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MACROECONOMIC DETERMINANTS OF STOCK MARKET PERFORMANCE IN MALAYSIA: EVIDENCE ON THE DOMINANT ROLE OF EXCHANGE RATE

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Abstract:

This study investigates the macroeconomic determinants of stock market performance in Malaysia, with a focus on identifying the dominant factor between exchange rate (ER), inflation rate (IN), interest rate (IR), and gross domestic product (GDP). By utilizing the Arbitrage Pricing Theory (APT), this study adopts a quantitative study method,

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using annual secondary data from 2005 to 2024 (n=20) from the International Monetary Fund (IMF), World Bank, Department of Statistics Malaysia, and Bursa Malaysia. Performance of the stock market is measured through the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI). Descriptive statistics analysis, Pearson correlation analysis, Variance Inflation Factor (VIF) testing, and multiple regression analysis with robust standard errors were used to investigate the relationships between variables. Empirical findings show that the exchange rate has a positive and statistically significant impact on the Malaysian stock market ($\beta = 0.9597$, $p < 0.001$) as it captures 89.9% of the variation in KLCI ($R2 = 0.8991$). However, inflation rate ($p = 0.585$), interest rate ($p = 0.441$) and gross domestic product ($p = 0.409$) positively but statistically insignificantly related to KLCI. These results suggest that Malaysia's export and trade-dependent economy make the stock market highly sensitive to fluctuations of currency exchange, while domestic macroeconomic fundamentals have negligible short-term influence. The findings are essential for investors, policymakers, and researchers as they highlight the importance of exchange rate stability as an instrument for the management of stock market volatility in emerging economies.

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Keyword:

Exchange Rate, FBM KLCI, Inflation, Interest Rate, GDP, Malaysian Stock Market

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Introduction

The stock market plays a crucial role in the global economy, serving as a barometer of the economic health and a significant vehicle of capital distribution that allows business growth while providing a macroeconomic snapshot (IMF, 2025). The broader Malaysian financial system also facilitates capital mobilisation by connecting firms seeking funds with investors seeking financial returns, thereby supporting business financing and firm development (Kassim et al., 2024). In Malaysia, the stock market, measured by the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI), is the key indicator of economic growth, investor sentiment, and economic dynamics. Examining the dynamic between the macroeconomic variables and the stock market performance is paramount for the policymakers, investors, and academics. Investor assessments also depend on the reliability of corporate information, as board financial literacy and effective disclosure practices can strengthen financial reporting quality (Izwan et al., 2024).

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Malaysia, as an open and trade dependent economy, has a unique set of vulnerabilities to the external shock. The imposition of 24% import tariffs by the United States on April 9, 2025, shows the effect of the global events to the domestic financial market (Althea, 2025). Bursa Malaysia dropped by 0.75% on February 28, 2025, indicating concern by the investors due to the possible effects on the economy (Mail, 2025). Chan et al. (2024) concluded that sectoral stock prices in Malaysia have considerable explanatory power, particularly mentioning the fact that most sectors are long run as.

Past empirical studies have consistently shown a significant impact of macroeconomic variables such as the exchange rate, the inflation rate, interest rate, and gross domestic product (GDP) on the stock markets. Siang et al. (2023) confirmed that the exchange rate and the inflation rate have a long-run positive impact on the stock markets, while Siow et al. (2023) confirmed that the exchange rate has a significant relationship with the performance of the stock market. However, Malaysian evidence from crisis periods indicates that inflation may adversely affect stock-market performance, suggesting that the direction of the relationship may depend on prevailing economic conditions (George & Md Yusof, 2023). As a measure of overall economic performance, the overall economic performance of the economy is directly linked to the investor sentiment. Good economic growth of the economy drives up the corporate profit, thus generating high investor confidence and pushing the stock prices up, while bad economic performance lowers the investor sentiment, thus triggering sell-off.

