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An Independent Study

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Exchange Rates, Capital Flows, and Stock Prices Relationships in Thailand

ABSTRACT

Financial markets are driven greatly by information. Two of the most active financial instruments in the financial world are common stocks and exchange rates. In this study, the relationships of these two prominent instruments are investigated using two conventional concepts about their relationship, namely traditional approach framework and portfolio approach framework. The former proposes that the exchange rate movements have effect over the portfolio investment inflows and eventually the stock prices while the latter predicts that the stock prices movements have effect over the portfolio investment and eventually to the exchange rate.

In this study, net flow of portfolio investment in equity securities is employed as a conduit. The empirical results from this study suggest that the exchange rate depreciation induces foreign fund inflows and eventually causes the stock prices to fall. This evidence partially supports the traditional approach explanation except that the inflows cause the stock prices to fall. The possible explanation is might be because most of the foreign fund in the stock market is short-run speculative fund which only cause the stock price to fluctuate and then shrink when the foreign investor close position to take profit. However the empirical results are found to be inconsistent with the portfolio approach framework as the impact of

the stock prices on the foreign fund flows and the impact of the portfolio investment in equity securities are trivial. This makes intuitive sense as the stock market-induced portfolio investment could not have effect over the exchange rate of the country.