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Dynamic relationship between stock prices & exchange rates:

Evidence from Sri Lanka

At the end of the separatist war that continued for over three decades in Sri Lanka , the Colombo Stock Exchange (CSE) started to peak, and became one of the most promising and best performing stock markets in Asia . Therefore, it is interesting to investigate the issue of whether stock prices and exchange rates are related. This has received considerable attention after the world economic crisis.

This paper examines the dynamic relationship between stock price and exchange rates in Sri Lanka. We used annual time series data on four foreign exchange rates and All Share Price index (ASPI) of the Colombo Stock Exchange for the period from 1990 to 2010. An assessment of the empirical evidence has been acquired through the co integration, error correction model and the Granger causality tests. This enabled us to search the relationship between stock prices and exchange rates both in the short –run and in the long –run.

Empirical result shows that exchange rates and stock price data series are non stationary and integrated. Then we applied the Johansen procedure to test for the possibility of a co integration relationship. Results show that there is no co integration relationship between stock prices (ASPI) and any of the four exchange rates during the sample period. Finally, we applied the Granger causality test to find any causal relationship between stock prices and exchange rates. Outcomes show that there is one unidirectional causal relationship from stock prices to the US dollar exchange rate, from Sterling pound to stock prices not vice versa; there is a bidirectional causal relationship between Indian rupee and stock prices and no causal relationship between Japanese yen and stock prices. These results have important policy implications for potential investors as well as policy makers in the economy.

Keywords: Stock Prices, Exchange Rates, Stationary, Co integration, Granger Causality