# Monetary Policy and Stock Market Dynamics: An Empirical Perspective

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Abstract:- This study examines the influence of monetary policy on stock market performance and activity in Bangladesh, focusing on the Dhaka Stock Exchange (DSEX) index, using monthly data from August 2012 to June 2024. The regression analyses incorporate key monetary variables: the 91-day treasury bill rate, broad money supply, and Consumer Price Index (CPI). The first model reveals that the current month's DSEX index is strongly dependent on the previous month's index level, with the 91-day treasury bill rate showing a significant negative correlation, the broad money supply exhibiting a positive relationship, and the CPI indicating a negative association with market performance. The second model demonstrates that both the 91-day treasury bill rate and CPI negatively impact market turnover, while broad money supply has a positive effect. These findings underscore the crucial role of monetary policy in shaping stock market dynamics in Bangladesh, providing valuable insights for policymakers and investors in emerging markets.

*Keywords:- Monetary Policy; Stock Market; Broad Money; CPI; DSEX; Bangladesh.* 

# I. INTRODUCTION

Within the field of financial economics, the connection between monetary policy and stock market dynamics continues to be a subject of ongoing interest and importance. With its thriving economy and expanding capital markets, Bangladesh offers a captivating opportunity to empirically examine these interactions. The effectiveness of monetary policy tools in impacting stock market behavior is of utmost importance for policymakers, as well as investors and stakeholders who are dealing with the intricacies of market fluctuations.

To keep in harmony with the aforementioned intent, this study seeks to explore the complex relationship between changes in monetary policy and the reactions of the stock market in Bangladesh. By examining empirical data from 2012 to 2024, the inquiry aims to reveal the influence of fluctuations in Treasury bill rates, broad and reserve money, call money rate, weighted average lending rate, inflation rate, and exchange rates instruments on the performance of the stock market. Gaining a deep understanding of these dynamics is crucial for accurately predicting market trends, Maliha Rabeta<sup>2</sup>

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fine-tuning investment strategies, and making informed policy decisions that promote economic stability and growth.

# II. LITERATURE REVIEW

Extensive global research has shed light on the intricate connections between monetary policy and stock market dynamics. These studies have uncovered a range of factors that influence these interactions, including economic conditions, policy instruments, and institutional frameworks. Gaining a deep understanding of these dynamics is of utmost importance for policymakers, investors, and economists who are eager to comprehend the wider implications for economic stability and growth.

There is substantial evidence indicating that alterations in monetary policy variables, such as interest rates, money supply, and exchange rates, have a significant impact on the performance of the stock market. Based on important studies conducted by Mishkin (1995) and Bernanke & Kuttner (2004) it has been found that monetary policy actions, such as changes in interest rates, can impact the discount rates applied to future cash flows, which in turn can influence stock prices.

In addition, Ehrmann and Fratzscher (2004) discovered indications of unequal reactions in stock markets when it comes to tightening monetary policy compared to easing it. Previous studies have indicated that the impact of monetary policy on stock market behaviour can differ based on factors such as economic development, financial market integration, and regulatory conditions (Bekaert et al., 2011; Levine and Zervos, 1998).

It has been empirically identified that the interest rate, credit, wealth effect, exchange rate, and monetary hypothesis are the five pathways through which monetary policy can individualistically affect stock market returns (Mishkin (2001); Iacoviello (2005); Bernanke and Kuttner,(2005); Agnello and Souse,(2010)).

According to Mishkin (2001), there is a two-way relationship between the stock market and monetary policy. On the one hand, the stock market feeds back information to authorities regarding the private sector's expectations for future changes in the fundamentals of macroeconomics. On the other hand, shocks to the monetary policy instruments Volume 9, Issue 8, August – 2024

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frequently impact the stock market's behavior through the mentioned five different channels.

