Economical Implication of Foreign Direct Investment on Development of Stock Market in Pakistan (1992-2015)

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ABSTRACT: This study conducted to analyze the role of "Foreign Direct Investment" in the development of stock market in underdeveloped country like Pakistan. in of some other variables like domestic savings, inflation and exchange rate in Development in Stock Market along with foreign direct investment which our main independent variable. The variables become stationary at level so the model is analyzed by the by simple method named Ordinary Least Square (OLS) by using the time series date from 1992 to 2015 to examine the relationship between variables. Result shows that foreign direct investment and domestic saving have is positively affected to the development of stock market in Pakistan. Whereas rate of exchange and inflation are negatively affected to the development of stock market.

Keywords: Development in Stock Market, Foreign Direct Investment, Domestic Saving, Exchange Rate and Inflation.

1 INTRODUCTION

IN the financial system of the country the stock market is a main element. The development of commerce as well as industry is largely depend on well develop stock market. The well developed stock market ultimately influences the financial system in a large extent. So the administration, corporation and also the state bank deep observe the stock market activities.

Stock market gives a platform to purchase or sale shares in companies from within the Pakistan and across the borders. It helps to create capital for the companies that are traded so that they can develop their businesses accordingly to meet the high demand. It permits the Pakistan and other countries to trade shares across the world.

When one buying a share of stock, he expect that the worth of the stock will increase and if it does, then he get a profit. While some investors use day trading, some short term and many invest for the long term expecting to create a large amount of stake in a company and to receive a large amount of cash. Today, hundreds of shares trade in the minute and the worth of stock market are in billions of dollars.

1.1 Stock Market in Pakistan: A stock market is the most important part of the financial system of a country. The growth and development of a country are depends upon a strong financial system. Investment is encouraged by a well organized stock market that will lead to an ultimate economic growth. The best measure of economic activity and economic strength is also stock market.

Therefore to increase the Development in Stock Market is very necessary for the country development. The country of Pakistan is to be found at the center of the three Asian's countries. Pakistan is developing state, GDP per capita is $2500 and population is 187 million. Pakistan has three stock markets. The Pakistan oldest stock market is Karachi stock market which is organized in 194. Lahore stock market is organized in 1974. Islamabad stock market is organized in 1997. Through a current study eighty to eighty five percent turnover take place in Karachi stock market. Pakistan investment atmosphere give the confidence both foreign and local investors which enhance the index of stock market in current years.

1.2 Volatility in stock market of Pakistan:_Volatility in stock market is defined as the stock market upward one day but downward next few days and again up and then down again. Volatility in stock market is a barrier in the way of investments in the developing countries. Savings and funds are transfer efficiently from savers to investors through financial markets and play very main role in the economic growth. Volatility is harmful for the process of the financial system and bad influence on performance of the economy.

The economies which are underdeveloped face too many challenges and hurdles in the financial markets and volatility is one of them. The market capital is affected by volatility because it contains uncertainty and high risk. Investors become worried due to the involving of risk and leave the market. However it is not the market ineffectiveness but it is due to the market volatility which gives a threat to destroy the market. Volatility in stock market contains uncertainty in the prices of security which decrease the return. There are many reasons for uncertainty in stock market
The following factors are causes the stock market volatility.

- News created by media
- Predication by analysts
- Change in the listed company's earning
- Government Policies
- Political Situation

Pakistan is also considered a developing country and the stock market of Pakistan is considered very sensitive and extremely volatile and immediate react on news and market activities. On the other hand stock market of Pakistan is flexible and it has the ability to recovers rapidly aftershocks. Karachi stock market is the Pakistan largest stock market. Karachi stock market is the major place of activities and seventy five to eighty percent trade occurs in Karachi stock market. The market however truly regained in 1990 because it allows the international investors to come and invest in markets that create new life by positive trend. The market volume and strength also better. The markets which are developing in these markets the Karachi stock market in third position due to its best performance. But due to the political instability and economic ups and downs decrease the market performance in the coming years.

