Effects of Monetary Variables on the Risk-Return Relationship

By

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Abstract

The main objective of this thesis is to explore the impact of monetary variables on risk-return relationship using daily data from July 2004 to July 2014. Least Squares technique is applied to test the interactive affect of all variables on risk-return relationship and the results of economic model proved that there is insignificant negative effect of interest rate, exchange rate, and interest rate on risk-return relationship. On the contrary, small size has relatively little impact on risk and return relationship than medium size of the firm. Subsequently, large size of the firm has shown highly positive impact on the relationship of risk and return compared to small and medium size. However, the robust tests are also carried out to counter check the results of economic model. Primarily, Vector Autoregression tests are applied to test the effects of monetary variables on prices of the stock and Granger Causality estimates are employed to examine the causal association among the variables. The overall statistical estimates of Granger Causality indicate that there is causal association between stock prices and exchange rates; stock prices and market capitalization. On the contrary, there is no causal association between stock prices and interest rate; stock prices and risk. The Vector Autoregression estimates showed fairly substantial results proving that the relationship among all underlying variables is positive. However, the statistical estimates have indicated that the risk-return relationship is negatively affected by contraction in the monetary policy. The statistical estimates of exchange rates have shown significant positive results throughout the research and it can be said that risk-return relationship improves with the improvement in exchange rate and the results support the theory of Sharpe-Litner (1964-65). The market capitalization has also indicated significantly positive results throughout the thesis and a judgment can be made that risk-return relationship improves with the increase in the size of the firm. Thus, all the monetary variables employed in this thesis except for interest rate significantly affect the risk-return relationship.