The fluctuations in interest rates affect the corporate cost of capital, thus altering the present value of future net cash flows. This suggests that rising interest rates will cause future net cash flow present values to decline, which would then translate into declining stock prices. An indirect means of transmitting monetary policy through interest rate adjustments is the credit channel. It illustrates how increased business investment activity is anticipated to result in increased future cash flows and raise the market prices of the companies. The ability of interest rates to determine the value of stock prices such that an increase in interest rates will result in a fall in stock prices helps investors make wise portfolio choices that ensure returns and protection from negative distortion in the interaction between the two policies. This is the wealth effect, which sheds light on how monetary policy affects stock market performance. An increase in interest rates will cause the domestic exchange rate to appreciate, which will result in decreased exports and greater imports. Lastly, rising interest rates cause a decrease in stock valuation, which causes money to move from the stock market to the bond market (assuming these are the only two assets available on the market), which drives down stock prices, according to Tobin's Q Theory of Investment. These findings were protracted by Isola Lawal et al., (2018) based on the previous works of Fama and French (1989), Bernanke and Gertler (1995), Jensen and Johnson (1995a, 1995b), King and Watson (1996), Patelis (1997), and Conover et al. (1999).

In the context of emerging economies like Bangladesh, previous studies have examined the impact of monetary policy adjustments on stock market volatility and returns. Hossain et al. (2016) studied the empirical association between monetary policy orientations and stock market return in Bangladesh using autoregressive distribution lag on data from January 2001 to December 2013. They concluded that monetary policy has an impact on the stock market by means of five measures of economic variables: the 91-day T-bill rate, call money rate, deposit rate, reserve money, broad money, and DSE index.

Rashid & Ima (2020) evaluated the effects and efficacy of various financial factors on Bangladesh's stock market. Three independent variables, namely, the money market rate, the inflation rate, and the repo rate have been used as proxies for monetary factors, while the dependent variable, the DSEX index, was used as a proxy for stock market performance. The findings recommended that investors take the aforementioned factors into account when making strategic choices regarding portfolio and investment management.

Shamshad et al. (2023) used monthly data to analyze the relationship between monetary policy and market liquidity for the Pakistani stock market from 2000 to 2021. Value traded was utilized as a stand-in for market liquidity, and foreign portfolio investment, the index of industrial production and the exchange rate were employed as independent variables. Broad money (M2) and interest rates (treasury bills rate) were used to capture the effects of monetary policy. The findings suggested that international portfolio investments are dejected by high interest rates.

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Chen (2021) examined how monetary and fiscal policy affect the stock market using evidence from the US, Australia, China, the combined 11 members of the Eurozone, and other nations through the use of secondary data and analysis from many sources. Theoretically, the interest rate, credit, and investor expectations were the three channels via which monetary policy influences the performance of the stock market. However, the findings show that, as a result of various market expectations, the impact of monetary policy on stock market performance varies between nations.

Keeping the varied results derived from previous literature in mind, this paper is an attempt to add to the existing body of literature by analyzing the empirical data from Bangladesh, a fast-growing economy with developing financial markets.

Through the analysis of up-to-date monthly data from August 2012 to June 2024, and the use of reliable econometric techniques on mechanisms like fluctuations in Treasury bill rates, broad and reserve money, call money rate, weighted average lending rate, inflation rate and exchange rates; this study seeks to offer valuable insights into monetary policy and stock market dynamics from an emerging economy. This study also investigated the impact of money market situation on capital market turnover which is new dimension of analysis in this topic in the context of Bangladesh.

# III. METHODOLOGY

#### ➢ Data Collection

Monthly data was collected for the two alternative dependent variables and the independent variables. The dataset spans from August 2012 to June 2024.

#### ➤ Variable Selection and Model Specification

A multiple linear regression model was specified with ln(dsex) as the dependent variable and the lagged independent variables as predictors. Another Multiple linear regression model was specified as DSE turnover or the total market activity as the dependent variable and the lagged independent as the predictors. Independent variables include the following:

#### • 91-Day Treasury Bill Rate:

The rate for 91-Day Treasury Bills is determined by the auction's cut-off yield. This reference rate will be the primary tool used to figure out the rate of floating rate instruments.

# • Ln(Reserve\_Money):

The Reserve Money factor displays the amount of reserve money in the banking system, including both required and extra reserves.