1.3 Stock market, Foreign Direct Investment and Economic Growth: It is usually known that the economic development and constancy are depended on well managed financial system. In the country financial system the stock market is the main element. It provides a way of funding for new projects which depends its estimated effectiveness. For the country growth stock market considers a strong point. Development in Stock Market very necessary for enhance savings, economic growth and investment opportunities and it can't ignore by country. The academic work explains that impact of stock market performance on country growth is positive. Rahman and Salahuddin (2010) argue that both in long -run and short-run stock markets and economic growth have positively associated. Agarwal (2001) found that positive association among development of stock market and growth of economies of African countries.

Foreign direct investment is the main element for investment inflow in the country which is under develops. Foreign direct investment gives a way of technical skill, management skills and capital of human resources. Foreign direct investment provides a foundation for those economies which want to make more improvement. So the foreign direct investors give a major contribution in the development of the economies. Due to this reason the economies give permission to international investors to approach and invest in their countries. It usually experiment that countries which are underdeveloped are always dependent on those countries which are developed. The countries which are developed provide financial help by investing for those countries which are underdeveloped and need help for attain growth and strength.

Academic literature shows different behavior among economic growth and foreign direct investment. Johnson (2005) found that foreign direct investment inflow not improves the economic condition of developed countries but it does improve the economic condition of the underdeveloped countries. Alfaro (2003) argue the foreign direct investments in the primary sector have negative effect and foreign direct investment in manufacturing has a positive effect on growth and investment in services sector is uncertain.

1.4 Objectives of the study: The main focus of this study is to examine the role of foreign direct investment in Development in Stock Market in Pakistan.

Sub objective include

- To identify the connection between Foreign Direct Investment and Development in Stock Market in Pakistan.
- To examine the effect of domestic saving in Development in Stock Market in Pakistan.
- To analyze the effect of exchange rate in Development in Stock Market in Pakistan.
- To explain the effect of inflation in Development in Stock Market in Pakistan.

2 LITERATURE REVIEWS:

Agarwal (2001) explained the association among development of stock market and growth of economies of African countries. He used cross-section data from 1992 to 1997 by applying the correlation coefficient test. He found that positive association among development of stock market and growth of economies of African countries. Hermes and Lensink (2003) explained the contribution of well developed financial system on economic growth through foreign direct investment. They used empirical investigation from 1970 to 1995 by applying the OLS. They found that developed financial system plays an important role to increase the positive association among foreign direct investment and economic development. Alfaro et.al. (2004) explored the different association among foreign direct investment, economies development and developed financial markets. They used the cross country data from 1975 to 1995 by applying the OLS method. They found that foreign direct investment play vital part in growth of economies and developed financial market gain significantly from foreign direct investment.

Baker et.al. (2004) explored the effect of foreign direct investment flows on stock market and investment. They used the data from 1974 to 2001 by applying the regression. They found foreign direct investment flow positive related to source country stock market valuation but unrelated to host country stock market valuation and negative related to future source country stock market valuation Subair and Salihu (2010) explained the impact of rate of exchange volatility on stock market in Nigeria. They used secondary data from period 1981 to 2007 by applying the error correction and stationary was checked by unit root method. They found that rate of exchange volatility has negative effect on stock market in Nigeria. While interest rate and inflation does not long- run association with capitalization of stock market.

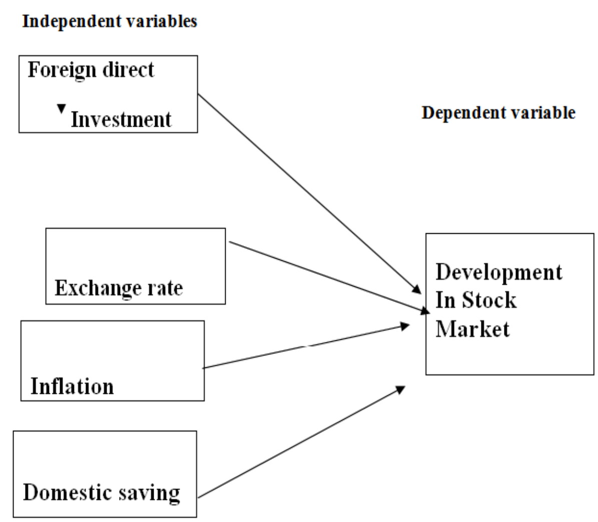
Raza et.al. (2012) explored the impact of Foreign Direct Investment in development of stock market of Pakistan. They used data from the period of 1988 - 2009 applying the method of ordinary least square. They found that positive impact of Foreign Direct Investment and domestic saving in the Pakistan stock market development. Whereas negative impact of exchange rate has in the development of stock market and inflation was insignificant impact in the Pakistan stock market development.