Despite the relationship between these variables as in previous studies, Malaysia, as an economy, has a unique set of characteristics that are worth investigating. The problem statement lying at the core of this study is that while the stock market's volatility leads to a negative impact on the investor sentiment and economic stability (Demir, 2025; Prasad et al., 2022), there is a lack of understanding on the extent of impact of each macroeconomic variables to the market, especially the most dominant influence factor in the Malaysian context. Transparent risk communication may reduce information asymmetry and strengthen investor confidence (Setyawan et al., 2025). The prior studies have mixed results. Huy et al. (2020) argued that stock market fluctuations arise from uncertainty arising from abrupt variations of macroeconomic variables. Radke (2021) showed that the stock market has widely developed as the primary barometer of economic development, suggesting poor stock market performance indicating economic instability. However, Ahmad and Ramzan (2016) suggested that investors determine their stock choices based on a number of considerations, thus making the macroeconomic-stock market relation complex and context-dependent.

These issues are closely aligned with Sustainable Development Goal 8, which emphasises sustained economic growth, productive financial systems, and economic resilience. Understanding how exchange rates, inflation, interest rates, and gross domestic product influence stock market performance provides important evidence on the transmission of macroeconomic conditions to market valuation and investor confidence. Such evidence is particularly relevant to Malaysia as an open and trade-dependent economy, where external shocks can rapidly affect capital-market stability and investment decisions.

Therefore, this study aims to accomplish four research objectives, including (1) to examine the impact of the exchange rate on the stock market in Malaysia, (2) to examine the impact of the inflation on the stock market in Malaysia, (3) to examine the impact of interest rate on the stock market in Malaysia, and (4) to examine the impact of gross domestic product on the stock

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market in Malaysia. The corresponding research questions ask whether each macroeconomic variable is significantly impacting the stock market performance in Malaysia. However, based on the empirical findings, this article focuses more on the first objective as the obtained results show that the exchange rate is the most compelling and statistically significant determinant.

Literature Review

Arbitrage Pricing Theory (APT)

The theoretical basis of this research paper is the Arbitrage Pricing Theory (APT), pioneered by Ross (1976), and developed later to test the effect of macroeconomic data variables on stock markets by Chen, Roll, and Ross (1986) (Tursoy et al., 2008). The APT provides a possible alternative to the Capital Asset Pricing Model (CAPM), claiming that the returns from assets are affected by multiple systematic risk factors instead of only one market factor. The risk factors can be considered various macroeconomic forces that affect asset prices.

Accordingly, the Riantani and Komariah (2024) specified that several macroeconomic factors are integrated in the analysis of stock markets to provide investors with information regarding how they could achieve a certain level of stock returns and how to maximize their portfolio. The change in exchange rate, the change in inflation, and the change in interest rate could cause mispricing of assets, providing arbitrage opportunities that the APT aims to take advantage of. This theoretical approach brings a great deal of context to the specific context of Malaysia where the global economic conditions are highly relevant to the domestic macroeconomic variables.

Exchange Rate and Stock Market

The exchange rate, indicating the value of the Malaysian Ringgit (MYR) against the United States Dollar (USD), is closely related to the stock market, especially in the case of open economies that operate within the international economy. The Ya'acob et al. (2021) defined the exchange rate as a fluctuating phenomenon, which can change its direction according to different economic and market factors. The currency weakness has the potential to increase exports but, on the other hand, can cause inflation through higher prices for imports. The Thang (2009) argued that the change of stock market indices, the sentiment of investors, and the flow of capital are good indicators for the prediction of the future exchange rate, where the performance of the stock market can be used as a proxy.

Norehan et al. (2020) detected a long-term statistically significant correlation between the exchange rate and the stock market, inferring that the variables are still correlated to each other in a time consistent manner. The Gokmenoglu et al. (2021) uncovered that the movement of exchange rates only impact stock markets under specific market conditions, as their effects become stronger at particular quantiles rather than in times of "normal". The El Khoury et al. (2024) substantiated that the correlation between the exchange rate and the movement in the stock market remains dynamic, time-varying, and asymmetric, particularly in the case of exposure to shocks or higher risk states.