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#### • Ln(Broad\_Money):

The total of demand deposits, money held outside of banks, and time deposits accepted by other deposit companies.

#### • Call Money Rate:

The rate at which short-term funds are borrowed and lent in the money market.

#### Weighted Average Deposit Rate:

The nation's banks' weighted average interest rate on deposits.

There are two control variables in the model which are-

# ✓ CPI Rate:

The Consumer Price Index or CPI measures changes in the prices paid by consumers for a basket of goods and services.

 ✓ Ln(Exchange Rate): USD to BDT exchange rate.

# ➤ Regression Equation

$$\label{eq:linear} \begin{split} & ln(dsex\_t) = a + b1ln(dsex\_t-1) + b2tbill\_rate\_t-1 + \\ & b3callmoney\_rate\_t-1 + b4deposit\_rate\_t-1 + \\ & b5ln(reserve\_money\_t-1) + b6ln(broad\_money\_t-1) + \\ & b7cpi\_rate\_t-1 + b8ln(exchange\_rate\_t-1) + e \dots \dots \dots (1) \end{split}$$

$$\label{eq:link} \begin{split} &ln(dsex\_turnover) = a + b1tbill\_rate\_t-1 + \\ &b2call\_money\_rate\_t-1 + b3deposit\_rate\_t-1 + \\ &b4ln(reserve\_money\_t-1) + b5ln(broad\_money\_t-1) + \\ &b6cpi\_rate\_t-1 + b7ln(exchange\_rate\_t-1) + e \dots (2) \end{split}$$

Tests of the data variables in the models for data related problem will be conducted which include but not limited to multicollinearity. Identifying and solving the data issues will lead to a better model to predict capital market movement relating with monetary stance of the country.

 $ln(dsex_t) = a + b1ln(dsex_{t-1}) + b2tbill_rate_{t-1} + b3ln(broad_money_{t-1}) + b4cpi_rate_{t-1} + e \dots (3)$ 

 $ln(dsex\_turnover) = a + b1tbill\_rate\_t-1+ + b2ln(broad\_money\_t-1) + b3cpi\_rate\_t-1 + e.....(4)$ 

#### IV. DATA ANALYSIS AND RESULT

#### Descriptive Statistics

The table below provides summary statistics for the key variables used in your regression analysis, offering a comprehensive overview of their central tendencies, variability, and range. The first variable, ln\_dsex, which represents the natural logarithm of DSEX, has an average (mean) value of 8.55 with a standard deviation of 0.17. This indicates that the data points are closely clustered around the mean, ranging from a minimum of 8.14 to a maximum of 8.9. Similarly, lndsex\_turn, the natural logarithm of DSEX turnover, shows a slightly higher mean of 8.65 and a larger standard deviation of 0.52, suggesting more variability in turnover compared to the index itself. The values for ln\_dsex\_t-1, representing the lagged value of the natural logarithm of DSEX, are identical to those of ln\_dsex, reflecting the nature of the lagged data.

Variable	Obs	Mean	Std.Dev.	Min	Max
ln_dsex	143	8.55	0.17	8.14	8.9
lndsex_turn	143	8.65	0.52	7.22	10.13
ln_dsex_t-1	143	8.55	0.17	8.14	8.9
tbill_rate_t-1	143	0.05	0.03	0.01	0.12
callmoney_t-1	143	0.05	0.02	0.02	0.1
deposit_rat_t-1	143	0.06	0.02	0.04	0.09
lnreserve_t-1	143	16.20	0.38	15.46	16.78
lnbroad_mo_t-1	143	14.57	0.40	13.79	15.16
cpi_rate_t-1	143	0.07	0.01	0.05	0.1
Lnexchange_t-1	143	4.44	0.11	4.34	4.76

