

## Can Macroeconomic Factors Lead Stock Returns in India?

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*This paper explores dynamic relation between macroeconomic variables and stock prices in India under a Vector Auto Regression framework during 2000-2012 using monthly data. Variance Decompositions and Impulse responses have been employed to determine how long it would take for the effect of variables to work through the system. The study found money supply, interest rate and exchange rate are the prime economic variables which could make significant impact on stock return volatility. Inflation rate and Index of Industrial Production have shown very negligible influence on the stock prices. Variance Decompositions and Impulse Responses found money supply as the strongest factor influencing stock market in the long-run. When the impact of interest rate and exchange rate are found of very short term, the shocks put forth by FIIs do not cause any significant variation in the movement of nifty prices. Highly integrated structure of monetary system and its linkage with financial sector leads to the conclusion that any variable which has a negative effect on cash flows shall be in a negative relationship with the stock prices. So the monetary policy could be viewed as an effectual instrument in the hands of the government to stabilize stock market.*

### I Introduction

In financial economics considerable attention has been given to the relationship between the macroeconomic variables and movement of stock prices. The assumption underlying such relationship is that the price of a stock will be equal to the discounted value of its future cash flows. These cash flows are highly sensitive to the real economic activities in a country. When a prosperous outlook for an economy results in increased cash flows and better stock prices, an outlook sagging economic growth may lead to lower corporate profits which endanger investor pessimism thereby lower stock prices.

A significant amount of literature examined the relationship between stock market returns and the macroeconomic environment over a number of stock markets and varying time periods. Campbell (1987), Fama and French (1989), Pesaran and Timmerman (2000), Chaudhari and Smile (2004), Shahid (2008), Rahman *et al.* (2009) and Ibrahim (2011) are some examples. On consolidating

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