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The impact of monetary policy decisions on stock returns: Evidence from Thailand

Chaiporn Vithessonthi^{a,*}, Yaowaluk Techarongrojwong^b

^a Mahasarakham Business School, Mahasarakham University, Khamriang, Kantarawichai, Mahasarakham 44150, Thailand

^b School of Management, Assumption University, 592/3 Ramkhamhaeng 24, Hua Mak, Bangkok 10240, Thailand

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ABSTRACT

Although numerous studies have examined the effect of monetary policy on stock prices, empirical research in the international setting remains relatively scant. Therefore, this topic is reexamined in the context of Thailand. In a sample of 50 repurchase rate announcements of the Bank of Thailand during 2003–2009, our regression results suggest that the raw change in the repurchase rate has a negative effect on stock returns at the market level, which is inconsistent with the literature. Contrary to the results of numerous studies, we find that at the market level the expected change in the repurchase rate has a negative effect on stock returns and the unexpected change in the repurchase rate exhibits no effect on stock returns. However, the effect of the unexpected change in the repurchase rate on stock returns is evident at the firm level. Our findings also suggest that the stock market's response to the repurchase rate change is asymmetric. The unexpected change in the repurchase rate that is considered as good news has a negative effect on stock returns. Overall, the evidence lends support to the notion that the monetary policy announcements have a significant effect on stock prices and further adds to the debate on whether the credibility of the monetary authority may contribute to the stock market's response to the monetary policy actions.

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* Corresponding author. Tel.: +66 43 754 333, fax: +66 43 754 422.

E-mail addresses: c.vithessonthi@mac.com (C. Vithessonthi), yaowalukt@gmail.com (Y. Techarongrojwong).

1. Introduction

As the levels of foreign investments in developing countries have been increasing in recent years, understanding how monetary policy in developing countries affects the economy is crucial to making investment decisions in these markets. Since the nature of financial markets and economic frameworks in developing countries differs from that of developed countries, our knowledge of how monetary policy works in developed economies may not be accurately applied in the context of developing economies. Consider, for instance, in many developing countries, there exists no organized futures markets or there are a limited number of futures contracts being available in the futures markets; therefore, domestic investors are likely to use different approaches to the estimation of assets' future prices. Furthermore, publicly available information available to investors in developing countries tends to be in relatively short supply. Given these contextual differences, a key question is then whether we would observe a similar pattern of stock price reactions to a change in monetary policy in small and developing countries as that of developed countries.

There is a large body of research on the implications of monetary policy for asset prices in the context of developed countries (see e.g., Bredin et al., 2007; Farka, 2009; Konrad, 2009; Lobo, 2000; Rigobon and Sack, 2004; Thorbecke, 1997), suggesting that monetary policy actions are associated with changes in stock prices. Research on the effect of monetary policy on equity prices at both the aggregate and disaggregate levels has shown that the unexpected changes in monetary policy affect equity prices (see e.g., Bernanke and Kuttner, 2005; Chuliá et al., 2010; Lobo, 2000; Reinhart and Simin, 1997; Thorbecke and Alami, 1994). Several studies have suggested that equity prices react negatively to a hike in interest rates (e.g., Bernanke and Kuttner, 2005; Bredin et al., 2007; Chuliá et al., 2010; Farka, 2009; Rigobon and Sack, 2004). For instance, Farka (2009) reports a negative relationship between an unexpected hike in the Federal funds target rate and stock returns in the US. Several studies (e.g., Basistha and Kurov, 2008; Bernanke and Kuttner, 2005; Chuliá et al., 2010; Farka, 2009) also show that the effect of monetary policy on equity prices is asymmetric. For example, Farka (2009) finds that an unexpected tightening monetary policy tends to have a smaller effect on equity prices than does an unexpected easing monetary policy. In the same vein, Chuliá et al. (2010) find that stock prices generally react more strongly to positive surprises in the Federal funds target rate in the US than to negative surprises in the Federal funds target rate.

In the context of developing countries, the evidence of the impact of monetary policy on equity prices is limited to a few empirical studies (see e.g., Goodhart et al., 2003). Therefore, we attempt to make a contribution to the literature by examining the effect of monetary policy on stock prices in a small and open economy. In particular, we investigate the effect of monetary policy on equity prices in Thailand, which is one of emerging market countries in Asia. As a result of the demand for the further development of the capital market in Thailand in the early 1970s, the Stock Exchange of Thailand (SET) was established in 1975. There were 21 listed companies on the SET by the end of 1975. As the Thai economy had expanded rapidly during 1980s–1990s, the SET had been growing steadily during this time period. By the end of 1996 (prior to the 1997–financial crisis in Asia), there were 454 listed firms on the SET with the market capitalization of 2,559,578 million Baht (approximately 98,445 million USD at the exchange rate of 26 Baht/USD at the time). At the end of 2003 the SET had 407 listed firms with the total market capitalization of 4,789,857 million Baht (approximately 121,262 million USD at the exchange rate of 39.5 Baht/USD), and at the end of 2009 the SET had 501 listed firms with the total market capitalization of 5,873,100 Million Baht (approximately 176,901 million USD at the exchange rate of 33.2 Baht/USD). As the Thai economy has continued to grow in recent years, the capital market in Thailand has also further developed. By the end of 2010 the market capitalization of the SET was 8,247,635 million Baht (approximately 274,921 million USD at the exchange rate of 30 Baht/USD). For a comparison purpose, Malaysia, which is also one of the emerging market countries in Asia, had the market capitalization of 1,275,280 million RM (approximately 411,380 million USD at the exchange rate of 3.1 RM/USD) at the end of 2010, which was about 50% larger than the SET in terms of total market capitalization.

Given that financial markets in Thailand are still relatively small but rapidly developed, the results reported in this paper can provide us a better understanding of the relationship between monetary policy and equity prices in emerging market countries. More specifically, we test whether in the

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