Table 1 Descriptive Statistics

The lagged Treasury Bill rate (tbill\_rate\_t-1) with a mean of 0.05 and a standard deviation of 0.03, indicating moderate variability in short-term interest rates; the lagged Call Money rate (callmoney\_t-1) with a mean of 0.05 and a smaller standard deviation of 0.02, indicating a tighter range of variability; and the lagged Deposit rate (deposit\_ra\_t-1) with a mean of 0.06 and a standard deviation of 0.02, indicating a stable deposit rate environment comprised of critical economic indicators. With a mean of 16.20 and a standard deviation of 0.38, the natural logarithm of lagged reserve money (lnreserve\_t-1) shows significant reserves with moderate variability. A broad monetary basis is

suggested by the natural logarithm of lagged broad money (lnbroad\_mo\_t-1), which has a mean value of 14.57 and a standard deviation of 0.40. With a mean of 0.07 and a standard deviation of 0.01 for the laggard CPI rate (cpi\_rate\_t-1), there is little evidence of inflationary pressure. In the end, the lagged exchange rate's natural logarithm (lnexchange\_t-1) displays a stable exchange rate environment with a mean of 4.44 and a standard deviation of 0.11.

#### > Market Return: DSEX Index Level

The first independent variable is the broad index of Dhaka Stock Exchange, DSEX. To understand the impact

of money market with the capital market performance, a multiple regression is run including all the initially selected independent variables.

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Table 2	Regression	with	Initially Selected Variables

Variables	Coefficient	T P> t	
ln_dsex_t1	.8014789	18.01	0.000
tbill_rate_t1	9878189	-2.56	0.012
callmoney_rate_t1	.7497911	1.35	0.178
deposit_rate_t1	4043783	-0.45	0.651
lnreserve_money_t1	3318077	-2.60	0.010
lnbroad_money_t1	.3613028	2.94	0.004
cpi_rate_t1	1.304137	2.03	0.044
lnexchange_rate_t1	0520294	-0.34	0.733
Cons	1.990567	2.91	0.004
R Squared	0.9248	Prob > F	0.0000
Number of Observations	143	F (8,134)	205.89

With an F-statistic of 205.89 (p-value = 0.0000), the regression model, which is based on 143 observations, shows a robust fit and statistical significance. Taking into consideration the number of predictors, the model accounts for 92.48% of the variation in the dependent variable

ln\_dsex ( $R^2 = 0.9248$ ), with an adjusted R-squared of 0.9203. The 0.04674 Root Mean Squared Error (Root MSE) suggests accurate predictions due to the tiny average magnitude of residuals.

Table 3 VIF Test Result						
Variable	VIF	1/VIF				
lnbroad_mo_t-1	158.61	0.006305				
lnreserve_t-1	156.66	0.006383				
Lnexchange_t-1	17.34	0.057671				
deposit_ra_t-1	12.31	0.081259				
callmoney_t-1	8.74	0.114467				
tbill_rate_t-1	8.28	0.120805				
cpi_rate_t-1	5.9	0.169357				
ln_dsex_t-1	3.57	0.279832				
Mean VIF	46.43					

However, the model's mean VIF of 46.43 indicates that multicollinearity is a serious problem that could have an impact on the accuracy and interpretation of the coefficients. Correctional actions like merging or eliminating strongly linked variables might need to be considered. Hence, variables are removed which were highly correlated. Now the reduced model looks like the following:

Table 4 Regression	after	Addressing	Multicollinearity

Variables	Coefficient	Т	P> t
ln_dsex_t1	0.829079	20.33	0.0000
tbill_rate_t1	-0.802585	-3.51	0.0010
lnbroad_money_t1	0.030674	1.92	0.0570
cpi_rate_t1	-0.930504	-2.14	0.0340
cons	0.99803	3.94	0.0000
R Squared	0.9195	Prob > F	0
Number of Observations	143	F (4,138)	393.86