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Harun and Afanddi (2021) used the regression analysis to analyze the effect of the change in the exchange rate on the Malaysian stock market, concluding that the local currency depreciation tends to cause a lower performance of the stock markets. Wei et al. (2023) substantiated this finding by showing that the change in the exchange rate negatively impacts on the stock markets, especially in emerging economies. On the other hand, Musa et al. (2024) generated a moderate correlation relation between the exchange rate and the return of the stock market, implying that an increased value of the exchange rate decreases the return in the stock markets. These contradictive findings motivate focused investigation in the specificities of Malaysia.

Inflation, Interest Rate, GDP and Stock Market

The inflation that is measured as the annual percentage change in the Consumer Price Index represents the changes in the prices of products on average over time. The Win (2024) concluded that the inflation has significant impact on the movement of the stock markets, generating uncertainty in the sentiment of investors, which tends to send investors away from stocks to assets such as bonds or gold. The Shamsudin et al. (2021) detected a significant correlation between the inflation and the stock market, while the Hassan et al. (2024) concluded that the inflation has significant impact on the movement of the stock markets, substantiating the importance of the inflation to the performance of the stock markets. However, contradictive evidence is existing with some studies which indicate that such relation could be weaker in specific cases.

The interest rate as defined as the fee that is being paid by a lender to a borrower who seeks to have borrowed money has been intensely studied. The Rayappan et al. (2023) detected that the rate of interest has significant impact on the stock market, as higher interest rate tends to attract investors to the bonds, instead of the stocks while higher the prices for the loans made to consumers, potentially slowing down economic growth and influencing the prices in the stock markets. However, the Hassan et al. (2022) detected that the rate of interest is insignificant for the stock markets in certain cases, proposing that the investors could be confident regarding the rate of interest changes in case of optimistic expectations over the future economic situation. The Rayappan et al. (2023) uncovered also an insignificant relation between the rate of interest and the stock in positive economic situations.

Gross domestic product that is the monetary value of all the goods and services that are being produced in the borders of the country is considered as an expression of the state of the economy. Musa et al. (2024) found that the GDP is significant at the level 0.01 with positive correlation between GDP and the stock market. The Harun and Afanddi (2021) confirmed that the GDP is significant for the stock markets, as the mean is higher than with other measured variables, implying a stronger impact regarding the performance in the stock markets. The Hassan et al. (2022) uncovered that the significance level of the stock markets is affected by the GDP, which is the expression of the expectations regarding the future and helps the investors to predict the trends in the stock markets.

Due to mixed and sometimes contradictive results in various contexts, this research paper aims to empirically test simultaneously all four macroeconomic variables in the context of Malaysia with theoretical support from the APT.

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Methodology

Data and Sources

The data analysis approach applied in this study is quantitative, utilizing annual secondary data over 2005 – 2024 (20 observations). The data were sourced from reliable international financial institutions such as the International Monetary Fund (IMF) as well as World Bank, the Department of Statistics Malaysia, and Bursa Malaysia. These institutions provide extensive and reliable macroeconomic data that serve as essential input for analyzing both independent and dependent variables. Leverage of available secondary data ensures an efficient research process, enabling timely analysis without the necessity of primary data collection.

Sample Description and Variables Measurement

The analysis unit is focused on the macro level, analyzing Malaysia at the macroeconomic level. The dependent variable – performance of Malaysia stock market was measured by FTSE Bursa Malaysia KLCI (FBM KLCI) which is a capitalization-weighted index composed of the largest companies listed on Bursa Malaysia (Shamsudin et al., 2021; Kumbure et al., 2022). The KLCI price was calculated using P/E Ratio multiplied by EPS (Earnings Per Share).

Measurement for independent variables was described as follows. Exchange rate (ER) is the value of the Malaysian Ringgit (MYR) against the United States Dollar (USD), measured in LCU/USD where LCU stands for the amount of local currency. The inflation rate (IN) was presented using the annual percentage change of the Consumer Price Index calculated as (CPI – PPI)/PPI × 100%. The interest rate (IR) is measured by the Overnight Policy Rate set by Bank Negara Malaysia, calculated by taking the difference between the Nominal Interest Rate and the Inflation Rate. Economic growth represented using the gross domestic product (GDP) growth rate calculated (GDP(CP) – GDP(PP))/GDP(PP) × 100%, which represents the economic growth that influence the performance of stock market.

