

Abstract

The basic objective of this study is to investigate the responsiveness of Pakistani banks' stocks returns to changes in exchange rate & interest rate along with their volatility. We employed Generalized Autoregressive Conditional Heteroskedastic in the mean (GARCH-M) model. This framework relaxes constancy assumption of classical linear regression (CLRM) model and allows exchange rate volatility and interest rate volatility to evolve over time. The GARCH-M framework also reveals results about risk-return trade-off in the context of Pakistani banks' stocks returns. The results show that changes in KSE-100 has a positive and statistically significant impact on banks stocks returns, whereas changes in interest rate and exchange rate has a negative and statistically significant impact on stocks return of Pakistani commercial banks. Unsurprisingly, the banks' stocks returns are influenced more by KSE (100) index than interest rate and exchange rate. The results also show a positive and statistically significant relationship between volatility of exchange rate & interest rate and banks stocks returns volatility. In addition, the positive and statistically significant relationship between risk and returns of Pakistani banks' stocks is in line with theory of risk-return trade-off, which suggests that investors gain higher returns when higher risk is assumed.