CHAPTER 1

INTRODUCTION

1.1 An Overview

Economic theory suggests that stock prices should reflect expectations about future corporate earnings. Meanwhile, corporate profits generally may reflect the level of economic activities. If stock prices accurately reflect the underlying fundamentals, then the forward-looking nature of stock prices would indicate that stock prices should be employed as leading indicators of future economic activity. Therefore, the causal relations and dynamic interactions among macroeconomic variables and stock prices are important in the formulation of the nation's macroeconomic policy.

There is a popular hypothesis regarding to the effect of macroeconomic variables such as money supply and interest rate on stock prices, which is the efficient market hypothesis (EMH). EMH suggests that competition among the profit-maximizing investors in an efficient market will ensure that all the relevant information currently known about changes in macroeconomic variables are fully reflected in current stock prices, so that investors will not be able to predict future stock market movements and therefore earn abnormal profit. The EMH implies that stock prices follow a random walk process.

The relationships among different macroeconomic variables have also been examined but to a lesser extent compared to the relationship between stock market and macroeconomic variables. The relationships among money supply, interest rate and real activity can be explained by the transmission mechanisms of monetary policy under the traditional Keynesian approach. For instance, an expansionary monetary policy by increasing money supply leads to a fall in nominal interest rate which in turn reduces the cost of capital, causing a rise in investment spending and subsequently inducing a rise in real output.

1.2 Objectives of the Study

This research paper attempts to study various aspects of the relationships among the stock prices and three key macroeconomic variables, namely, real interest rate, real economic activity and real money balances. The objectives of this study are as follows:

1. To examine the long-run equilibrium and short-run dynamics among stock prices, real economic activity, real interest rate and real money balances using a multivariate framework.
2. To determine the lead-lag relationships or the direction of causality among these variables.

3. To investigate if the long-run equilibrium, short-run dynamics and the lead-lag relationships among these variables differ before and after the implementation of capital controls.

1.3 Organization of the Study

This study consists of seven chapters and is organized as follows:

Chapter 1 sets out the introduction for the study, which contains an overview and the objectives of the study.

Chapter 2 reviews the relevant literature for both the domestic economy as well as other countries.

Chapter 3 describes the data used in the study. The behaviour of the data series are also discussed in this chapter.

Chapter 4 presents the methodology adopted for the study.

Chapter 5 discusses the results for the entire sample period analysis. The results for the two sub-periods analyses (before and after implementation of capital controls) are reported in Chapter 6.

Chapter 7 concludes the study. A summary of findings, the limitations of the study and suggestions for further research are included in this chapter.