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   REVIEW OF LITERATURE

   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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MACROECONOMIC VARIABLES AND STOCK PRICES: A STUDY OF COLOMBO STOCK EXCHANGE (CSE) IN SRI LANKA

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ABSTRACT
One of the most enduring debates in economics is whether financial development causes economic growth or whether it is a consequence of increased economic activity. Financial markets play an important role in the process of economic growth and development by facilitating savings and channelizing funds from surplus unit to deficit unit. Stock market plays an significant role in the economic development of a country. A number of studies have been investigated on the causal relationship between economic indicators and stock exchange prices. Many studies have been made from time to time; however, after post war to find out the causal relationship between the economic variables and stock prices is vital to the policy makers. There are many factors which influence the stock market and ASPI. This study is focused on that how macro economic variables influence the stock prices of CSE in Sri Lanka. For the reason four macro independent variables i,e Interest Rate (IR), Exchange Rate (ER), Balance of Payment(BOP) and Gross Domestic Product (GDP) were taken under consideration to measure influences of these factor on dependent variable of All Share Price Iindex(ASPI). For analysis, secondary data was taken for 20 years from 1993 up to 2012.Yearly data was used considering all of the variables. Excel sheet was used to arrange the Data and SPSS was used to analyze the data .The findings revealed that GDP is significantly strong positive correlation with ASPI. Further there is a significant positive correlation between ER and ASPI whenever negatively correlated with IR. Finally multi regression analysis indicates that macroeconomic variables significantly impact on stock prices.

KEYWORDS
Economic Growth, Economic Indicators, Stock Market.

INTRODUCTION
A common problem plaguing the low and slow growth of small developing economies is the shallow financial sector. Financial markets play an important role in the process of economic growth and development by facilitating savings and channelizing funds from savers to investors. While there have been numerous attempts to develop the financial sector, small island economies are also facing the problem of high volatility in numerous fronts including volatility of its financial sector. The relationships of stock returns and the macroeconomic factors have been the main focus of academia and investors. It is frequently quarreled that some fundamental macroeconomic variables such as IR, GDP, BOP and ER play vital role in determining the stock prices. The evidences of subjective from the financial press also shows that all the investors usually consider the monetary policies and macroeconomic variables and the influential elements of stock prices. This proves that a macroeconomic variable can influence the investment decisions of a rational investor and can also motivate a researcher to examine the relationship of stock return and a macroeconomic variable.

The level of economic activity has an impact on investment in many ways. If the economy grows rapidly, the industry can also be expected to show rapid growth and vice versa. The analysis of the macroeconomic environment is essential to understand the behavior of the stock prices. The commonly analysed macroeconomic factors are: GDP, saving and investment, Inflation, IR, budget, the tax structure, BOP, infrastructure facilities and demographic factors. Much of economic and financial theory is based on the notion that individuals act rationally and consider all available information in the decision making process.

It is frequently stated that some fundamental macroeconomic variables such as inflation rates, GDP, interest rates and exchange rates play vital role in determining the stock prices. Many studies have tried to observe the variations in share prices due to the variations in macroeconomic variables. There are many articles written on the relationship between stock return and macro-economic factors in highly developed states like Europe, Japan and United States. The study will be examining the relation between the ASPI and a set of some of the macroeconomic factors (like IR, GDP, BOP and ER) from 1994 to 2010 on yearly basis.

OBJECTIVES OF THE STUDY
The aim of this study is to identify and measure the impact of four major economic factors i.e. IR, ER GDP and BOP on ASPI.

Research is focused to find the impact of macro indicators on stock prices.

- To identify the relationship between macroeconomic variables and stock prices.
- To analysis the impact of macroeconomic factors in stock prices.

BEHAVIOUR OF STOCK PRICES AND ECONOMIC GROWTH
The literature of the effects of macroeconomic variables on stock prices dates back to the late1970s. Studies were focused on developed, emerging, and both developed and emerging capital markets context and the extant literature reveals strong relationships between different macroeconomic variables and stock prices. Numbers of studies have been conducted to examine the effects of macroeconomic variables on stock market of developed economies. Chen, Roll & Ross (1986) test the multifactor model in the USA by employing seven macro economic variables. They find that consumption, oil prices, and the market index are not priced by the financial market. However, industrial production, changes in risk premium, and twist in the yield curve are found to be significant in explaining stock returns. Chen (1991) performed the second study covering the USA. Findings suggest that future market stock returns could be forecasted by interpreting some macroeconomic variables such as default spread, term spread, one month t-bill, industrial production growth rate, and the dividend-price ratio. Clare and Thomas (1994) investigate the effect of 18 macroeconomic factors on stock returns in the UK. They find oil prices, retail price index, bank lending and corporate default risk to be important risk factor for the UK stock.

