

A STUDY OF STOCK MARKET DYNAMICS IN MALAYSIA
1990-2013

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ASIA e UNIVERSITY
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**A STUDY OF THE STOCK MARKET DYNAMICS IN
MALAYSIA 1990-2013**

KAN YOKE YUE

A Thesis Submitted to the Asia e University in
Fulfillment of the Requirements for the
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ABSTRACT

This dissertation explores the empirical influence of domestic and foreign factors on equity pricing in Malaysia for the period 1990-2013. In addition, this study reviews and discusses the salient features of major bull and bear markets in Malaysia based on past evidence. This research seeks to determine if the dynamics have changed over time with the period of study spanning across major episodes of crisis such as the Asian Financial Crisis, the Global Financial Crisis and the European Debt crisis. Advanced econometric techniques namely unit root test with structural breaks, multivariate cointegration analysis, error correction model and innovation accounting technique are employed in the analysis. The findings show that share prices and macroeconomic variables (inflation rate, industrial production, money supply and US share price) are cointegrated in Malaysia for the period 1990-2013. In the long-run, consumer price index and US share prices contribute positively to share price movement while industrial production and money supply have a negative relations with KLCI. As for short-run dynamic interaction, Malaysia share prices are not significantly affected by lagged information from macroeconomic variables. Macroeconomic activities have weak explanatory power on stock market movements in short-run. Structural change has occurred after the Asian Financial Crisis. The Malaysian stock market is integrated with global markets of the US, UK, Singapore and Thailand. These stock markets do have a tendency to move together in the long run. The increase in integration after the Asian Financial Crisis is likely due structural change. The high degree of exogeneity prior to the Global Financial Crisis may be a sign of decoupling. Based on stylish facts and historical evidence, the following historical events or global circumstances surround a bullish or bearish market in Malaysia: capital flow, political instability, global and regional development, war, change of ratings, market sentiment and outlook, major government policies announcement and speculative activities on corporate developments.

APPROVAL PAGE

I certify that I have supervised / read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the fulfillment of the requirements for the degree of Doctor of Philosophy.

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DECLARATION

I hereby declare that the thesis submitted in fulfilment of the PhD degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

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Date: 10 September 2014

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
ADF	Augmented Dickey-Fuller unit root test.
AIC	Akaike Information Criterion.
APT	Arbitrage Pricing Theory
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
CAPM	Capital Asset Pricing Model
DJIA	Dow Jones Industrial Average
ECM	Error correction model
ECT	Error-correction term.
EMH	Efficient market hypothesis
EX	Exchange rate
FDI	Foreign Direct Investment
FTSE	FTSE 100 Index
GDP	Gross Domestic Product
GIRF	Generalized Impulse Response Function
HSI	Hang Seng Index
IFS	International Financial Statistics
IMF	International Monetary Fund.
IP	Industrial production
IRF	Impulse response function
JCI	Jakarta Composite Index
KLCI	FBM Bursa Malaysia KLCI
KOSPI	Korea Composite Stock Price Index
LR	Average lending rate (as proxy to interest rate)
MG	Annual growth rate of money supply M3
MOF	Ministry of Finance Malaysia
NIKKEI	Nikkei 225
OP	Oil price
OPR	Overnight Policy Rate
PP	Phillips-Perron unit root test.
PVM	Present Value Model.
RM	Ringgit Malaysia
SCI	Shanghai Composite Index
SET	Stock Exchange of Thailand SET Index
SIC	Schwarz Information Criterion.
STI	FTSE Strait Times Index
UK	United Kingdom
US	United States
USD	United States Dollar
VAR	Vector autoregression
VDC	Variance Decomposition Analysis
VECM	Vector Error Correction Model

Chapter 1 Introduction

1.1 Introduction

The stock market has traditionally been regarded as a sensitive segment of the financial market, as it is believed that the impact of any development or policy change is quickly reflected in the share prices. News media often report that stock prices drop because of negative economic and political developments or increase due to encouraging economic and political events. Stock prices are also commonly associated with expectations about future economic activity. It is often viewed as the most informationally efficient price. A variety of developments – domestic and international – can influence movement in share prices.

Stock market plays an important role in an economy. A healthy and stable stock market can promote economic growth by attracting domestic and foreign capital as well as channeling investment fund to business. Stock market has been associated with economic growth through its role as source for capital. On the other hand, economic growth may be the catalyst for share price growth.

The study of equity market has attracted much interest and attention from both practitioners and academicians. Economists, investment analysts, portfolio managers, investors, regulators, policy makers and researchers have sought to identify variables that can influence or predict stock pricing in an ever-changing investment environment. Forecasting stock return is particularly important in investment.

The dynamic of stock prices have been empirically analyzed for the past three decades. Various studies have tried to explain the determinants of stock price using

different variables and methodologies across different countries and sample sizes. In summary, these analyses can be grouped into two broad categories.

