

EVALUATING THE IMPACT OF INFLATION ON STOCK
MARKET IN CHINA



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EVALUATING THE IMPACT OF INFLATION ON STOCK MARKET IN CHINA

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ABSTRACT

This study attempts to investigate the possible relationship between stock price and inflation rate in China over the period of September 1997 to July 2015 using variables of share price index, consumer price index (CPI), interest rate and industrial production. Past studies mainly focus on the developed countries. Despite numerous theories, literature reveals that there is not enough information and investigation about developing countries especially China. This study aims to narrow this gap by examining the relationship between stock and inflation in China. The Vector Error Correction Model (VECM) has been employed to determine the long and short run relationships among the variables respectively. The cointegration test reveals a significant long run relationship between the underlying variables. Based on the VECM results, inflation is found to have a significant and positive influence on the stock market in the long run as well as in the short run. The Granger causality test also indicates that inflation has a unidirectional causality on the stock market index. In general, the results suggest a positive significant relationship between inflation and stock price.

ABSTRAK

Kajian ini bertujuan untuk mengkaji hubungan antara harga saham dan kadar inflasi di China sepanjang tempoh September 1997 hingga Julai 2015 menggunakan pembolehubah indeks harga saham, indeks harga pengguna (CPI), kadar faedah dan pengeluaran perindustrian. Kajian lepas terutamanya memberikan tumpuan kepada negara-negara maju. Walaupun terdapat banyak teori yang menerangkan hubungan antara harga saham dan kadar inflasi, maklumat yang ada masih lagi tidak mencukupi terutamanya penyiasatan yang melibatkan negara-negara membangun terutamanya China. Kajian ini bertujuan untuk merapatkan jurang dengan mengkaji hubungan antara saham dan inflasi di China. Model *Vector Error Correction* (VECM) telah digunakan untuk menentukan hubungan jangka panjang dan hubungan jangka pendek antara pembolehubah-pembolehubah asas. Ujian kointegrasi telah mengenalpasti wujudnya hubungan jangka panjang yang signifikan antara pembolehubah-pembolehubah asas. Berdasarkan keputusan VECM, inflasi didapati mempunyai pengaruh yang signifikan dan positif ke atas pasaran saham dalam jangka masa panjang dan juga dalam jangka masa pendek. Ujian kesan *Granger* juga menunjukkan bahawa inflasi mempengaruhi indeks pasaran saham. Secara umumnya, keputusan kajian menunjukkan bahawa wujudnya hubungan yang signifikan dan positif antara inflasi dan harga saham.

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TABLE OF CONTENT

CHAPTER 1: INTRODUCTION.....	1
1.1 Background of the Study.....	1
1.2 An Overview of the China’s Stock Market and Inflation	4
1.3 Problem Statement	7
1.4 Research Questions	11
1.5 Research Objectives	11
1.6 Significance of the Study	11
1.7 Organization of the Study	12
CHAPTER 2: LITERATURE REVIEW.....	13
CHAPTER 3: METHODOLOGY.....	28
3.1 Introduction.....	28
3.2 Data	28
3.3 Stationary Tests.....	30
3.3.1 Augmented Dickey-Fuller (ADF) Test.....	31
3.3.2 Phillips-Perron (PP) Test	32
3.3.3 Kwiatkowski–Phillips–Schmidt–Shin (KPSS) test	33
3.4 Cointegration Test and Vector Error Correction (VEC) Model.....	33
3.4.1 Optimal Lag Selection	38
3.5 Granger Causality Test.....	38
3.6 Impulse Response and Variance Decomposition	39
3.7 Theoretical Framework	40
CHAPTER 4: RESULTS AND DISCUSSION.....	42

4.1 Introduction	42
4.2 Correlation Test.....	42
4.3 Unit Root Tests.....	43
4.4 Cointegration Test.....	44
4.5 Vector Error Correction Model (VECM).....	45
4.6 Granger Causality Test.....	46
4.7 Diagnostics Tests.....	47
4.7.1 CUSUM squares Test	47
4.7.2 Serial Correlation Test.....	48
4.7.3 Normality Test	49
4.7.4 Residual Heteroskedasticity Tests	49
4.8 Variance Decomposition Analysis	50
4.9 Impulse Response Functions.....	51
4.10 Summary	54
CHAPTER 5: CONCLUSION	56
5.1 Conclusion.....	56
5.2 Policy Suggestions	57
5.3 Limitation of the Study	57
REFERENCES	59
APPENDIX.....	68

LIST OF TABLE

Table 2.1 Literature Review Map	23
Table 3.1 Summary of the Variables Characteristics.....	29
Table 4.1 Spearman Rank Correlation.....	42
Table 4.2 Unit Root Tests	43
Table 4.3 Optimal Lag Length Estimation	44
Table 4.4 Johansen-Juselius Test for Multiple Cointegrating Vectors	44
Table 4.5 Normalized Cointegrating Coefficients	45
Table 4.6 Short run VECM results	46
Table 4.7: Granger Causality Test and Block Exogeneity Test Based on VECM	47
Table 4.8: VEC Residual Serial Correlation LM Tests	49
Table 4.9 VEC Joint Tests for Skewness, Kurtosis and Jarque-Bera Test	49
Table 4.10 Residual Heteroskedasticity Tests	50
Table 4.11 Variance Decomposition.....	51

LIST OF FIGURES

Figure 1.1 Changes in the Consumer Price Index: China.....	7
Figure 4.1: CUSUM square test.....	48
Figure 4.2 Impulse Response Functions	53



CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Financial economists are always keen about the relationship between stock price and inflation. These financial economists have the feelings that equity can be used to hedge against the inflation. Even though there are numerous studies on stocks and pricing model, investigations on the relationship between stock prices and inflation in emerging countries are still limited. Furthermore, the inconclusiveness of empirical results across developing countries regarding the relationship between stock prices and inflation creates a gap to be studied.

Inflation and stock prices are two crucial indicators of a country's economy. In 1970s, because of the high inflation, western economists begin to examine the relationship between stock prices and inflation (Nelson, 2005). The impact of inflation on the stock market provides an important implication for risk management practices, financial securities valuation and government policy towards financial market. Inflation causes the redistribution of wealth. For the rational investors, there is a risk-return trade-off that they need to consider. At the same time, they need to evaluate whether the rate of return in the stock investments can compensate the loss of purchasing power as a result of inflation. In this study, we seek evidences of correlation and relationship between inflation, stock prices, industrial production and interest rate and mainly investigate the impact of inflation on stock prices through the time series data. Results of this study can benefit not just the shareholders but also the policy makers.

Earlier researches have been focusing on the Fisher Effect Theory (Fisher, 1965). According to

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