# Chapter 1

Introduction

1.1 Background and Significance of the study

The stock market is one of the most important sources for companies to raise money. This allows businesses to go public, or raise additional capital for expansion. The liquidity that an exchange provides affords investors the ability to quickly and easily sell securities.

**Figure 1.1** SET Index data between 2000-2006
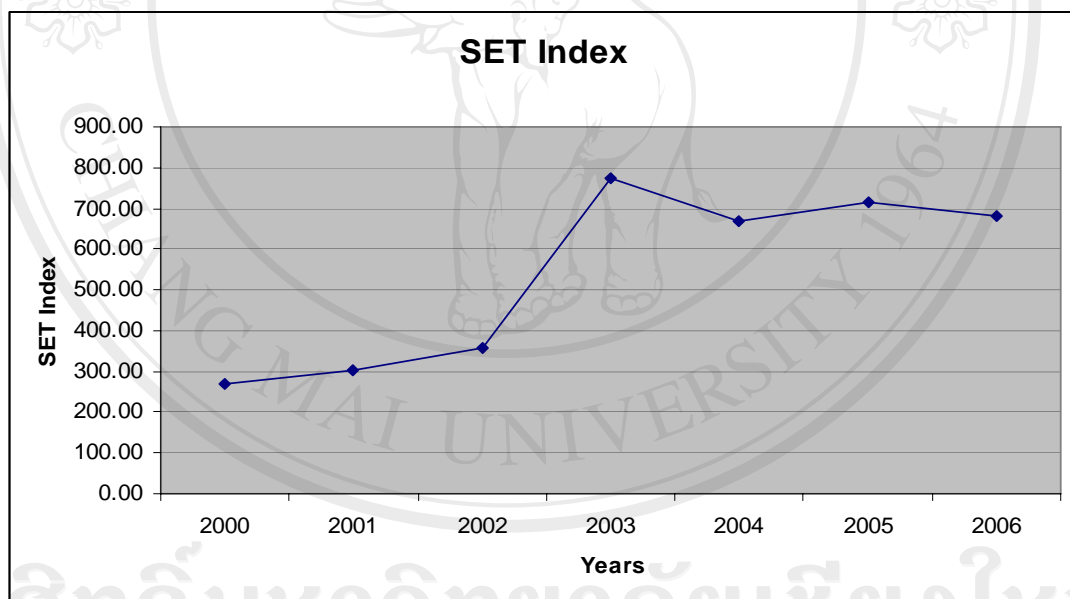
Source: Statistics Information, Stock Exchange of Thailand (2007).

A broad-base index represents the performance of a whole stock market. The most regularly quoted market indices are broad-base indices comprised of the stocks of large companies listed on a nation's largest stock exchanges, such as the American Dow Jones Industrial Average and S&P 500 Index, the British FTSE 100, the French CAC 40, the German DAX, the Japanese Nikkei 225 and the Hong Kong Hang Seng Index.

History has shown that the price of shares and other assets is an important part of the dynamics of economic activity, and can influence or be an indicator of social mood. Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an eye on the control and behavior of the stock market and, in general, on the smooth operation of financial system functions. Financial stability is the reason of central banks.

A central bank, reserve bank or monetary authority who responsible for the monetary policy of its country or of a group of member states. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates which influence the stock and bond markets as well as mortgage and other interest. Therefore, they should remind and awareness to establish monatary policy which develop theirs economics.

