Analysis of Dynamic Linkage of Stock Returns and Exchange Rates: Comparative Evidence from Sri Lanka and India

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This study attempts to analyze the dynamic linkage between stock market returns and the exchange rate in two South Asian emerging economies: Sri Lanka and India. We employed monthly data of All Share Price Index (ASPI) from Colombo Stock Exchange and CNFNIFTY index from the National Stock Exchange of India and monthly exchange rate of the US dollar in LKR (USD/LKR) and the US dollar in Indian Rupee (USD/INR) for the period 2000 to 2014. First, the study performed Augmented Dickey Fuller (ADF) to test the integrating order of the variables. Then, we employed Johansen's Cointegration test to examine the long run relationship among variables and Granger causality test to determine causal relationship between variables and Ordinary Least Square (OLS) analysis to determine the relationship between the stock returns and the exchange rate. The results establish that there is a long run equilibrium between variables in Sri Lanka and India. Furthermore, there is one-way causality from stock returns to exchange rate in both countries. Finally, the results suggest the existence of a negative impact of stock returns on exchange rate only in Indian context.

Keywords: Causality; Cointegration; Exchange rate; Stock returns