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INTERACTION OF STOCK MARKET WITH MACROECONOMIC VARIABLES: A STUDY OF KSE 100 INDEX PAKISTAN

SHAHZAD KHAN
RESEARCH SCHOLAR
INTERNATIONAL ISLAMIC UNIVERSITY
ISLAMABAD

NIAMAT ULLAH
MS SCHOLAR
CITY UNIVERSITY OF SCIENCE AND INFORMATION TECHNOLOGY
PAKISTAN

SHAHZAD ZEB
RESEARCH SCHOLAR
IQRA UNIVERSITY
ISLAMABAD

ABSTRACT

Karachi Stock exchange is the largest stock exchange of Pakistan. There are many factors which influence the Stock market and 100 Index. This research is focused on that how macro variables influence the Karachi stock Exchange 100 index. For the reason four macro independent variables i,e Interest Rate, Rates of inflation, GDP and Rates of Exchange were taken under consideration to measure influences of these factor on dependent variable KSE 100 index. For analysis part of the study, Secondary data was taken for 17 years from 1994 up to 2010 (Using SBP official site for Interest, Inflation, GDP and Exchange rates, whereas used "brecoder.com" website for KSE100 index data). Yearly data was used considering all of the variables. Excel sheet was used to arrange the Data and SPSS was used to regress the data.. Finding of the study shows that KSE 100 index has a significant relationship with GDP and exchange rate and has insignificant relationship with inflation and Interest rate.

KEYWORDS

KSE 100 Index, Interest Rate, Rates of inflation, GDP and Rates of Exchange.

INTRODUCTION

For the recent few decades, the relationships of stock returns and the macroeconomic factors have been the main focus of academia and investors. It is frequently quarreled that some fundamental macroeconomic variables such as inflation rates, GDP, interest rates and exchange rates play vital role in determining the stock prices. The evidences of Anecdotal from the financial press also shows that all the investors usually consider the monetary policies and macroeconomic variables and the influential elements of stock prices. This proves that a macroeconomic variable can influence the investment decisions of a rational investor and can also motivate a researcher to examine the relationship of stock return and a macroeconomic variable.

It is frequently stated that some fundamental macroeconomic variables such as inflation rates, GDP, interest rates and exchange rates play vital role in determining the stock prices. Many studies have tried to observe the variations in share prices due to the variations in macroeconomic variables. E.g. exercising the Arbitrage Pricing Theory which was derived by Ross 1976, Chen et al. (1986) used some macroeconomic factors to explicate stocks' returns in stock markets of United States. The results demonstrated variations in risk premium, variations in industrial productions, and variations in the terms' structure had positively relation with projected stock returns, whereas rates of inflation had negative relation with the anticipated stock returns.

The developing of co-integration technique helped in providing an additional approach to observe the relations in stocks returns and macro-economic variables. E.g., Mukerjee Naka and (1995) applied the co-integration technique of Johansen in the Vector's Error Correction Model (V.E.C.M) and came up with the results that the Stocks' market of Japan is cointegrated with 6 macroeconomic factors which are supply of money, inflation rates, exchange rates, industry productions, call money rates (short term) and government bonds (long term). The long term coefficients resulted in consistent expected equilibrium relationship. Koh and Mayasmai (2000) applied the co-integration technique (of Johansen in the Vector's Error Correction Model (V.E.C.M) and came up with the result that Singapore's Stock Exchange is also co-integrated with 5 macroeconomic factors.

Shin and Kwon (1999) used Eagel Granger's co-integration test and Granger causality assessment from Vector's Error Correction Model (V.E.C.M) and came up with results that the Stock Markets of Korea is cointegrated with a bunch of macroeconomic variables. Still when Ganger casualty test on macroeconomic factors and the stock indices is used that author stated that stock indices of Korea cannot be mentioned as a leading indicator of economic factors.

Cheung and Nag (1998) used Johnson's co-integration procedures taking year's quarter data from US, Germany, Canada and Italy and came up with the results showing a long run cointegration between stock indices and some specific variables of those five countries. In addition the analyst detected an actual returns of indices are in general related to variation from long-run relation and to change in macroeconomic factors.