The first type of analysis models the relationship between share prices and domestic macroeconomic variables such as productivity, GDP growth, interest rate, yield spread, inflation, corporate profit, dividend yields and etc. Economic factors are believed to be closely related to stock prices. It is often argued that stock prices are determined by some fundamental macroeconomic variables. Economic forces affect discount rates and the ability of firms to generate future cash flows and dividends. Through such mechanism, economic forces become risk factors and exert influence over equity pricing. Since it is not easy to quantify non-economic factors and qualitative information such as news, political events, most studies concentrate on macroeconomic variables for which data are readily available.

The second type of research analyzes the integration of stock market in different regions or countries. The last two decades have witnessed rapid international capital mobility in the form of investment and intra-regional trade. Globalization has led towards rising integration of stock markets. Economic and financial development in one country can create impacts on other countries' financial markets. A series of severe stock market crises, such as the 1987 Wall Street crash, 1997 Asian Financial crisis, 2001 terrorist attack in US, and 2007 subprime mortgage crisis in 2007 have significant spillover effects in the capital markets across the world. In this respect, a number of studies have examined the interrelationship between the stock indices in the global stock markets.

1.2 Statement of Problem

This thesis explores the empirical influence of domestic and foreign factors on equity pricing in Malaysia. The central question is: what are the major factors driving share prices in Malaysia over time? In particular, this study explores whether the determinants of share price and their influence have been altered by a series of major developments in the past 20 years such as financial crises, capital control, low interest rate environment, international development etc. That is, how have the influence of these factors evolved over the past two decades?

From the literature, the determinants of share price can be grouped into three broad categories. The first category emphasizes the role of macroeconomics variables in driving share prices. The second category emphasizes the spill-over effect resulting from interdependence among regional and international stock markets. As for the third category, stock market volatility is not linked to observed changes in macroeconomic or other fundamentals but is solely the result of behaviour of investors. These three approaches differ in the way they explain the determinants of share price.

A few major research gaps are identified. The analysis of this gap will provide some meaningful insights to the body of knowledge and strengthen the theoretical framework of the determinants of share prices from the perspective of a developing country like Malaysia.

First, asset pricing theories do not specify the underlying economic forces or systematic risk factors that drive securities prices. There is no consensus of any established model or appropriate set of regressors so far. Literature reveals varying

causal patterns between macroeconomic variables and stock prices¹. The direction and magnitude vary depending on the study market, the sample period, the frequency of observation and the methodology used. Disagreement exists on which variables are significant and how they influence stock prices. Some studies show that there is relationship between stock prices and fundamental economic activities, while others do not support this relationship. This research hopes to study the shift in economic and financial structures, external environment as well as the impact of financial crises, which can result in significant changes in the way macroeconomic variables influence share prices. The evolving nature of the relationship between macroeconomy and international stock markets is an important consideration in this dissertation. It is also crucial to reexamine the issue using more recent data and analyze across different sub-periods where a structural break could have occurred.

Second, while previous studies have produced mixed results, there is little explanation on why such disagreements exist and how they influence share price. Qualitative factors are not accounted for due to difficulty in data collection and measurement. For example, structural and institutional differences are difficult to account for explicitly. It is possible that the different economic background between countries and over time could be the proximate causes of inconsistent findings in various studies. Such factors may include macroeconomic fundamentals and policies, financial reform and deregulation, non-economic events, political structure, risk and return profile, international development, globalization, capital mobility, financial crisis, contagion, investor confidence, etc. It is important to provide an in-depth analysis of the macroeconomic environment as well as historical events that could possibly account for the difference in findings. This study hopes to contribute further

¹ For details, refer to Section 2.2 of this dissertation.

to the existing literature by providing a qualitative assessment to understand and explain the key drivers of stock prices in Malaysia and its dynamics based on past evidence.

Third, researchers in the past have proven that financial market linkages are not stable and change over time. Early studies in 1960s and 1970s report no co-variation or low correlations among stock markets². However, national stock markets are found to become more interrelated after the 1987 October stock market crash. In addition, stock markets tend to show greater degree of integration during crisis period such as Asian Financial Crisis in 1997/98. However, the global economic crisis in 2008 has prompted debate on possible decoupling or difference in pattern and magnitude of effects on Asia stock markets. This change is related to the patterns of correlations or influences, especially in share market linkages. To sum up, the financial markets could have experienced changes in one way or the other, and there could possibly be either a partial or total reversal in linkage with the passage of time. As literature showed conflicting evidence of possible international stock market linkages, this subject needs further investigation especially to account for the time variation in the long-run relationship.

Fourth, there are only few studies available with reference to Malaysia³. From literature review, we observe that previous studies only explore a few variables and neglect the role of external influence and global market integration in the determination of stock prices. A gap exists to incorporate a wider range of macroeconomic variables in the context of Malaysia to have a more comprehensive coverage. In addition, previous studies also fail to consider possible structural break in

² Examples of study: [(Levy & Sarnat, 1970); (Grubel & Fadner, 1971); (Agmon, 1972); (Ripley, 1973); (Lessard, 1976); (Hilliard, 1979)].

