

# THE EFFECT OF INTEREST RATE AND EXCHANGE RATE ON SECTORAL STOCK PRICES IN SRI LANKA

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Stock market plays a vital role in any country directing much needed capital into required sectors. The research on stock prices generates vital information for investors, stock market brokers, policy makers and the general public. Many studies have investigated the overall performance of the stock market indexes and the impact of associated macroeconomic variables. However examining the aggregate stock price index does not generate sufficient information related to a particular industry or a sector. For example an investor who wants to invest in the hotel sector might be more interested in the performance of hotel sector stock price index than the aggregate price index such as all share price index (ASPI). In this context, this study examines the behavior of stock price indexes in five major sectors according to the Central Bank report 2010, namely, bank, finance and insurance sector (BFI), hotel and travel sector (H\_T), beverage food and tobacco sector (BFI), diversified sector (DIV) and telecommunication sector (TLE). The performance of these sectors as indicated by the sectoral stock price indexes was examined considering the past stock price information, interest rate and the exchange rate.

This study used monthly average Sectoral Share Price Index (SSPI) values for five sectors, and examined the cointegration relationship with exchange rate, interest rate and inflation data for the period of February 2003 to December 2010, using Auto Regressive Distributed Lag (ARDL) models. Results indicate bank, finance and insurance sector, hotel and travel sector and diversified sector stock prices and all share price index have long and short run equilibrium relationships with current and lagged interest rate, exchange rate and lagged stock price index. Hotel sector showed the biggest impact of current interest rate. Lower interest rates will increase sectoral stock price, which is also consistent with theory. This study did not find any evidence of cointegration in the models estimated using inflation rate in place of the interest rate to avoid possible multicollinearity. Variables such as current interest rate and exchange rate have some impact on the three sectors identified with cointegration and policy makers can adjust them accordingly in favorable directions. Stock market investors and stock brokers also can make use of this information in their transactions.