There are many articles written on the relationship b/w stock return and macro-economic factors in highly developed states like Europe, Japan and United States. However some markets like Australian Stock Market or New Zealand Stock Market has less exposure because of their diminutive sizes and geographic locations, the study will be examining the relation b/w the KSE 100 index and a set of some of the macroeconomic factors (like Interest rates, GDP, Inflation rates and Exchange rates) from 1994 to 2010 on yearly basis by applying simple regression model.

LITERATURE REVIEW

A lot of discussion and debates have been done over the affiliations between macroeconomic factors and stock return. Such workings were based on tests which stated that the stock prices can be used as anticipated discounted cash flows. That's why RRR (required rate of return) or expected cash flow can be expressed as the determinant of stock prices.(Elton & Gruber, 1991). Economic factors and variables which can influence the expected cash flows and RRR can therefore be anticipated to impact stock prices.

Fama & Gibon (1982) studied the relationships b/w inflation rates, share returns and share investments and came up with some results supporting Toben (1965) and Mundel (1963) findings, which say that real returns of bills and anticipated inflations have negative relationship. The authors are suggesting that some the relation arises with stock returns are due to positive relation b/w projected real returns on financial stocks and real activities. Fama (1991) did not agree the prior workings which were showing a negative relationship b/w inflation rates and stock returns. Gresk and Rol (1983) found a negative relation of stock prices of US and a positive one with real economic activities. The post relationship was in line with Fama (1981) and Lee (1991) researches.

Lee (1992) stated in that the stock returns gives signals about inflation rates because there is a linkage between the supply of money and anticipated real activities. Darat (1990) examined in Canadian stock markets that monetary and fiscal policy affect the stocks' returns. He also proved that stock returns are determined by industries' productions, interest rates' variations and long term bonds' rates. While testing the applicability of Arbitrage Pricing Theory, Ros, Chen and Rol (1986) concluded that macroeconomic factors usually affect stock returns. Rehman and Najand (1991) used Schwart (1989) volatility measures and came up with some results which were showing a casual relationship b/w inflation rates and stock returns.

A rise in interests will raise the RRR and the stock price will fall due to the rise in the interest rates. The rise in interest rates will increase the opportunity cost of holding money, so therefore a trades off to holding other interest bearing securities would cause a reduction in stock prices. French et al., (1987) proved theoretically that shares' returns respond negatively in both cases of long and short run interest rate. Alen & Jagtianti (1997) pointed out that interest rates sensitivity to stocks' return has declined severely since 80's and early 90's due to the development of interest rates derivative contracts that were mostly being used in hedging purpose. In addition, Bolmash and Trevoli (1991) found stated that the United States shares' prices are positively with prior months' share prices, supply of money, latest governmental debts, latest tax exempted governmental debts, long term un-employment and the extensive supply of money and government rates. Though a negative relation was found b/w the share price and treasury bills' rates.

When the currency of a country decreases against the currency of some other countries, the prices of the goods and services that are going to be export will decrease and as a result the quantity of export will rise, considering that the demand related to these product is elastic. Mukerji and Nakka (1995), Achasani and Strohi (2002) also found this positive relation in two extensive exporting countries like Indonesia and Japan. Ajay and Mogoue (1996) confirmed the negative effect of rise in the share prices with domestic currency in short run but in long run the effect was found positive whereas a short run and long run negative relation was also reported b/w currency depreciation and stock's market.

Chin (1991) observed the relationship b/w the change in financial investment opportunities and changes in macro-economy in the United States and stated that the market surplus return can projected when macro-economic factors are used knowingly slow production growth rates, the default spreads, the terms' structure, the dividend's yield and T-bill rates. There was a negative relationship between market surplus on returns and economic growth factors (slow production growth rates, the default spreads, the terms' structure, the dividend's yield and T-bill rates) and a positive relation between market surplus on returns and anticipated future economic growth variables (like dividend's prices ratio and unanticipated GNP growth).

