

# The dynamic relationship between economic crisis, macroeconomic variables and stock prices in Sri Lanka

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## Abstract

**Purpose** – This study aims to examine the short- and long-term equilibrium relationship between All share price index (ASPI), macroeconomic variables and the economic crisis in Sri Lanka.

**Design/methodology/approach** – Monthly time series data for inflation (CPI), industrial production (IP), an exchange rate (ER), an interest rate (TR), short-term interest rate (KID) and economic crisis were used from 2010 to 2021. The ADF test, the bound testing approach, the CUSUM test and the CUSUMQ test were used in this study.

**Findings** – The findings show a long-run stable relationship between stock price, macroeconomic variables and political crisis (i.e., CPI, IP, ER, TR, CD and economic crisis). The results of the Johansen cointegration test suggest that there is at least one cointegrating equation, indicating that there is a long-run equilibrium relationship between macroeconomic variables and stock prices in Sri Lanka.

**Research limitations/implications** – The vector error correction estimates show that the coefficient of the error correction term is significant with a negative sign, indicating that a long-run dynamic relationship exists between macroeconomic variables and stock prices. In the short term, economic crisis has had a big effect on stock prices suggesting that Sri Lanka's domestic financial markets are linked to the stability of the country.

**Originality/value** – This research establishes the links between stock returns, macroeconomic variables and economic crisis. So far, research has been unable to establish the empirical nature of such links. The authors believe that this paper fills that gap.

**Keywords** Impulse response, VAR, Stock prices, Macroeconomic indicators, Economic crisis

**Paper type** Research paper

## Introduction

The business cycle is a prominent characteristic of the capitalist economy. Numerous studies have been conducted to comprehend the nature of this topic. Utilising leading economic indicators, it is possible to predict the business cycle. On the other hand, the stock market is assumed to be a forward-looking predictor of the business cycle and is a significant indicator for predicting the economy. The global economy has been affected by the COVID-19 pandemic and financial crisis and political crisis, but it is still not clear how these will affect stock markets. Even though the pandemic is still going on, most markets seem to have recovered. This suggests that there has been a structural break in the relationship between stock returns and COVID-19. The ongoing economic crisis in Sri Lanka began in the year 2019 and it is the worst economic crisis the nation has faced since it gained its independence in 1948. It has brought about unprecedented levels of inflation (CPI), a near-depletion of foreign



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