

ABSTRACT

Stock Markets play a crucial role in channelizing savings from the surplus sector of the economy to the deficit sector, hence are the most crucial pillar of the financial system of a country. Being such a crucial aspect of the financial system, stock markets have been an area of key concern for economists, policy makers as well as researchers. Therefore understanding this sector and the effect of macro-economic variables on it becomes important. Studies suggest that there exists a nexus between macro parameters and stock market indices. Hence this paper uses Johansen and Juselius (1990) multivariate cointegration technique to explore the long-run relationships between SENSEX share price index and certain crucial macroeconomic variables like interest rate, money supply, consumer price index, gold prices, exchange rate and the index of industrial production. It employs the multivariate Vector Error Correction Model (VECM) to examine short run causal nexus between SENSEX and these macro variables in India. It also employs VECM to test Granger Causality; if there is one way or bi directional causality between stock prices and selected macro variables. The analysis reveals that macroeconomic variables and stock market index are cointegrated, suggesting a long run relationship between them. Stock prices were found to be positively related to growth in industrial output and money supply but negatively to gold prices. The exchange rate, gold prices and inflation does not seem to correct long run deviation from equilibrium. The Granger Causality revealed a strong bidirectional short run causality from exchange rate to stock prices, and unidirectional short run causality from inflation to stock prices.