The regression analysis looks at the link between four independent variables (ln\_dsex\_t-1, tbill\_rate\_t-1, lnbroad\_money\_t-1, and cpi\_rate\_t-1) and the dependent variable (ln\_dsex). Approximately 92% of the variation in ln\_dsex can be explained by the predictors included in the model, demonstrating an exceptional fit with an R-squared value of 0.9195. The regression model's overall significance is further supported by the F-statistic of 393.86. When examining the individual coefficients, it can be seen that there is a strong positive correlation between ln\_dsex and the variable ln\_dsex\_t-1. Specifically, an increase of one unit in ln\_dsex\_t-1 corresponds to an increase of almost 0.829 units in ln\_dsex. An increase in the Treasury bill rate of one unit is correlated with a fall in ln\_dsex of 0.803 units, as indicated by the coefficient for tbill\_rate\_t-1, which is -0.803. This indicates a considerable

negative influence. With a p-value of 0.057, the coefficient for lnbroad\_money\_t-1 is 0.031, indicating a marginally significant but positive association. Finally, a one-unit

increase in the CPI rate translates into a 0.931-unit decrease in ln\_dsex, as demonstrated by the cpi\_rate\_t-1 value of 0.931, which reveals a negative relationship with ln\_dsex.

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Table 5 VIF Test Result					
Variable	VIF	1/VIF			
ln_dsex_t-1	2.89	0.346583			
tbill_rate_t-1	2.8	0.357566			
cpi_rate_t-1	2.61	0.383307			
lnbroad_mon_t-1	2.58	0.388181			
Mean VIF	2.72				

The mean VIF is 2.72, suggesting that multicollinearity is not a significant issue in the model. After dropping the highly correlated variables, now the model has become stronger predictor of the change in the dependent variable fixing multicollinearity problem. The correlation coefficient is also showing alignment with result of the VIF test.

Table 6	Correlation	Matrix

	ln_dse~t1	tbill_~1t	lnbroa~t1	cpi_ra~t1
ln_dsex_t1	1.0000			
tbill_rate~t1	-0.3182	1.0000		
lnbroad_mo~t1	0.5763	-0.2767	1.0000	
cpi_rate_t1	-0.1903	0.5567	0.1806	1.0000

Market Activity: DSE Turnover

The regression analysis here aims to elucidate the relationship between market turnover, the dependent variable, and three independent variables: the Treasury bill rate, broad money, and the Consumer Price Index (CPI) rate. Market turnover is another important indicator of market performance showcasing the liquidity situation of the market.

Table 7	Regression	after	Addressing	Multicollinearity
	0			

Variables	Coefficient	Т	P> t
tbill_rate_t1	-5.26241	-2.59	0.0110
lnbroad_money_t1	0.99112	3.84	0.0000
cpi_rate_t1	-11.04242	-2.02	0.0460
cons	5.089288	2.29	0.0230
R Squared	0.7838	Prob > F	0
Number of Observations	143	F (3,138)	209.49

The adjusted R-squared of 0.7659 confirms the model's robustness, accounting for 76.59% of the variance. An F-statistic of 209.49 and a p-value of 0.0000 highlight the overall significance of the model, suggesting the predictors collectively have a substantial effect on market turnover.

Investigating the individual coefficients offers more indepth understanding of the effects of every predictor. With a p-value of 0.011, the coefficient for the Treasury bill rate is -5.262. A one-unit increase in the Treasury bill rate is linked to a roughly 5.26-unit drop in market turnover, according to this negative coefficient, which shows a strong inverse association between the two variables. The broad money variable has a 0.000 extremely significant p-value and a coefficient of -0.991. This indicates that decreases in market turnover are likewise associated with rises in broad money, with a one-unit increase in wide money translating into a 0.99-unit drop in market turnover. In a similar vein, the CPI rate shows a large and significant negative impact on market turnover with a coefficient of -11.04242 and a p-value of 0.000. There is a significant 11.04 unit drop in market turnover for every unit increase in the CPI rate. When all independent variables are zero, the constant term, 5.089288, with a p-value of 0.023, represents the predicted level of market turnover. The adverse links between market activity and key economic indicators are highlighted by the coefficients, which collectively imply that greater values of the Treasury bill rate, wide money, and CPI rate are linked to lower market turnover.

The result of the VIF test also shows that there is no significant redundancy in among the independent variables. VIF of 5.77 is below the threshold of 10.