To correct for the potential stationarity problems that are inherent in time-series data, both KLCI and exchange rate variables were log-transformed before data analysis. It is a standard econometric practice to transform variables to ensure stable variance and robust statistical inference (Gujarati & Porter, 2020).

Research Model and Data Analysis

To analyze the effect of macroeconomic factors affecting the Malaysian stock market, this research used various research approaches and techniques. The descriptive statistical approach described the behavior of variables to provide preliminary insight on volatility and central tendencies (Musa et al., 2024). The Pearson correlation analysis to detect the presence of linear relationships between the macroeconomic factors and KLCI, assessing the strength and direction between continuous variables (Rahman & Isa, 2022). Variance Inflation Factor (VIF) test was performed to detect the presence of multicollinearity among independent variables (Murel & Kavlakoglu, 2023).

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The regression analysis using multiple regression with robust standard errors to correct for potential heteroscedastic problems (Mansournia et al., 2020). The regression formula was developed as follows:

$$\mathbf{KLCI = \alpha + \beta_1 ER_{it} + \beta_2 IN_{it} + \beta_3 IR_{it} + \beta_4 GDP_{it} + \varepsilon_i}$$

Where KLCI represents the Kuala Lumpur Composite Index, ER is the exchange rate, IN is the inflation rate, IR is the interest rate, GDP is the gross domestic product, t represents time, i represents years, ε is the error term.

Data screening was performed for all variables to ensure the consistency of measurement unit and time alignment. Inspection of data revealed no systematic absence of observations due to the credibility and consistency of data sources. Outliers were detected using descriptive analysis and standardized analysis. Instead of removing outliers, a robust standard error was applied to the regression analysis to mitigate the impact of the heteroscedasticity and extreme values.

Results

Descriptive Statistics

Table 1 shows the descriptive statistics on all variables used in this study (n=20). The outcome indicated that the variables reveal various stages of variability over the study period. Exchange rate (ER) has a minimum value of 3.0600 and maximum value of 4.5764. The mean and standard deviation is 3.7982 and 0.5082 respectively. The relatively small value of standard deviation suggests that exchange rate shows the most stabilized movement compared to all variables.

The inflation rate (IN) shows a minimum value of -1.1387 to a maximum of 5.4407 with a mean of 2.2499 with a standard deviation of 1.4121 which includes a negative minimum value that suggests a period of deflation. The interest rate (IR) has the highest dispersion with minimum value of -3.9034 and a maximum value of 11.7824 with a mean of 2.2459 (SD = 3.8304), suggesting the the interest rate variable is the most volatile one during the observation period. The gross domestic product (GDP) also shows considerable dispersion with a minimum value of -5.4568 and with a mean of 4.4713 (SD = 3.0508).

Table 1: Descriptive Statistics of Research Sample (n=20)

Variables	Denotation	Min	Max	Mean	SD
Exchange Rate	ER	3.0600	4.5764	3.7982	0.5082
Inflation Rate	IN	-1.1387	5.4407	2.2499	1.4121
Interest Rate	IR	-3.9034	11.7824	2.2459	3.8304
Gross Domestic Product	GDP	-5.4568	8.8618	4.4713	3.0508
Stock Market (KLCI)	KLCI	3.06	4.59	3.8125	0.5112

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Inflation rate (IN) has a range from -1.1387 to 5.4407, with a mean of 2.2499 and standard deviation is 1.4121 which include a negative minimum value showing a period of deflation. Interest rate (IR) demonstrates the widest range of dispersion, with a range from -3.9034 to 11.7824 and mean of 2.2459 (SD = 3.8304) which indicates that interest rate is the most volatile variable during the observation period. Gross domestic product (GDP) also exhibited that the fact which is that dispersions are noticeable, with a minimum of -5.456 and a mean of 4.4713 (SD = 3.0508).

Regarding the stock market measured by FBM KLCI, the stock market shows a minimum index of 3.06 to a maximum of 4.59 with a mean value of 3.8125 (SD = 0.5112). The moderate value standard deviation implies that the market stock movements were relatively more stable compared to the interest rate and GDP, yet slightly volatile compared to the exchange rate. These results confirm the importance of examining more on the potential impact of these macro-economic variables to changes on the stock market.