Shahzad, Niamat & Zeb (2012) confirmed that they analysis of Karachi Stock exchange is the largest stock exchange of Pakistan. There are many factors which influence the stock market and 100 Index. The research is focused on that how macro variables influence the Karachi stock Exchange 100 index For the reason four macro independent variables i,e Interest Rate, Rates of inflation, GDP and Rates of Exchange were taken under consideration to measure influences of these factor on dependent variable KSE 100 index. For analysis part of the study, Secondary data was taken for 17 years from 1994 up to 2010 (Using SBP official site for Interest, Inflation, GDP and Exchange rates, whereas used "brecoder.com" website for KSE100 index data). Yearly data was used considering all of the variables. Excel sheet was used to arrange the Data and SPSS was used to regress the data. Finding of the study shows that KSE 100 index has a significant relationship with GDP and exchange rate and has insignificant relationship with inflation and Interest rate.

The focus in now being extended towards the analysis of stock markets of developing economies, due to their enormous profit potentials. An illustrative list of studies for developed economies includes Fama (1990), Chen (1991), Kaneko & Lee (1995), Cheung (1998). These studies identify such factors as industrial production, risk premiums, slope of the yield curve, inflation, interest rate, money supply and so forth as being important in explaining stock prices.

The few notable studies for developing economies include Mookerjee & Yu (1997) and Maysami & Koh (2000) for Singapore, Kwon & Shin (1999) for South Korea, and Habibullah & Baharumshah (1996) and Ibrahim (1999) for Malaysia. Using bivariate co-integration and causality tests, Mookerjee and Yu (1997) note significant interactions between M2 money supply and foreign exchange reserves and stock prices for the case of Singapore. However, Maysami & Koh (2000) document significant contribution of interest rate and exchange rate in the long-run relationship between Singapore's stock prices and various macroeconomic variables.

A lot of discussion and debates have been done over the affiliations between macroeconomic factors and stock return. Such workings were based on tests which stated that the stock prices can be used as anticipated discounted cash flows. That's why RRR (required rate of return) or expected cash flow can be expressed as the determinant of stock prices. Elton & Gruber, (1991). Economic factors and variables which can influence the expected cash flows and RRR can therefore be anticipated to impact stock prices.

A rise in interests will raise the RRR and the stock price will fall due to the rise in the interest rates. The rise in interest rates will increase the opportunity cost of holding money, so therefore a trades off to holding other interest bearing securities would cause a reduction in stock prices. Alen & Jagtianti (1997) pointed out that interest rates sensitivity to stocks' return has declined severely since 80's and early 90's due to the development of interest rates derivative contracts that were mostly being used in hedging purpose. In addition, Bolmash & Trevoli (1991) found stated that the United States shares' prices are positively with prior months' share prices, supply of money, latest governmental debts, latest tax exempted governmental debts, long term un-employment and the extensive supply of money and government rates. Though a negative relation was found between the share price and treasury bills' rates.

When the currency of a country decreases against the currency of some other countries, the prices of the goods and services that are going to be export will decrease and as a result the quantity of export will rise, considering that the demand related to these product is elastic. Mukerji & Nakka (1995), Ajay & Mogoue (1996) confirmed the negative effect of rise in the share prices with domestic currency in short run but in long run the effect was found positive whereas a short run and long run negative relation was also reported between currency depreciation and stock's market.

From the previous decade, studies are extending their scope of investigation between macroeconomic factors and stock returns to more countries and states other than just the United States e.g. Kwon & Shen (1999) studied the market of Korea and came up with the results that such markets have cointegration and have positive relationship with production-index, trade balances, rate of exchange and supply of money. The authors were not able to justify the share prices indices to be the leading indicator for macro-economic factors. Leigh (1997) examined the stock market of Singapore in Singapore Stock exchange and came up with the results showing a positive relation with stock indices and money demands, but no relation between stock index and macro-economic fundamentals. Similarly in Taiwan Fung & Lie (1990) also agreed in results with Leigh (1997).

Achsaani & Strohi's (2002) investigation resulted in a negative relation between inflation rates and share prices. Though, it was found that the share prices are positively correlated with GDP, rates of exchange and with supply of money. Besides they were unable to notice any significant relation between interest rates and share prices.

Ali (2011) investigates the impact of changes in selected microeconomic and macroeconomic variables on stock returns at Dhaka Stock Exchange. A Multivariate Regression Model computed on Standard OLS Formula has been used to estimate the relationship. Regression coefficient reveals that inflation and foreign remittance have negative influence and industrial production index; market P/Es and monthly percent average growth in market capitalization have positive influence on stock returns. All the independent variables can jointly explain 44.48 percent variation in DSE all share price index. No unidirectional Granger Causality is found between stock prices and all the predictor variables except one unidirectional causal relation from stock price and market P/Es. Finally, lack of Granger causality between stock price and selected micro and macro variables ultimately reveals the evidence of informational inefficient market.

