Chapter -1

INTRODUCTION

Investment is briefly defined as the commitment of funds. In this process, economic agents are intended to generate wealth. An efficient allocation of funds can be facilitated through the stock market where the agents try to identify the undervalued stocks. They are interested to earn profit by purchasing the undervalued stocks and then selling at a higher price after same time in the market. There is always a great debate regarding the factors that are determining the security price. A great number of models were designed to determine the asset prices. The applications of those models are frequently seen in the developed market whereas in developing economies fundamentals of the economy are explaining the security/asset prices. It is assumed that domestic economic fundamentals play vibrant/important-role in performance of stock market.

Macroeconomic variables are theoretically expected as the key factor of stock market movement. Therefore, these variables are regarded as the leading indicator of stock return. The movement of stock prices is highly sensitive to changes in fundamental factors of the economy. There are many factors such as enterprise performance, dividends, stock prices of other companies, gross domestic production, interest rate; exchange rate, money supply, foreign exchange reserve, inflation, and other information have an impact on stock prices (Ogushan Aydemir 2009). In literature, the relationship between economic variables and stock prices are well documented. Even though significant relationships between stock prices and economic variables are commonly founded both in developed and in emerging markets. The ever increasing world trade enhances the capital movement between countries, which affects the exchange rate phenomena. The exchange rate is one of the main determinants of business profitability and equity prices.

In many developed countries like USA, Germany, Japan, and Brazil etc. stock prices are considered to be one of the leading indicators for the future growth of the economy. In many previous theoretical and empirical literatures, several researchers or economists have shown that the relation may or not exist (A. Kanakaraj et al. 2008). Moreover, economic theory suggests that stock prices should reflect expectations about future corporate performance, and corporate profits generally reflect the level of economic activities. If the stock prices accurately reflect the underlying fundamentals, then the stock prices should be employed as leading indicators of future economic activities. Therefore, the causal relationships between stock prices and macroeconomic variables are important in formulation of economic policy.

There are a vast number of studies to investigate the relationship between macroeconomic variables and stock markets. However, the direction of causality still remains unresolved in theory as well as empirics. Examining the significance of relationship between stock prices and fundamental macroeconomic factors has been a very crucial and interesting research subject. The present study is an attempt to identify the relationship between macroeconomic variables and stock market performance in the ongoing environment.

Statement of the problem

The stock market has an important linkage with the macro environment of the economy. The linkage can be understood in two ways, first, the stock market leads the economic activity, whereas, the second case suggests that the stock market follows economic activity. The process of economic reforms (Liberalization, Privatization, and Globalization) was started in the year 1991 in our economy. The various actions had been adopted at the time of economic reforms. Our economy was integrated with rest of the countries or economy in resultant of economic reforms. The economic reforms led to an increase in international trade. Therefore, FDI inflow also increased in our country, which affects the balance of payment position of the host country favorably. Beside the several reforms, the capital market leads international investors to invest their money in stock markets to earn more profits. If stock market is moving on upward, it will lead to an increase economic activity. In such a position, it needs to investigate impact of macroeconomic variables on stock prices in India. Base on the above consideration, the present study have framed some objectives.

Objectives of the Study

1. To carryout unit root tests to see whether the macroeconomic variables are stationary or not.
2. To perform co-integration tests to know whether the macro variables are co-integrating and what is the number of co-integrating vectors.
3. To estimate the speed of adjustment to equilibrium relationships and to estimate long-run and short-run relationship among macro variables by estimating VECM model.

Limitation and significance of the study

The study has employed the index of industrial production (IIP) as a proxy for Gross Domestic Production (GDP), which is not available on monthly basis. IIP data may not adequately represent GDP as it is based on a sectoral activity (industry) only. The significance of the study lies in the fact that since it is based on monthly data, the analysis can capture short-term effects live seasonal effect, which may not be captured by an analysis based on annual data.

Organization of the Study

In addition to this chapter on introduction, the dissertation contains five more chapters:

Chapter: 2 This chapter contains a brief review of literature relating to the theme of the present work.

Chapter: 3 This chapter presents the history of Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) and recent performance of the BSE Sensex and NSE Nifty indices.

Chapter: 4 This chapter present the data description and methodology. This section describes the selection of the variables, brief description of data and econometric tools such as unit root tests, Johansen co-integration tests, Error correction model to investigate the impact of macroeconomic variables on stock prices in India.

Chapter: 5 This chapter deals with the empirical analysis presents the results and their interpretation.

Chapter: 6 This chapter contains the conclusion of the present study.

Finally, the study presents the Bibliography and relevant appendix of the dissertation respectively.