

## **F-21: Short-term interest rates and expected stock returns in Sri Lanka**

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This study examines the ability of short-term interest rates to forecast stock returns in the Colombo Stock Exchange during the 1990-1995 period. The Treasury bill rates are used to proxy for short-term interest rates, while stock returns are measured by the changes in the All Share Price Index. Expected stock returns for monthly, quarterly and annual return horizons are related to Treasury bill rates of 3, 6, and 12 month maturity employing a Generalised Least Squares regression. The results indicate that short-term interest rates are positively related to expected stock returns in Sri Lanka in a statistically and economically significant manner. Past Treasury bill rates are able to predict as much as 7% of monthly returns, and 14% of quarterly and annual returns. There is a tendency for the explanatory power to increase with longer maturity Treasury bill rates.