Figure 1.2 Money Supply, M2 data of Thailand between 2000-2006
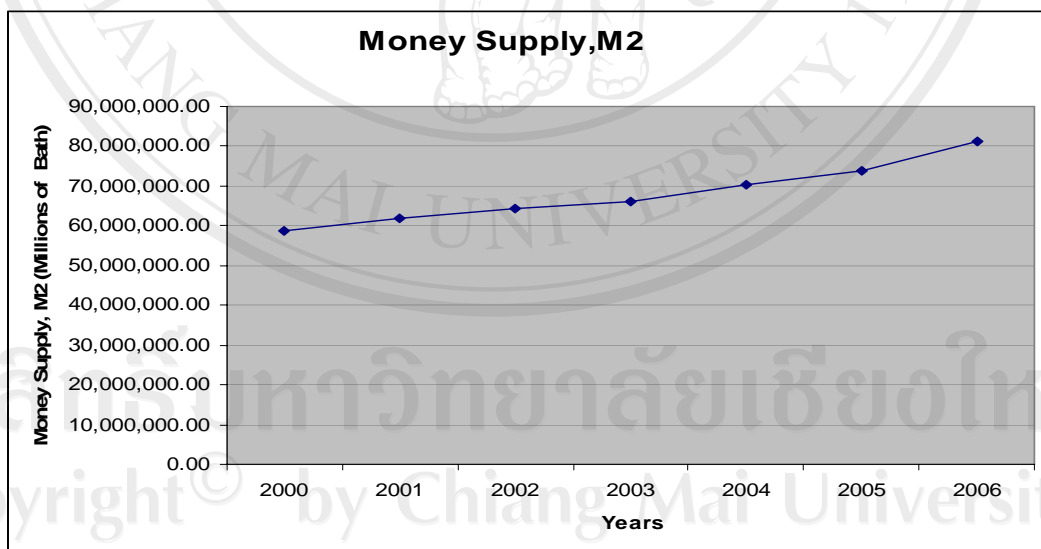
Source: Econ Data, Bank of Thailand (2007).

Much of the related research that addresses the empirical link between the stock prices and the money supply that common stock prices can be predicted from prior changes in the money supply. Sprinkel (1964), Palmer (1970) and Homa and Jaffee (1971), suggest a significant linkage between the money supply and stock price.

Theses authors generally conclude that money supply changes precede stock price change. Brunner (1976), Friedman and Schwartz (1973), Tobin (1963), Sorenson (1982), Pearce and Roley (1983) and Hardouvelis (1985) emphasize the unexpected component of the change in money supply as the cause variable in their empirical model of stock prices valuation. Hashemzadeh and Taylor (1988) suggest that macroeconomic variables which money supply and interest rates more may useful for predicting the direction and perhaps the strength of stock price movement. These studies appear to develop along three distinctive lines of thinking. Some suggest that a change in the money supply upset the equilibrium position of money with effect to other assets in the portfolios of individual investors. So they make an effort to rearrange their portfolios of financial and real assets to a new equilibrium, asset prices, including stock prices, inevitably adjust to new point. One of indices that investors will used as a tool to represent the characteristics of its component stocks is stock market index and other indices compiled by news or financial services firms are used to benchmark the performance of portfolios. On the other hand, research by Cooper (1974), Pesando (1974), Rozeff (1974, 1975), Auerbach (1976), suggest that historical information may not be of much value in predicting stock prices. Moore (1978) observes that stock price indices are among the better known leading indicators of the business cycles in all the major industrial countries. He further observes that there is evidence that some types of economics indicators lead the business cycles by longer intervals than do stock prices, and hence they persistently lead stock price. Other works by Cooper (1974) and Rozeff (1974) an entire generation of the proponents of efficient market hypothesis suggest that stock prices accurately reflect all available information about the anticipated direction of monetary policy and future change in the monetary aggregated. However, doubts have arisen regarding the accuracy of this simplistic linkage between money or other macroeconomic variables and stock prices by all sides is impressive, underlying these doubts appear to lack the statistical methodologies used to support the linkage.

Examination which exclusively focuses upon the short-run relationship between some variable and other variable which may remove important information contained in the permanent component of economic activity concerning the evolution of short-

run movements. Thus, examination of the long-run relationship is important. Moreover, if there is structural change in time series data can creates a "spurious unit root", unit root test is not able to reject a null hypothesis of unit root, when a true model is trend stationary.

In this research has been examined causality of the long-run relationship between money supply and SET index for the Thailand economy in the presence of a structural change.

1.2 Purposes of the study

To study causality between money supply and SET index for the Thailand economy in the presence of a structural change.

1.3 Application advantages

1. The benefit from relationship between money supply and SET index to guide investors who interested to invest in Thailand.

2. The benefit from relationship between money supply and SET index in Thailand to guide the government for establish monetary policy.

1.4 Scope

In this study, examine causality between money supply which choose M2 and SET index data of Thai economy in the presence of a structural change, over the period of monthly from 1995 to 2006.