Chin, Rol and Ros (1986) pointed some macroeconomic factors has systematically affected assets returns. Those factors are the gap between long run and long run interest rate, anticipated and unanticipated inflations, the growth in industries' production and gap b/w high and low grade bonds. The growth of industry production is considered as to proxy for real cash flow, inflation rates influences returns as nominal cash flows growth rate are not equal to anticipated inflation, at the same time as the gap b/w short run and long run interest and higher and lower-grade bong gap influence the choices of discount rates.

Same as Chin, Rol and Ros (1986), Homoa (1988) finds out whether the relation b/w macroeconomic factors and stock returns are still appropriate for applying when the analysis is carry out on markets like Japan. The author also incorporated the variables which were related to international trading. Despite the industry production showing insignificant results in asset pricing, Humao's finding were in lined with Chin, Rol and Ros (1986) study.

Poun and Tailor (1991) same like Chin, Rol and Ros (1986) studied UK markets. Their results are showing that macro-economic factors are not affecting the stock returns in UK as they are doing in US. Poun and Tailor (1991) proposed that either other macro-economic variables are influencing the stock returns in UK market or the technique which was applied in Chin, Rol and Ros (1986) is not sufficient.

In theory the supply of money negatively affects the share prices because as the supply of money increases, the inflation rates will also increase, and the results are the share prices will fall. But the growth in supply of money up to some extent will also encourage the economies and business earnings will also be encouraged. This will increase the expected FCF (future cash flows) and share price. Mukerjee and Naaka (1995), Mysami and Kohh (2000) and Kwon & Shen (1999) also agreed to the results that the money supply has a positive relation with the share returns.

From the previous decade, studies are extending their scope of investigation b/w macroeconomic factors and stock returns to more countries and states other than just the United States e.g. Kwon& Shen (1999) studied the market of Korea and came up with the results that such markets have cointegration and have positive relationship with production-index, trade balances, rate of exchange and supply of money. The authors were not able to justify the share prices indices to be the leading indicator for macro-economic factors. Leigh (1997) examined the stock market of Singapore (SSE –Singapore Stock exchange) and came up with the results showing a positive relation with stock indices and money demands, but no relation b/w stock index and macro-economic fundamentals. Similarly in Taiwan Fung and Lie (1990) also agreed in results with Leigh (1997).

Gjirde & Saetem (1999), Achsane & Stcohi (2002) studied small local markets including Norway and Indonesia and stated that share return reacts negatively to changes in interest rates, whereas with real-economic activities and oil prices the reaction is positive. But the share prices' relation with inflation rates is vague. Achsaani & Strohi's (2002) investigation resulted in a negative relation b/w inflation rates and share prices. Though, it was found that the share prices are positively correlated with GDP, rates of exchange and with supply of money. Besides they were unable to notice any significant relation b/w interest rates and share prices.

RESEARCH OBJECTIVES

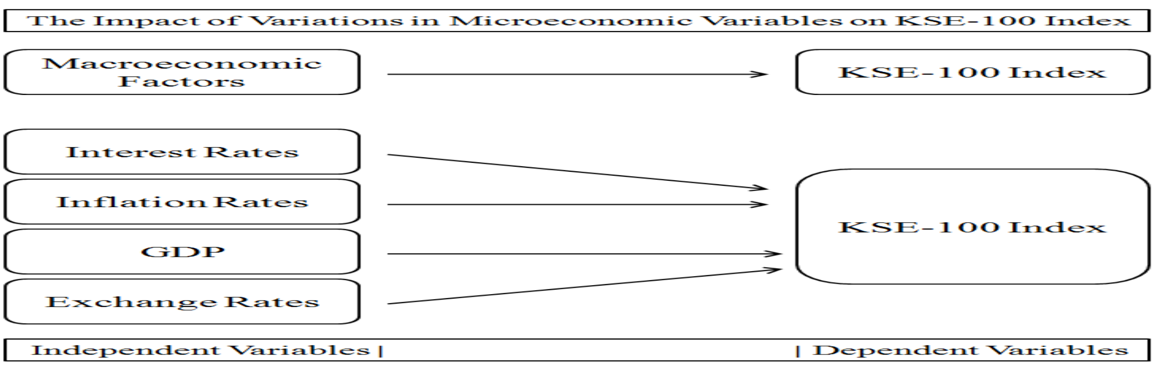
Research is focused to find the impact of macro indicators on KSE 100 Index. The research operationalise into the following hypothesis.

