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An Empirical Study on the Impact of FDI on Karachi Stock Exchange

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Abstract:

Purpose: *The research paper aim is to analyze the impact of stock exchange on FDI in Pakistan for the period of 1990 to 2010. It evaluated and assessed the historical trends of the FDI and KSE 100 index in Pakistan.*

Methodology: *The link between KSE 100 index, FDI and its return is measured with the help of different statistical tools where FDI is independent variable and KSE 100 index is a dependent variable.*

Findings: *Foreign direct investment in Pakistan positively impacts on Karachi stock exchange 100 index and it is the most important determinant of the economy.*

Key words: impact of stock exchange, FDI, Pakistan, KSE 100 index, returns

Introduction:

Foreign direct investment is deeming as a major foundation of funding from external sources. To influence economy Foreign Direct Investment plays a major role. In Pakistan, during last three years there has been a rapid decline in the Foreign Direct

Investment inflows which leads Pakistan towards unemployment, fall in tax revenues and destabilization in the economy. The contributing factor was the Karachi Stock Exchange 100 index and its returns. In 2008, Foreign Direct Investment of Pakistan was 5,409.8 Million US Dollars, which in 2011 reduced to 2150.8 Million Us Dollars, meaning 71% decrease since 2008.

One of the main reasons affecting Pakistan's economy is currency devaluation. Since 2008, the Pakistani rupee has been devalued as a result foreign investors' withdrawing their money from Pakistan due to decrease in the return. On the other hand country's biggest stock exchange market (KSE-100 index) crashed in 2008, many investors having lost their investment; due to these reasons and many other macroeconomic factors trading in KSE has been decreased.

The study predicts an important accumulation to the observed inference of the impact of foreign direct investment on Karachi stock exchange and its return. The outcome of the study endows with the policy makers with a solid foundation to devise suitable programs directed to the growth of the Pakistan's economy.

Literature Review:

On the subject of the Karachi stock exchange and foreign direct investment most of the studies have been presented from which the major part of the research work has been done internationally, which viewed significantly and analyzed to draw some important conclusions.

In 2009 Falki conducted a study on the FDI impact data collected from the Handbook of Pakistan economy, 2005 and arranged from 1980 to 2006 using domestic variables, like labor force and foreign invested capital. Falki used a regression analysis and endogenous theory of growth. The study of Falki concluded that Foreign Direct Investment had a statistically unconstructive outcome on the gross domestic product and foreign direct investment in the country. (Falki 2009)

The study on the topic of FDI conducted by Agarwal in 2000 established that the reasons of FDI increase in South Asian countries was in alliance with the proponent investment by domestic investors, providing substantiation to certainty that the correlation between FDI and GDP and the influence of FDI on GDP was off-putting till the year 1980. In the subsequent years, early 80s, the relation was slightly positive and strengthened over the years in the late eighties into the nineties. (Agarwal 2000)

Exchange rate:

To determine the foreign direct investment, the exchange rate plays a very important role. The reason behind this is that the foreign investor brings their return or profit to their home countries. The author also concluded that the exchange rate has an opposite relationship and that aspect shows that if there is a decrease in the value of the currency there will be negative impact on the inflow of FDI. Here the author took exchange rate as an independent variable. (Ahmed and Malik 2012)

Exchange Rates and FDI inflow:

The study of Linda in 2011 says basically that the change in the amount of return occurs due to the exchange rate or the price of home currency against the foreign currency. Whenever there is a decrease in the value of currency it will give two way impacts: either the impact would be negative or it would be positive. On the first stage it tights the cost of production and wage rate of that particular country with the link of the foreign foils (Linda 2011).

The other impact of this aspect is that the foreign investor's investment in those countries becomes less attractive due to the reduction in the profit or return. When international markets started the flawed information at that stage the relation between exchange rate and FDI arises. (Froot and Stein 1991)

In 2008 a study concluded that most of the time FDI inflow is persuaded by the decrease in the value of a countries currency. We consider this aspect because most of the theories state that the foreign investor invests in the other countries to gain more return on FDI and stock exchange. (Adam & Tweneboah 2008)

Stock exchange and FDI inflow:

A study in 2009 sustains that for the growth of a country there should be an established and organized financial system. In the financial system of an economy the stock exchange plays an important role because a stable stock market attracts the foreign investors. (Kalim and Shahbaz 2009)

The study simply gave a conclusion that there is a positive relationship between the development of stock exchange and foreign direct investment. (Shabaz, Ahmad and Ali 2008)

Data and methodology:

This study is based on annual, secondary data ranging from 1990 to 2010.Data is taken from the sbp and some other web sites. Variables included in the research are foreign direct investment, stock exchange and return.

Unit Root:

Variables	t-statistic	Probability
FDI	-2.904627	0.0634
KSE 100 INDEX	-2.650413	0.0754
RETURN	-2.934104	0.0600

Data is tested for unit root in e-views to remove the problem of wrong results as the t-test of all three variables is more than 2.5 and probability is less than 0.5 at 1^{st} level, it shows the significance of data. Now for the final results there will run regression equation in e-views.

Hypothesis and Regression Results:

Variables	t-value	p-value	Coefficient
FDI	1.39	0.0000	-0.253067
KSE 100 INDEX	2.79	0.0000	-0.131364
RETURN	6.06	0.0000	-0.744200

Regression results show the effect of one variable on the other variable; this means that if one variable changes, we want to know how much the other variables will change and in which manner they will change (Positively or negatively). In this paper FDI is taken as the independent variable and the return and KSE 100 as a dependent variable.

Hypothesis $_{H1}$ is if FDI changes - how this will affect the KSE and its return. Results are showing the significant but negative relationship due to the negative sign of the coefficients. This means that if the FDI will change 1% there will be -0.131364% change in the KSE and -0.744200% change in the return. As the value of p is 0.000, we can assume that the results are significant and not by chance.

Conclusion and findings:

The results of the study showed that there is a negative relationship among the variables. If we see the coefficients, coefficients are with a negative sign, which shows that if one variable changes, the other variable will have a decreasing effect as the study of Falki in 2009 (refer in literature review) concluded.

Foreign Direct Investment and Karachi Stock Exchange are the most important economic variables which show the countries equity market and attracts the Foreign Direct Investment. Hence to increase the foreign direct investment the government should ensure the stable economic and political environment and transparent and efficient financial markets.

Limitations and Recommendations:

The study is for a developing country like Pakistan where foreign investors or companies invest and earn more as compared to the domestic investors due to the better services and quality, and take all the return to their home country. For the future, the researcher can study on the other variables such as, how economic growth or law and order situation may affect Pakistan's economy.

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