Do Fiscal and Monetary Policies impact Investment Performance in Sri Lanka?

The effect of fiscal and monetary policy is transmitted in several ways on investors' choice and performance of investments. The government designs the above two key macroeconomic policies to achieve the objectives such as the rate of growth in real activity, the exchange rate, the price stability, the balance of payment equilibrium and employment. The Central Bank implements monetary policy to control the availability and cost of credit in the economy which is aimed at changes in money supply and interest rate. Alternatively, fiscal policy employs policy instruments such as government revenue and government expenditure to influence the aggregate level of economic activity.

A change in either fiscal or monetary policy instruments leads to a change in interest rate instantaneously; hence investors respond quickly by changing their portfolios based on the intrinsic value of stocks. Accordingly, contractionary or expansionary fiscal and monetary policies would have either positive or negative effects on the stock returns of individual investors. The investment performance in which the investors expect depends on how they perceive the changes in fiscal and monetary policies (Change in government tax policies, expenditure, money circulation among the public and interest rate). Further, the value of their wealth, provided by the sum of discounted future cash flows, is affected by an easing or tightening of monetary policy through the discount rate. It is believed that the investors are generally more sensitive to fiscal and monetary policy news announcements. Thus, investigating the behaviour of investors in response to fiscal and monetary policy changes is an important aspect which is missing in the literature in the Sri Lankan context. Surprisingly, it will benefit the country to eliminate the harmful influence of persistent budget deficit on investment performance, thereby bringing the country to a faster growth path.

Theoretically, the impact of fiscal policy on the stock market may either be positive, negative or insignificant based on whether one takes a Keynesian, a Neo-classical or a Ricardian view.

The Keynesian model states that an increase in government expenditure leads to higher economic growth, which boosts domestic output and fuels the economy's growth, potentially increasing stock prices. In contrast, the Ricardian view requires that policy can have no impact on aggregate demand as any public borrowing will be offset by the private savings of rational households. Alternatively, the classical economic theory argues about the crowding-out effects of fiscal policy in the market for loanable funds and the productive sectors of the economy. Thus, fiscal policy could drive stock prices lower through the crowding out of private sector activity.

Although the impact of monetary and fiscal policy on the stock market has been widely analysed, this study is the first to examine the effect of fiscal and monetary policy jointly on individual investor performance using survey data.

Data were collected through a semi-structured questionnaire from 364 active investors in the Colombo Stock Exchange (CSE).

This approach offers information on how individual investors perceive government fiscal and monetary policy decisions and how they respond to such policy changes to make profitable investments.

Significantly, the results revealed that the interaction between the two policies plays a key role in determining the stock returns expected by individual investors in the CSE. Specifically, the individual stances on fiscal and monetary policy, whether expansionary or contractionary, through government expenditure, taxes, money supply and interest rates and their interaction, directly affect the investment performance of individual investors.

The findings indicate that income taxes and withholding taxes (direct taxes) have a more significant effect on investors expected stock returns as they directly affect household disposable income. Decreased income tax and withholding tax rates imply higher disposable household income, enabling people to invest more in stocks and, in turn, yield higher returns. This finding suggests that budget deficits do matter for the rational investment decisions by the investors and infers a violation of the Ricardian Equivalence Proposition, which states that current government deficits become irrelevant for current portfolio substitution decisions by rational investors if they correctly anticipate increased future taxation.

Government expenditure as a fiscal policy variable positively impacts investment performance, indicating a continual increase in government expenditure might enhance firms' profits and returns to investors, causing stock prices to go up.

Thus, market participants might assume that expansionary fiscal policy signals an increase in future returns. This strongly supports the Keynesian model, which predicts that increase in government expenditure leads to higher economic growth that it boosts the domestic output and fuels the economy's growth, potentially increasing the stock prices. Conversely, it violates the Ricardian view, which suggests that the fiscal policy cannot impact aggregate demand as any public borrowing will be offset by the private savings of rational households.

A decrease in interest rates is sensitive public information, and an increase in money circulation among the public under the monetary policy dimension positively impacts investors' investment performance.

This is as expected, as increased money circulation in the economy would prompt investors to make investments since extra funds are available.

Further, as theory explains, a decrease in interest rates increases the value of stock prices in the basic stock valuation model and persuades investors to make buy decisions; hence funds flow to the stock market from less profitable investments.

Moreover, a low interest rate facilitates easy and cheap credit to firms resulting in low borrowing costs and higher profits, hence increased returns to investors. Besides, easier monetary policy raises stock prices, lowers risk premiums and higher stock prices increase the wealth of households, inducing consumers to spend more. Furthermore, high stock prices in fact reduce the cost of capital for firms, stimulating increased capital investment which tends to stimulate the economy. This reveals that stock market participants seem to be highly responsive to government monetary policy actions.

In summary, the results reveal that investors in the CSE are highly responsive to fiscal and monetary policy news announcements. For instance, market participants react positively to a decreasing interest rate if companies offer increasing returns to their investors. Investors view growing government expenditure and tax cuts as good news for their investment performance and act accordingly to achieve higher returns. Besides, they show that they tend to make investment strategies if excess money is available because of increased money circulation.

Impressive policy recommendations are essential for investors and stock market analysts in their effort to understand the impact of fiscal and monetary policies on the stock return expectations of individual investors.

However, they should consider fiscal and monetary policy decisions and their interactions together rather than in isolation. The Government should be aware of how fiscal and monetary variables influence stock market performance and how investors react to such policy changes and act accordingly to achieve higher economic growth and stock market development by attracting both local and foreign investors with an improved investor-friendly environment.

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