Thesis Proposal

Do Foreign Exchange market fluctuations have an effect on the stock markets?

The thesis topic I have chosen I believe is a very interesting one, one that has worldwide implications with respect to financial markets. I will be looking at whether or not foreign exchange fluctuations have an effect on stock markets.

Clearly this question has implications for stock markets and companies worldwide. However I will be focusing my attention to emerging markets. Emerging markets are a key factor in the future of global growth of trade and financial stability, and I believe due to these factors and their less efficient financial markets, they will prove to be a more interesting case to study than developed countries. In developed countries firms may also use instruments to hedge their currency exposure risk. These instruments may not be as available in emerging markets which may give a better indication between a country's foreign exchange and stock market.

Approaching this issue from a theoretical viewpoint, there should be a link between the two. Due to the increasing levels of globalisation and world trade, exchange rates have become a driver of profits. "A country's exchange rate can have a significant effect on the ability of domestic firms to compete in international markets" (Nellis and Parker). The effects exchange rates can have on a company are due to the impact exchange rates have on prices of goods. For example if the British pound depreciates against the US dollar, it will be cheaper for Americans to buy British goods, increasing the profitability of British firms. The profitability of a firm has implications on the value of a firm, and therefore by extension on the stock market as well. This is due to the fact that a way of valuing companies takes into consideration the expected future cash flows of a firm, which are discounted back to give a present value of the firm. If a firm's growth is amplified by a favourable exchange rate, this will lead to a higher valuation of the firm, or if its growth is being impeded by the exchange rate, it will drop. If enough companies experience an increase or decrease in their stock prices, the whole market will move up or down respectively. Not only are multinational firms affected by exchange rate movements, but so are domestic firms, for example they may import some materials for their products and they may export some of their finished goods.

If we look at the theory from a reversed angle, a drop in a country's stock market will encourage investors to leave the country and find better investment opportunity elsewhere. This would decrease the interest rate, due to the low demand for money hence the currency would depreciate.

Previous studies in this area have brought up mixed views. Abdalla and Murinde (1997) for example found causality between stock markets and exchanges rates for India, Korea and Pakistan. Kanas (2002) examined if the volatility of the exchange rate in the US, UK and Japan was affected by volatility in stock market returns. He concluded that volatility in stock market returns was determined by volatility in the exchange rate. In 1992 Oskooe and Sohrabian found that there was no long term link between exchange rates and stock markets. McPherson (2006) also found that there is a relationship between the two variables. Chhabra (2002) amongst others found that there are contagion effects between exchange rates and stock markets in times of currency crisis.

In this study I will be looking at countries in emerging markets more specifically the BRIC countries (Brazil, Russia, India and China). Another important factor for choosing these countries is that their

exchange rates are freely floating. Having a freely floating exchange rate would imply that exchange rate movements will respond more too stock price movements.

The time period for my study will be from 2002 – 2010. The rationale for using this time period is that within this time we have a period of stability and the period of the credit crunch. I will look at this time period as a whole and also further examine the relationship of exchange rates and stock markets during the time of the credit crunch to see if there are any interesting results.

Exchange rates are affected by a number of factors such as: inflation, GDP growth, the levels of imports and exports and interest rates. The importance of these factors will vary for different countries and will vary for currencies over time. I will examine the factors that affect exchange rate, and see how they have an impact on the stock market and then look at how foreign exchange affects the stock markets. This way I will be able to determine the most important factors in movement of the stock market with respect to the foreign exchange market.

There is a strong link between interest rates and exchange. A high interest rate in one country relative to others will tend to attract capital inflow from the countries with a lower interest rate. This inflow of capital will raise the exchange rate of that particular country.

The difference in inflation rates between countries will be reflected in their exchange rates. Countries with high levels of inflation will experience a depreciation in the value of their currency and vice versa. Under freely floating exchange rate these movements occur gradually, but more slowly when exchange rates are fixed or managed.

The amount of international trade through imports and exports affects the value of a currency. Those countries that export a lot of goods will tend to appreciate their currency; this may be due to the fact that they may run a budget surplus and those that import a lot will tend to depreciate.

GDP could also give an indication in which direction the currency of a country is going to move. The GDP gives an indication of the state of economic growth within a country. If it is positive that may lead to an increase in the value of the currency.

“The link between foreign exchange and stock markets has numerous practical business and economic implications. If international diversification strategies are to be successful, these markets should display low levels of correlation.” (McPherson). Both foreign exchange and stock markets play an influential role in the development of a countries economy. Not only that but investors often use exchange rates and stock markets to predict future trends for each other. Finding a link between these two variables could have huge implications for investors and businesses worldwide.

References

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