3 THEORETICAL FRAMEWORK:

The main function of stock market is trade in shares. Securities are trading in stock market according to certain rules. It provide different services to investors and the companies who borrowing. When companies desired to build up or construct new factories companies require money. If company obtains money from bank it is responsible to repay the loan. But if the company issues a stock it can increase money and not responsible to repay the money. If a company wants to issue stock for the purpose of getting funds the company first requires to list in the stock market. Stock cannot be issued by every company. The companies which have legal rights, good will and exclusive name only those companies issue the stock and these companies are responsible to fulfill certain rules.

Funds are not only given by the stock market for business requirements but it also provides a universal platform for trading. Stock market gives the opportunity to sell the stock any time and investment back with profit. The stock market makes the nature of stocks is more liquid that's why more investors are attract and invest in stock market.

There are many factors that affect the Development in Stock Market like foreign direct investment, exchange rate, domestic saving and inflation. They have positive or negative effects on Development in Stock Market. They are discussing briefly in below.



Country savings also contribute in the development of stock market because when saving increase people have additional idle money for investment so they doing invest in stock markets as a result through the stock market more capital is flow. Relationship among Development in Stock Market and domestic saving shows positive behavior in academic literature. Naceur, Ghazouani, & Omran (2007) argue that financial development is necessary for growth of economy and financial development dependent on rate of savings. Aduda et.al (2012) Argue that domestic saving has positive impact on development of stock market**.**

The inflation rate explains the rate of change in prices in the economy. Acknowledged evidence explains that when the rate of inflation is very high it has negative effect on the performance of the country. Evidence proves that the financial sector is well developing when country has average rate of inflation than those countries which has high rate inflation. Relationship among Development in Stock Market and inflation show mixed behavior in academic literature. Kalim and Shahbaz (2009) argue that positive impact of inflation on Development in Stock Market. Ghazouani (2004) found that negative association among inflation and performance of financial sector when the increased some threshold but minor increased is not dangerous for performance of stock market and development of banking sector.

The association among exchange rate and prices of stock is very essential, because when exchange rate is changed the prices of stock market is also changed the reason is that when the country currency is weak than the foreign investors less like to invest in that country because currency risk is include. Foreign investor faced the risk due to fluctuation in currency. Raza, Iqbal and Ahmed (2012) found that positive impact of rate of exchange in the Development in Stock Market. Subair and Salihu (2010) found that rate of exchange has negative effect on stock market.

4 METHODOLOGY

The researcher wants to check the role of Foreign Direct Investment (FDI) in the development of stock market in Pakistan because FDI is the major element in the Development in Stock Market and both are main factors of the economy. Foreign direct investment gives the amount of capital, managerial skills, and technical skill and provides a better way to enter the market but due to terrorism and political instability foreign direct investment is affected which affect the Development in Stock Market because stock market get the large amount of capital through foreign direct investment.

4.1 Hypothesis: The null hypothesis (H_0) is that there is no relationship between FDI and Development in stock market and the alternative hypothesis (H_1) is that there is relationship between these two variables

H_o = Foreign direct investment does not affect the Development in Stock Market.

H_1 = Foreign direct investment affect the Development in Stock Market.

4.2 Data and Sample Size: Five variables are used in our present study. The data on Development in Stock Market (DSM), Foreign Direct Investment (FDI), exchange rate (ER) and Domestic Saving (SAV) is obtained from world development indicators and the data on inflation (INF) is obtained from international monetary fund. The sample size is 24 years from 1992 to 2015

4.3 Model Specification with Operational Definition of the Variables: The following model is used in the form of equation to check the association among Development in Stock Market and foreign direct investment beside with the gross domestic savings, exchange rate and inflation.

DSM = f (FDI, SAV, ER, INF)

DSM = Development in Stock Market measured as stock market capitalization (current US$).

FDI = Foreign direct investment measured as foreign direct investment net inflows (current US$).

SAV = Domestic savings measured as gross domestic savings (current US$).

ER = Exchange rate measured as the official exchange rate (current US$).