Menike (2006) investigates that 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 2002. The multivariate regression was run using eight macroeconomic variables for each individual stock. The null hypothesis which states that money supply, exchange rate, inflation rate and interest rate variables collectively do not accord any impact on equity prices is rejected at 0.05 level of significance. The results indicate that most of the companies report a higher R_2 which justifies higher explanatory power of macroeconomic variables in explaining stock prices. Consistent with similar results of the developed as well as emerging market studies, inflation rate and exchange rate react mainly negatively to stock prices in the CSE. 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 especially in manufacturing, trading and diversified sectors in the CSE

OBJECTIVES ORIENTED HYPOTHESIS

H_1 Micro economic variables and ASPI have a significant relationship with each other

H_{1a}.The GDP and ASPI have a significant relationship with each other

H_{1b}.The BOP and ASPI have a significant relationship with each other

H_{1c}.The IR and ASPI have a significant relationship with each other.

H_{1d}. The ER and ASPI have a significant relationship with each other.

H_2 Macro economic variables significantly impact on ASPI

METHODOLOGY

RESEARCH DESIGN

This study fundamentally falls under business and management research. The current research is aimed to examine interaction of stock market with macroeconomic variables. The quantitative method has been followed in order to find better results and outcomes.

DATA SOURCES

The study was used secondary data. This data were collected from annual reports of Central Bank of Sri Lanka and data CD published by CSE. In addition secondary data was collected from research studies, books, journals and newspapers.

RELIABILITY AND VALIDITY

Secondary data for the study were drawn from Central Bank reports and CSE as fairly accurate and reliable. Therefore, these data may be considered reliable for the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence, researcher satisfied content validity.

ESTIMATION TECHNIQUE (REGRESSION ANALYSIS)

Regression model is used to predict one variable (dependent variable) from one or more other variables (independent variables.

$ASPI = b_0 + b_1 * IR + b_2 * ER + b_3 * BOP + b_4 * GDP + uit$

Where b_0 denotes the intercept of the regression equation, and b_1, b_2, b_3 and b_4 the regression coefficients of IR, ER, BOP and GDP.

In the above general equation the ASPI is the dependent variable and it is influenced by the independent variables i.e. IR, ER, BOP and GDP. Further, researcher analyzed the collected data by descriptive statistics (i.e., means and standard deviation) and inferential statistics (correlation and linear regression). SPSS 16 used in order to analyze the data.

RESULTS & DISCUSSION

CORRELATION ANALYSIS

TABLE 1: CORRELATION BETWEEN ASPI AND MACROECONOMIC VARIABLE

Independent variables	Dependent variables	R - Value	P - Value
GDP	ASPI	0.854**	0.000
BOP	ASPI	0.158	0.507
IR	ASPI	-0.441*	0.039
ER	ASPI	0.666**	0.001

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

The table 1 indicates that GDP is positively associated with ASPI. Pearson correlation for GDP and ASPI is 0.854. This means there is a strong positive relationship between GDP and ASPI and highly significant at 1% level. Further result revealed that IR is negatively associated with ASPI. Pearson correlation for IR and ASPI is -0.441. This means there is a moderate negative relationship between IR and ASPI at 5% significant level. In addition results point out that ER is positively associated with ASPI. Pearson correlation for ER and ASPI is 0.666. This means there is a moderate positive relationship between ER and ASPI and significant at 1% level.

H_1 Micro economic variables and ASPI have a significant relationship with each other

The multiple correlation results revealed that the correlation between the macro economic variables and ASPI are strong positive correlation which point out that the macroeconomic variable can positively affected the ASPI. As per the 'Significant' test results, it is clear that the correlation is significant at the 0.01 level. Therefore, hypothesis H_1 is accepted. Hence, microeconomic variable and ASPI have a significant relationship with each other

H_{1a}: The GDP and ASPI have a significant relationship with each other.

The results revealed that the correlation between the GDP and ASPI is strong positive correlation which point out that the GDP can positively affected the ASPI. As per the 'Significant' test results, it is clear that the correlation is significant at the 0.01 level. Therefore, hypothesis H_{1a} is accepted. Hence, the GDP and ASPI have a significant relationship with each other.

H_{1b}.The BOP and ASPI have a significant relationship with each other

The results revealed that the correlation between the BOP and ASPI is weak positive correlation which point out that the BOP can positively affected the ASPI. As per the 'Significant' test results, it is clear that the correlation is insignificant at the 0.05 level. Therefore, hypothesis H_{1b} is rejected. Hence, the BOP and ASPI have an insignificant relationship with each other.