³ Examples of study conducted in Malaysia are: [(Habibullah & Baharumshah, 1996); (Ibrahim & Aziz, 2003); (Mohd Yusof, Abd Majid, & Razali, 2006); (Abdul Rahman, M. Sidek, & Tafri, 2009)].

the variables over time. As far as the author knows, no other studies have been conducted taking the structural breaks into account in the cointegration analysis of share prices. To date, there is little research and explanation on the qualitative aspect and economic environment that could possibly account for the change in relationship between macroeconomic variables and share prices as well as international linkages of stock markets.

To highlight, this study extends the previous literature in a few ways:

- Two complementary approaches are used to model the behaviour of share prices in Malaysia. The first model builds on and extends the work of Chen, Roll and Ross (1986), Mukherjee and Naka (1995), Habibullah and Baharumshah (1996) and Abdul Rahman *et al.* (2009) to examine the influence of macroeconomic variables on share prices. A broader set of variables that are hypothesized to jointly affect share prices are identified. The model in this research captures the impact of domestic macroeconomic variables and global factors on share prices in Malaysia. Possible structural break in the variables over time is also taken into consideration. The second approach extends the work of Chan *et al.* (1992), Hassan and Naka (1996), Baharumshah *et al.* (2003) and Abd Majid and Kassim (2009) to investigate the impact of international stock markets linkage on Malaysia. This study is much more comprehensive than earlier studies as a broader set of variables that are relevant in the Malaysia context is used. The models capture the impact of domestic macroeconomic variables and global factors on share prices in Malaysia. To do so, two separate analyses are run. In the first one, macroeconomic variables are examined; while in the second one, international stock

markets linkage are examined. The results for both analyses for under various sub-periods are cross checked to compare the difference in interactions among the variables.

- Latest and up-to-date dataset encompasses the Asian Financial Crisis, Global Financial Crisis and European Debt Crisis is used. As there is no study done during the period concerned, it is not documented whether the established relationships remain unchanged during period of extreme volatility and crisis. The Malaysian economic landscape has changed during the last two decades. In addition, the sample is divided into sub-periods which correspond to bull and bear market conditions. This division of observation periods is aimed at revealing the impact of particular market environment on the stock indices of Malaysia and to detect potential changes in the dynamic linkages between the variables over time. It would be interesting to examine whether the explanatory power of certain variables perform significantly better if one allows for time-varying effects. This study seeks to identify which variables are key drivers across different sub-periods and economic environment. The findings may provide a new perspective on the analysis of the Malaysian stock market.
- A rigorous statistical treatment is employed to analyze the issue. The economic environment varies considerably in long run; it may not be prudent to assume that a model's parameters are constant. We seek to identify the changing explanatory power of the variables and identify the most influential factors that drive share prices. The methods employed include unit root test with structural break, stationarity test, cointegration

analysis, vector error correction model, Granger causality test, generalized impulse response function and variance decomposition analysis.

- We conduct an in-depth into the analysis by describing and interpreting the qualitative aspects such as historical events and developments in which rapid rise or fall in share prices have occurred. Explanations based purely on economic indicators are inadequate for explaining how stock market crises develop largely due to the ignorance or down-play of the impact of non-economic factors. Economic indicators are interdependent with various market participants' behaviors. Market participants' behavior, however, are not only determined by economic factors, but also strongly affected by a plethora of expected and unexpected non-economic factors stemming from the domestic political, social, institutional, as well as external developments of countries. This research hopes to provide a critical assessment and insight to understanding the key drivers of stock prices in Malaysia based on past evidence. The analysis and conclusion is supported by historical evidence and stylized facts as much as possible. By giving additional context to explain phenomena missed by quantitative research methods, this study hopes to contribute to the body of knowledge.

This research studies the phenomena in the Malaysian stock market in its multifaceted form. Such analysis may further enrich understanding of the Malaysian stock market behavior and its interaction with internal and external factors. In addition, this study hopes to contribute to the literature by exploring how far the change in economic structure and the financial system, and the improvement in macroeconomic fundamentals have increased the resilience of the stock market.

Investigation on the issues are rewarding and fascinating given the dynamic nature of the relationships. This study hopes to enrich the academic literature about stock market behavior in emerging markets with particular focus on Malaysia. To understand what the stock market is today, we have to know the historical development and what is in fact behind the Malaysian stock market.

1.3 Research Objectives

This dissertation aims to explore the domestic and external influences on share prices in Malaysia. The following questions are focused on: (i) How significant are domestic and external factors in explaining Malaysian stock market fluctuations and (ii) How has the sensitivity of Malaysian stock market to domestic and external factors changed over time?

With these research questions in mind, the investigation focuses on three inter-related issues in the Malaysia stock market. First, to support the analysis, this study examines macroeconomic environment as well as historical events and developments in which rapid rise or fall in share prices have occurred. The second issue is to examine the influence of macroeconomic variables on stock prices in Malaysia. Third, this study investigates how the Malaysian stock market is integrated with global and regional markets. This study uses an integrative approach in evaluating share price behavior in Malaysia.

More specifically, the objectives of this research are as follows:

1. To review and discuss the salient features of major bull and bear markets in Malaysia based on past evidence.