

**A STUDY ON THE DYNAMIC RELATIONS BETWEEN MACROECONOMIC
VARIABLES AND STOCK MARKET PERFORMANCE**

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ABSTRACT

The purpose of this study is to investigate the dynamic relationship between stock market performance and macroeconomic variables in Malaysia. The Kuala Lumpur Composite Index (KLCI) is used to proxy for the stock market performance and macroeconomic variables employed are three-month treasury bills rate, inflation rate, and economic growth as measured by gross domestic product. This study utilizes cointegration and causal relationship approach to accomplish the research objectives. The findings from this study exhibit that there are long run cointegration relationship between stock market performance and macroeconomic indicators. Moreover, results of further analysis generally show that all the indicators have substantial impacts on KLCI with the most immediate impact coming from treasury bills rate. In addition it is shown via the variance decomposition procedure that treasury bills rate is highly exogenous. The major policy implication of this study is that market performance can be monitored by Central Bank through treasury bills rate.

CHAPTER ONE

INTRODUCTION

1.1 ECONOMIC VARIABLES AND STOCK MARKET PERFORMANCE

The Malaysian Stock Market had been experiencing heavy losses since the devaluation of the Thai currency in 1997 and it was signaling the currency crisis in the Asian region. However, Malaysian Government led by Dr. Mahathir Mohamad has bounced back by taking a bold step in fighting the speculation against Ringgit. The establishment of the National Economic Action Council (MTEN) and the imposition of selective exchange controls and pegging of Ringgit brought back the confidence in financial markets particularly the equity market. With this unilateral policy, the Malaysian economy has recovered and officially out of recession. It was also due to the strong economy rebound in the third quarter of 1999 and ever since has shown a more positive growth.

The current economic indicators show an encouraging future for the equity investment to grow in Malaysia. This is due to economic recovery with stable and low interest, high liquidity in the economy, profit gained by corporate sector and reforms implemented by the government to reinforce the banking system.

CHAPTER TWO

LITERATURE REVIEW

2.1 MACROECONOMIC VARIABLES AND STOCK MARKET PERFORMANCE

The issue concerning the relation between stock market performance in a country with the macroeconomic factors has been widely studied during the last two decades. The previous studies are mainly focused on the developed markets such as the USA, Japan, UK and the markets in other developed countries. There are only a few studies concerning this issue in the Asian emerging markets.

Several studies on the relationship between macroeconomics variables and national stock market have been conducted and it became the cornerstone of most economic literature. Among the many macroeconomic variables, the relationship between money supply changes (short term and long term interest rate), inflation and real economic activity has important direct effects and become the fundamental determinants of stock prices.