

Title: The Lead-lag Relationship between Stock Index Futures and Spot Market in Malaysia: A Cointegration and Error Correction Model Approach

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Abstract: The difference in trading mechanisms in the stock index futures and spot markets in Malaysia is argued to contribute to the lead-lag relationship between the two. Hence, the aim of this paper is to analyze the lead-lag relationship between spot and futures markets of the Malaysian Kuala Lumpur Composite Index (KLCI) by employing the cointegration and error-correction approach. Results of the study suggest that cash market and futures market are cointegrated. The results of the Error-correction model (ECM) suggest that futures price lead spot price and the change in futures price is relatively more efficient as compared to spot price. The results also indicate that spot price do lead futures price but the lead-lag relationship is relatively weak as compared to the impact of futures price on spot price. Thus, investors are able to use futures price as a good indicator in predicting spot price. The causal relationship suggests that policy makers should take into consideration the impact of futures market towards cash market when developing a policy for the futures market.

JEL Classification: E44; G12

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