# Chapter 9
# Stock Market Responses to Monetary and Fiscal Policies:
## Case Studing China, India, Indonesia, and Malaysia

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## ABSTRACT

*This study analyzes the short-run and long-run effects of interaction between fiscal and monetary policies on stock market performance in four emerging Asian economies, which are China, India, Indonesia, and Malaysia, by using ARDL model. The study covers the period of 2003:Q1-2020:Q1. The findings from this study show monetary and fiscal policies play an important role in determining stock market returns. Also, the results theoretically support Richardian neutrality hypothesis for China and Indonesia, Keynesian positive effect hypothesis for India, and classical crowding out effect hypothesis for Malaysia, and interest channel of monetary transmission mechanism only for China.*

## 1. INTRODUCTION

After 2008 Global Financial Crisis to have caused to collapse in asset prices, especially equity prices, the effect of money and fiscal policies on financial markets has been an issue growing importance. Monetary policy can affect stock markets by means of five channels, namely the interest rate channel, the credit channel, the wealth effect, the exchange rate channel and the monetary channel. The early studies are Fama and French (1989), Jensen and Johnson (1995), Bernanke and Gertler (1995), Mishkin (2001). The relationship between stock markets and fiscal policy is based on the work of Tobin (1969),

Blanchard (1981), Shah (1984) and Darrat (1988). This effect can be examined through three channel: the Keynesian positive efect hypothesis, the Classical crowding out effect hypothesis and the Richardian Neutrality hypothesis.

The theoretical aspect assumes that the interaction between fiscal and monetary policies influence output, inflation, interest rate and so the stock market, which can be categorized in two groups. The first is the co-movement impact focusing on the complementary or substitutionability of the so-called policies on each other. The second impact is the competing impact concentrating on movement of these policies into adverse direction depending on game theory framework (Melitz, 1997; Wyplosz, 1999). These policies interact via two channel: The first channel is the effect of the government inter-temporal budget constraint on monetary policy. In this channel, it is proposed for the government expenditure to finance via tax, debt or seignorage. The second channel is the effect of fiscal policy on monetary variables such as inflation, interest rate and exchange rate (Sargent and Wallance, 1981; Sargent, 1999; Zoli, 2005; Yakubu et. al., 2010; Çebi, 2012; Akkaya and Aktaş, 2013; Chatziantoniou et. al., 2013; Dedi and Yavas, 2016).

The aim of the paper is to investigate how fiscal and monetary policies influence stock market in the four Asean countries. There is a widespread view that monetary and fiscal policies should support to each other. The interaction of both has an important on the economy, as well as stock market performance. Although many studies focus on the relationship between monetary policy and stock market (Thorbecke, 1997; Patelis, 1997; Conover et. al., 1999; Gali and Gertler, 2007; Bjornland and Leitemo, 2009), few studies examine the impact of fiscal policy on stock market (Darrat, 1988; Jansen et. al., 2008; Agnello and Sousa, 2010; Afonso and Sousa, 2011, 2012). Also, the studies investigating the impacts of interaction between monetary and fiscal policies on stock market performance are rare (Jansen et. al., 2008; Chatziantoniou et. al., 2013). This study is expected to contribute to the literature in this respect.

The aim of this study is to investigate the short-run and long-run effects of fiscal-monetary policy interaction on stock markets in China, India, Indonesia and Malaysia. In this study, we used quarterly dataset of four emerging Asian economies, namely China, India, Indonesia and Malaysia over the period of 2003:Q1-2020:Q1. Our data include Shanghai Stock Exchange (SSE) Composite index, Bombay Stock Exchange Sensetive Index (BSE SENSEX), Jakarta Stock Exchange Composite Index (JKSE) and FTSE Bursa Malaysia KLCI index. Following Tobin's (1969) and Blanchard's (1981) theoretical claims and Chatziantoniou et. al. (2013)'s study, we took into consideration monetary policy, as well. In this context, we considered government expenditure as a proxy for fiscal policy stance and 3-month interest rate as a monetary policy instruments. Also, we used GDP growth rate, inflation as control variables. We employed the ARDL Bounds Testing approach. Thanks to this method, we can examine the effect of monetary and fiscal policies on stock market prices in both short-run and long-run.

## 2. THEORETICAL BACKGROUND

### 2.1. Monetary Policy and Stock Market Returns

Early studies of the effect of monetary policy on stock market returns built on Fama and French (1989), Patelis (1997), Conover et al. (1999) Mishkin (2001). According to Fama and French (1989), the expected returns are higher in weak economic periods than other periods. Patelis (1997) stated that changes in stance of monetary policy affect future expected returns, such that contractionary monetary policy affects

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