Table o vir Test Result	ılt	Res	Test	VIF	8	Table
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Variable	VIF	1/VIF
lnbroad_mo~1	8.93	0.11199
cpi_rate_t1	5.47	0.18281
tbill_rate~1	2.93	0.34186
Mean VIF	5.77	

# V. DISCUSSION

Monetary condition and thereby the interest rate have always been a determining factor for the capital market performance in Bangladesh where the financial sector is dominated only by banks and capital market is relatively smaller in size and contribution. Moreover, the institutional investor base of the market is also mostly banks. Overtime in the last few business and economic cycles, it has been evident that when there is a liquidity tightening condition. investors in the capital market struggled to take positive return to home and the market participation and activity of the investors also narrowed (Hossain et al., 2016). After investigating the intricacies of this relationships, the result shows that three among the four independent variables that we have finally selected significantly affect the capital market performance at 5% significance level and the other one is significant at 6% significance level.

The level of DSEX of current month is heavily dependent on the level of the index in the last month (Fama and French, 1989). This is an expected relationship proven by many finance theories and literature. Momentum factor is one of the factors of Fama-French five factor model. 91-day treasury bill rate shows a strong negative correlation with the stock index level. This shortest maturity government security rate changes first in response to any change in economic cycle and this send a signal to the capital market that the monetary condition of the country will be tightened going forward and the return of the alternative investments to capital market will be relatively lucrative (Rashid & Ima, 2020). Treasury rate rises faster when government heavily borrows from domestic sources to finance the fiscal deficit. Excessive borrowing of the Government through open market operation leading to limited lending capacity of banks to the private sector and the crowding out effect. Hence, when the treasury rate increases, market smelling the upcoming monetary tightness underperforms, which is reconfirmed by the result of this study.

Broad money in circulation another important monetary policy indicator portrays significant positive relationship with the index level which align with the theoretical expectation. As the broad money supply increases, monetary condition eases (Chen, 2021). An ease led to lower interest rate. When interest rate gets lower, return from alternative investment becomes less lucrative and people take more margin loans and other borrowing facility to participate in the market. Fundamentally, business also earn and expand well in as they can easily avail loans to expand and continue business operations smoothly Mishkin (1995). Positive boost in corporate earnings boost investors sentiment and the index level up. Inflation rate denoted by the point-to-point Consumer Price Index (CPI) is also displayed a significant negative relation with the index level. When inflation is high, purchasing power of people decreases which also means limited savings and in investable funds remains in the hand of people which reduces the market activity and performance (Bernanke and Kuttner, 2005). Discretionary sectors bear greater burnt because the demand less of the products which are not necessary. Moreover, when inflation rate goes higher, the most likely policy action is also to increase the policy rates.

If the lens is changed to see the impact of monetary policy stance on market participation of activity denoted by the market turnover, we also get similar result as market performance or index level. All three independent variables significantly affect market participation. As inflation rises, monetary policy stance becomes contractionary, broad money supply decreases, and interest rate goes up (Isola Lawal et al., 2018). Investors shy away from participating in the market, turnover goes down. When the opposite happens, market activity rises up with the easy money available in the economy at cheaper rate.

# VI. CONCLUSION

This study emphasizes how monetary policy stance have a significant impact on Bangladesh's capital market performance. Capital market return and turnover both are significantly affected by the monetary policy variables namely, broad money supply, interest rate, and inflation rate. The momentum effect is demonstrated by the analysis, which shows that the DSEX index is significantly impacted by its level from the previous month. The rate on 91-day Treasury bills exhibits a robust negative association with the stock index, indicating that rises in the cost of short-term government securities, frequently resulting from government borrowing, anticipate impending tightening of monetary policy and impede market performance. Conversely, the broad money supply exhibits a positive correlation with the index, implying that a rise in money supply results in a decrease in interest rates, an acceleration of company expansion, and an improvement in investor sentiment. Excessive inflation reduces investable funds and erodes purchasing power, which has a negative impact on the stock index. These findings highlight the critical role of monetary policy in shaping capital market dynamics in Bangladesh, providing valuable insights for policymakers to support market growth and stability.

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