important task it is very necessary that the stock market has a significant relationship with the macroeconomics variables. In this study the relationship between the All Share Price Index (ASPI) and macroeconomic variables namely the real economy, inflation rates, exchange rates, money supply, and interest rates are investigated in the context of Sri Lanka.

The empirical analysis was carried out by using 40 quarterly data observations where the period spanned from the 1st quarter of 2002 to the 4th quarter of 2011. Data were collected from annual bulletins issued by the central bank of Sri Lanka. The methodology used in this study was the time series econometric technique. For the stationary series the Johansen Co-integration test was used to investigate the long run relationship and the short run relationship investigated by using the Error correction model. The Granger causality test was applied to test the causal relationship.

It was revealed that there is a significant relationship between ASPI and the real economy in Sri Lanka. There is a moderate positive significant relationship between the narrow money supply and ASPI, and a moderately negative influence between the nominal wage rate of industrial and service sectors with ASPI at 5% significance level. It was noted that all other major branches of the economy insignificantly correlated to ASPI. Real economic variables and money supply variables have co-movement with the share price in the long run equilibrium path. Neither long-run nor short-run relationship exists between ASPI and the inflation rate, exchange rate and interest rates. Since all the real economy variables are leading indicators, they can be used to measure ASPI. Changes in inflation will have a certain impact on share market performance, and at the same time, changes in share market will determine the flow of foreign investments to the economy. Wholesale Price Index (WPI) and interest rate variables are not good indicators to measure ASPI in Sri Lanka.