H_{1c}.The IR and ASPI have a significant relationship with each other.

The results exposed that the correlation between the IR and ASPI is moderate negative correlation which point out that the IR can negatively affected the ASPI. As per the 'Significant' test results, it is clear that the correlation is significant at the 0.05 level. Therefore, hypothesis H_{1c} is accepted. Hence, the IR and ASPI have a significant relationship with each other.

H_{1d}. The ER and ASPI have significant relationship with each other

The results revealed that the correlation between the ER and ASPI is moderate positive correlation which point out that the ER can positively affected the ASPI. As per the 'Significant' test results, it is clear that the correlation is significant at the 0.01 level. Therefore, hypothesis H_{1d} is accepted. Hence, the ER and ASPI have significant relationship with each other.

REGRESSION ANALYSIS

TABLE 2: MODEL SUMMARY OF REGRESSION ANALYSIS

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.875[a]	.766	.704	981.81410
a. Predictors: (Constant), RE, BOP, IR, GDP				

Source: survey data

The R-square in the table highlights that the dependent variable ASPI is influenced by 76.6% by independent variable i.e. GDP, BOP, IR and ER. It explains that GDP, BOP, IR and ER are liable for change in ASPI. The above mentioned model has also significant, examined with the aid of ANOVA. The results are shown in the following table.

TABLE 3. ANALYSIS OF VARIANCE

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4.742E7	4	1.186E7	12.299	.000[a]
	Residual	1.446E7	15	963958.930		
	Total	6.188E7	19			
a. Predictors: (Constant), ROE, BOP, IR, GDP						
b. Dependent Variable: ASPI						

Source: survey data

TABLE 4. COEFFICIENTS[A] OF VARIABLE

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2197.950	2349.426		.936	.364
	GDP	.001	.000	1.043	4.279	.001
	BOP	.285	.286	.128	.997	.335
	IR	-58.639	112.784	-.075	-.520	.611
	RE	-19.038	16.984	-.270	-1.121	.280
a. Dependent Variable: ASPI						

Source: Survey data

In this table, the standardized co-efficient explain that the factors are influencing the ASPI. Since the independent variables are different nature and have different units of measure so Standardized Coefficients is considered. The beta value (-0.075) with sig value =0.611 shows that there is insignificant relationship between interest rates and ASPI because the P-value 0.611 > 0.05. Though, it was found that the ASPI are positively correlated with GDP. The beta value (-0.270) with sig value =0.28 shows that there is insignificant relationship between ER and ASPI because the P-value 0.28 > 0.05.

H_2: Macro economic variables significantly impact on ASPI

To test the hypothesis this stipulates that macro economic variables have significant effects on ASPI. The ANOVA results indicate that the effect of macroeconomic variables on ASPI. Macroeconomic variables were found to be F = 12.299, P = 0.000 < 0.05, indicating statistical significance. Therefore, H_2 is accepted. This result shows that macroeconomic variables significant impact on ASPI.

CONCLUSION

This study investigated the effects of macroeconomic variables on stock prices in Sri Lanka using yearly data for the period from 1994 to 2010. A multiple regression model was used to find out relationships and for examining the impact of macroeconomic variables on stock prices. The results indicate that higher explanatory power of more than 76% in the stock prices for the period 1994 to 2010, the period which provides the strongest evidence of predictability of macroeconomic variables on stock prices.

Stock exchange is considered as the backbone of economy. The negative and positive effects of macroeconomic variables on stock prices found in this study have several practical implications. Findings of the study shows that there is a significant relationship exist between ER, IR and GDP with ASPI. While there is an insignificant relationship exist between ASPI and BOP. Study suggest that IR should be control as it has negative relationship with ASPI so controlling interest rate, Exchange rate and GDP will lead positive and negative change in ASPI. So these three factors are important to be controlled, if their positive impact is needed in an economy. The evidence provides that stock prices appear to react mainly negatively to rising interest rates. One reason suggested for this relation is the expected returns on stocks on which the higher interest rate has a direct bearing. Thus, the higher interest rates would directly affect the returns on stocks causing prices to fall consistent with the theory. Whenever the interest rate on treasury securities increases, the investors tend to switch out of stocks causing fall of stock prices.

Policy makers should be aware of these macroeconomic effects on stock market and make their decisions in a more effective and accurate way. The results of this study are based on the data sets, which are of high quality. Future researchers can investigate the effect of macroeconomic variables on stock prices using alternative methodologies and using sector share price indices. Further, they can use data of various frequencies such as weekly and monthly and examine whether the results are sensitive to the frequency of data. Other aspects on which future researchers can concentrate on are the longer time periods, larger sample sizes with greater numbers of sectors using other macroeconomic and non-macroeconomic variables.

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