

IMPACT OF EXCHANGE RATE ON STOCK PRICES THROUGH MEDIATING EFFECT OF INFLATION RATE AND INTEREST RATE: EVIDENCE FROM SRI LANKA

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Sri Lanka is experiencing a foreign exchange shortage, which has reduced its ability to purchase food and fuel and led to a complete default on its international debt. This economic vulnerability has created a political instability in the country. Accordingly, this situation has been directly impacted to the Colombo Stock Exchange since investors will remain under a fear of losing their wealth. Thus, this study aims to examine the relationship between exchange rate and stock prices through interest rate and inflation being they are the most critical economic indicators for the current economic crisis. Monthly data were collected for the period from June 2014 to May 2022 and dollar rate was used as the exchange rate, three months treasury bill rate was used as the interest rate and inflation rate announced by the Central Bank of Sri Lanka based on the National Consumer Price Index, was used as inflation rate. Structural equation modelling was used to analyze the data. The results indicated that the exchange rate had significant negative relationship with stock prices. Sobel test indicated that the interest rate significantly mediated the relationship between exchange rate and stock prices while inflation rate was not. Authorities should take actions to create political stability immediately while restructuring its debts to reduce dollar out flows. If they are able to control, however, the exchange rate fluctuations while reducing imports and increasing exports, it will be a proper solution to have good economic condition of the country. Then, they can secure the financial market of the country, increasing the confidence of the investors of the market.

Keywords: Colombo Stock Exchange, exchange rate, inflation rate, interest rate, stock prices