Correlation Analysis

Table 2 shows the Pearson Correlation coefficients between all variables. Correlation analysis aims to measure and describe the strength and direction of relationships between the dependent variable and independent variables (Mao & Wu, 2021). The most significant finding is the strong positive correlation between the exchange rate (ER) and KLCI ($r = 0.9453$, $p < 0.01$). This indicates that as the exchange rate (Ringgit depreciation), the KLCI tend to increase. This association is consistent with export-oriented characteristics of stock market that weaker currency strength leads to improved export competitiveness.

Table 2: Pearson Correlation Matrix

	Year	IN	ER	IR	GDP	KLCI
Year	1.0000					
IN	-0.2918	1.0000				
ER	0.7649***	-0.1677	1.0000			
IR	-0.2157	-0.6207**	0.1617	1.0000		
GDP	-0.1363	0.6357	-0.1524	-0.5521*	1.0000	
KLCI	0.7693	-0.1038	0.9453***	0.1431	-0.0867	1.0000

Notes: ***, **, and * represent significance at 1%, 5%, and 10% levels respectively

The inflation (IN) has a low correlation with KLCI (r = -0.1038), suggesting inflation may not be a good predictor of stock market performance in Malaysia during the 20-year observation period. The interest rate (IR) also shows weak positive correlation (r = 0.1431) and GDP shows a weak negative correlation (r = -0.0867) with KLCI. These weak correlations regarding the direct linear relationships suggest the three domestic macro-economic variables have weak correlation with the Malaysia's stock market.

Multicollinearity Test (VIF)

Table 3 presents the Variance Inflation Factor (VIF) and Tolerance results of all independent variables. According to Murel and Kavlakoglu (2023), VIF is most commonly used method to detect multicollinearity in linear regression models, and it represents the extent of variance of

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variables inflated by other variables. High multicollinearities cause less reliable regression results.

Table 3: Variance Inflation Factor (VIF) Results

Variables	VIF	Tolerance
IN	2.04	0.44895
ER	1.80	0.5545
IR	1.75	0.5710
GDP	1.04	0.9648

Table 3 shows all of VIF is below 5 (maximum VIF = 2.04) which is the accepted value indicating no multicollinearity problems between independent variables. Each of these independent variables is unique in providing information about the stock market and does not duplicate an explanatory effect of another variable. This implies the regression model is stable and appropriate and that the predictors do not interfere with explanatory power among each other.

Regression Analysis

Table 4 presents the multiple regression results with robust standard errors to correct possible heteroscedasticity. When the homoscedasticity assumption of linear regression models is violated, robust standard errors are implemented which implies that the variance of the outcome variable is non-constant through the observations (Mansournia et al., 2020).

Table 4: Multiple Regression Results (Robust Standard Errors)

Variables	Coefficient	T-Statistic	p-value
IN	0.0200	0.56	0.585
ER	0.9597***	14.28	0.000
IR	0.0069	0.79	0.441
GDP	0.0087	0.24	0.409
Constant	0.0674	0.24	0.815

Notes: ***, **, and * represent significance at 1%, 5%, and 10% levels respectively

The regression results indicate that the exchange (ER) is the only statistically significant variable affecting KLCI ($\beta = 0.9597$, $p < 0.001$). An increase in the exchange rate (Ringgit depreciation) by one unit, leads to an increase 0.9597 units in the KLCI. This evidence confirms Research Objective 1 (RO1) that exchange rate is has a significant impact in the Malaysian stock market.

On the contrary, inflation rate (IN) shows a positive yet insignificant effect on KLCI ($p = 0.585$). Inflation has no statistically significant relevance on the stock market during the study period; thus, Research Objective 2 (RO2) is not supported. Moreover, the interest rate (IR) shows a insignificant relationship ($p = 0.441$), suggesting that changes in interest policies have no direct effects on KLCI. Research Objective 3 (RO3) is not supported. Finally, gross domestic product (GDP) has a positive yet insignificant effect ($p = 0.409$) which shows that

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economic growth does not have robust influence on stock market performance; thus, Research Objective 4 (RO4) is not supported.