INF = Inflation rate measured as inflation consumer prices (annual %).

Method of Estimation: The researcher checked the stationarity. Surprisingly all variables become stationary at level. The model equation is estimated by using OLS method. OLS is considered the easy method to estimate the regression only if the variables are stationary at level. The main purpose of OLS is to closely fit a function through minimizing the residual sum of squared in the data.

5 RESULTS AND DISCUSSION

DSM = f (FDI, ER, INF, SAV)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-25.83839	7.412448	-3.485810	0.0025
LN_FDI	0.287662	0.139757	2.058304	0.0535
LN_ER	-0.815102	0.352385	-2.313100	0.0321
LN_INF	0.206483	0.149874	1.377718	0.1843
LN_SAV	1.984170	0.429361	4.621214	0.0002
R-squared	0.908016	Mean dependent var		23.23040
F-statistic	46.88940	Durbin-Watson		2.055688
Prob(F-statistic)	0.000000			

5.1 Individual Coefficients and its Significant:

B_1 (FDI) is the coefficient of Foreign Direct Investment and its value is 0.28, sign is positive. It shows that when one percent increases in foreign direct investment then 0.28 percent increase in Development in Stock Market. Its standard error is 0.13 and its t test value is 2.05. It is highly significant at 0.05 levels which mean it shows 95% confidence. **B_2** (ER) is the coefficient of exchange rate and its value is -0.81, sign is negative. It shows that when one percent increases in exchange rate than 0.81 percent decrease in Development in Stock Market. Its standard error is 0.35, and its t test value is -2.31. It is highly significant at 0.03 levels which mean that it shows 97% confidence. **B_3** (INF) is the coefficient of inflation and its value is 0.20, sign is positive. It shows that when one percent increases in inflation than 0.20 percent increase in Development in Stock Market but it's statistically insignificant. Its standard error is 0.14, and its t test value is 1.37. It is insignificant at 0.18 levels which mean it shows 82% confidence. **B_4** (SAV) is the coefficient of the saving and its value is 1.98, sign is positive. It shows that when one percent increases in saving than 1.98 percent increase in Development in Stock Market. Its standard error is 0.42 and its t test value is 4.62. It is highly significant at 0.00 levels which mean it shows 100% confidence.

5.2 R square: R Square shows the goodness of the model. Here the value is .90, it means that 90% variation in dependent variable is only due to existing independent variables.

6 CONCLUSION AND POLICY RECOMMENDATION

6.1 Conclusion: This study conducted to analyze the role of foreign direct investment in Development in Stock Market in underdeveloped country like Pakistan. The purpose of this study is also to determine the relationship between foreign direct investment and Development in Stock Market exist in Pakistan or not because every country have its own political and economic conditions. In this study we also check the affect of some other variables like domestic savings, inflation and exchange rate in Development in Stock Market along with foreign direct investment which our main independent variable. We use the time series data from the period of 1988 to 2011.The model equation are estimated by the method of ordinary least square. We find that positive impact of foreign direct investment in Development in Stock Market in Pakistan. Result shows that one percent increases in foreign direct investment than 0.28 percent increase in Development in Stock Market. While the results of other variables are, domestic saving has positive impact in Development in Stock Market of Pakistan. Whereas exchange rate has negative impact in the Development in Stock Market and impact of inflation is insignificant in Development in Stock Market of Pakistan.

6.2 Policy Recommendation: The policy makers make those policies which provide the pleasant business atmosphere for foreign investors where they feel comfortable and provide better foreign investment design to achieve complete benefits from this investment. First and most important thing in the country is the guarantee of political stability. The Pakistan administration must give a law for the protection of foreign investor's assets and interest from modifying the policies of government. The availability of better infrastructure in country can also improved the inflow of foreign direct investment. Government encourages the savings of the country through appropriate policy of savings. When foreign investment come into the country people get more jobs and earned more money so they have more unused money for savings. The government does efforts for controlling the volatility in inflation rate and exchange rate through useful measures of monitory policy. If Pakistan government wants to attain above mentioned objectives political stability is the first and most important priority. This study results cannot be applicable in all underdeveloped countries because every country have their own political and social aspects. In addition, the researchers in future can modify this model according to their requirements in different direction.

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