

RELATIONSHIP AMONG SRI LANKA STOCK INDEX AND WORLD STOCK INDICES

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Stock market is an important part of the economy of a country. It plays a vital role and affects the economy of the country to a great extent. Earlier, stock market indices were much less correlated across countries than within a country, as economic, political and institutional factors affecting stock markets tend to vary a great deal across countries and investors found better diversification opportunities across stock markets. With the globalization, increased international trade and advances in information technology, national economies are gradually getting closely linked and this influences the stock markets getting inter-linked across borders. It is found that market integration has increased significantly over the years. This study investigates the relationships between main stock indices of Colombo Stock Exchange (CSE) and selected Foreign Stock Exchanges. Regionally close stock markets and large developed markets are selected for this study. Indian and Pakistani stock markets are selected as they are in the same region. New York, UK and Japanese stock markets are selected as they are among the highly influential stock markets of the world. Hong Kong and Singapore stock markets are selected as they are among the leading stock markets of the Asian region. Daily and weekly indices are collected from each market from January 2007 to June 2012. The Pearson's correlation analysis and Vector auto regression analysis are used to find out the pair-wise correlations and lagging relationships between the CSE and other markets. Correlations are analysed between CSE's All Share Price Index (ASPI), and every other index. The results depict that ASPI shows the highest frequency of correlations with US, Indian and Singapore stock market indices. Sri Lanka has higher trade linkages with these countries. ASPI shows moderate correlations with Hong Kong and UK market indices and weaker correlations with Pakistan and Japan stock indices. Though Pakistan is in the same region CSE shows a weaker relationship. Investors can reap the opportunity of international diversification between CSE and these less correlated markets. Higher trading links can lead to higher economic ties and this must have an impact on the correlations among the stock indices. Therefore, the findings reveal that there exists higher relationship between CSE index and other world stock indices when they become major trading partners.

Keywords: Colombo Stock Exchange, Linear regression, Stock market index, Vector auto regression