Abstract

The interaction between exchange rate, interest rate, stock price and money supply, the existence and effect of volatility spillovers across the foreign exchange, stock and call money markets, and the impact of Foreign Institutional Investors (FII) investment flows on stock prices are studied over a 9-year period from 1993 to 2001.

The study finds evidence of cointegrating relationships between the four variables-stock prices, exchange rate, interest rate and money supply, indicating the existence of a long-term equilibrium relationship between them. Significant volatility spillovers across the three markets are also observed, some of them asymmetric, suggesting that the financial markets (stock market, foreign exchange market and call money market) are sensitive to news originating in the other two markets. However, the results also indicated that either the common factors between markets are small, with investors from one market processing information from other markets gradually or that the spillovers are the result of contagion effects. The study also found evidence in support of the omitted variable hypothesis, indicating that returns in stock markets were being driven by a number of factors apart from unexpected purchases. In addition, tests conducted using daily data showed evidence in favour of the base broadening hypothesis and indicated market overreaction to unexpected purchases followed by a subsequent correction.