The model is remarkably powerful with $R^2 = 0.8991$, implying the four macro-economic variables altogether explain almost 90% of the variation in the Malaysian stock market. The Prob > F value is 0.0000 implying the model overall statistically significant.

Discussion

The empirical results derived from this study highlight a fascinating story: the exchange rate dominates the Malaysian stock market performance, and inflation, interest rates, and GDP have no statistically significant impact on the market. This result is remarkable since it defies common economic dogma that the stock market performance is driven primarily by domestic macro-economic fundamentals. Instead, the Malaysian's equity market seems to be a fundamentally external-facing asset with currency movements vis-à-vis the US dollar is the dominant driving force.

The significant positive link between the exchange and KLCI ($\beta = 0.9597$; correlation $r = 0.9453$) suggests that Ringgit depreciation has positive impact on stock prices. This reflects the export-oriented economic structure of Malaysia. When the Ringgit weakens against the US dollar, export of Malaysia becomes cheaper and competitive for export to the international market. Core export sectors such as electronics, palm oil, petroleum products and manufacturing benefit directly from depreciation where they enjoy price competitiveness on the international market. Higher export volumes and sales mean the benefit to corporate profitability that positively impact stock prices. This mechanism explains why the influence of exchange rate is not only statistically significant but economically substantial.

The insignificant of inflation, interest rates, and GDP, although surprising at first glance, gain more sense when viewed in the context of Malaysia. The level of inflation in Malaysia during the study period (mean 2.25%, SD 1.41) was relatively moderate with only short spikes. Investors could view inflation as a manageable or even already priced factor rather than a market-shock. Moreover, the Overnight Policy Rate (interest rate) although showing highest volatility (SD 3.83), may not have direct effects to stock markets as monetary policy transmission in Malaysia mainly works through the lending channels in bank rather than by revaluations of equity markets. The insignificant impact of GDP suggests that the stock market in Malaysia is a forward-looking market with the investor who have anticipated the economic growth would have been priced in in the current price level. Alternatively, Malaysia stock market is dominated by huge export-oriented companies, the fortunes of which are more influenced by external demand and exchange rates rather than the domestic economic growth.

From Arbitrage Pricing Theory (APT) perspective, these findings suggest that in the Malaysian context, the exchange rate serves as the dominant systematic risk factor. APT suggests that asset return should be sensitive to multiple macro-economic factors, but this theory does not prescribe which factors are relevant to which market. This study empirically confirms that Malaysia's case, the exchange rate is the primary APT factor while inflation, interest rates and GDP add minimal explanatory value beyond the currency movements that are captured in the model.

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Conclusion

This study's purpose was to analyze the macroeconomic determinants of the stock market performance in Malaysia, with special focus on the exchange rate, inflation rate, interest rate, and gross domestic product. The findings lead to an inescapable conclusion: the exchange rate is the only macro-economic variable that has a statistically significant impact on the Malaysian stock market performance while inflation, interest rates, and GDP show no statistically significant impact. The presence of a formidable positive association between exchange rate and KLCI ($\beta = 0.9597$, $p < 0.001$) confirms that Ringgit depreciation drives the stock market appreciation which is consistent with Malaysia's export-oriented trade dependent economic structure. The model explains almost 90% of the stock market variation, exhibiting an exemplary explanatory ability. These results add new valuable information to the present literature by offering specific empirical insights derived from the Malaysian context, with the foundation in Arbitrage Pricing Theory. Practically, investors are advised to prioritize the exchange rate movement when considering investment in Bursa Malaysia and to apply the currency hedging strategy to hedge the exchange rate risks. Policymakers and regulator should take cognisance that stability in exchange is critical to stock market stability and that the coordination monetary and fiscal policies should be used to control currency fluctuations. For future research study, this study suggests using higher frequency data (monthly or quarterly) to capture more nuanced dynamics; using more external global variables (such as oil prices, performance of US's S&P 500, and growth of China's GDP); and doing comparative study in all ASEAN's stock markets to see regional integration effects. Advanced econometric methods such as ARDL, GARCH and VAR models are recommended to capture long run relationship and volatility relationship.

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