- To find does KSE 100 index is dependent upon macro economic factors.
- To fine and what is the impact of each macro economic factor in KSE 100 index.

The ultimate aim of this research is to identify and measure the impact of four major economic factors i,e Interest rate, Inflation rate, GDP and Exchange rate on KSE 100 index. The most important thing is to measure what is and how much is the impact of each variable on KSE 100 Index.

THEORETICAL FRAMEWORK

The following diagram shows that KSE 100 is dependent upon Rates of interest, Rates of inflation, Gross domestic product (GDP) and Rates of Exchange.



The model is consisted of four independent variables and one dependent variable as mentioned above in theoretical framework. There are also some other macroeconomic variables which can be included in independent variable but since it an academic thesis and time is short so that's why those are skipped for the time being. But if they were considered, there would be no change with the methodology. The model can be explained as the variation and ups and down in dependent variable (KSE-100 index) is because of four mentioned independent variables.

HYPOTHESIS OF THE STUDY

An overview of the hypothesis related to the relationship of KSE 100 index and Rates of interest, Rates of inflation, Gross domestic product (GDP) and Rates of Exchange.

Objectives	Hypothesis
Relationship between KSE 100 and Macro Variables	H1.The interest rates and KSE 100 index has relationship with each other. H2. The inflation rates and KSE 100 index has relationship with each other. H3.The Exchange rates and KSE 100 index has relationship with each other. H4.The GDP and KSE 100 index has relationship with each other.

METHODOLOGY

The research paper demonstrates to discover the factors that influence KSE4 100 index. The research user following research methodology.

PROCEDURE OF DATA COLLECTION

Secondary data was taken for 17 years from 1994 up to 2010 (Using SBP official site for Interest, Inflation, GDP and Exchange rates, whereas used “brecoder.com” website for KSE100 index data). Yearly data was used considering all of the variables. Excel sheet was used to arrange the Data and SPSS was used to regress the data.

SIGNIFICANCE OF THE STUDY

Since the research is all about the relationship b/w KSE 100 index and macroeconomic variable and knowing that stock plays a vital role in strengthening a country’s economy so recommendation section may help in taking some positive steps for the betterment of the economy. Result may also help an investor in taking some positive decisions.

RESULTS AND ANALYSIS

For the analysis part of this research SPSS 19 were used. The following results has attained after inserting the multiple linear regression.

TABLE 1

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.865[a]	.748	.657	.273

a. Predictors: (Constant), Change-GDP, Change-ExchangeRate, Change-InterestRates, Change-Inflation

The adjusted R-square in the table highlights that the dependent variable KSE 100 Index is influenced by 65.7% by independent variable i.e. Rates of interest, Rates of inflation, Gross domestic product (GDP) and Rates of Exchange.

It explain that Rates of interest, Rates of inflation, Gross domestic product (GDP) and Rates of Exchange are liable for change in KSE 100 Index. The above mentioned model has also significant, examined with the aid of ANOVA. The results are shown in the following table.

TABLE 2

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.432	4	.608	8.177	.003[a]
	Residual	.818	11	.074		
	Total	3.250	15			

a. Predictors: (Constant), Change-GDP, Change-ExchangeRate, Change-InterestRates, Change-Inflation

b. Dependent Variable: Change-KSE

TABLE III REGRESSION CO-EFFICIENT

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.504	.091		5.546	.000
	Change-InterestRates	-.443	.386	-.208	-1.149	.275
	Change-Inflation	.054	.202	.051	.270	.792
	Change-ExchangeRate	-3.562	.788	-.697	-4.520	.001
	Change-GDP	-.425	.170	-.405	-2.492	.030

a. Dependent Variable: Change-KSE

In this table, the standardized co-efficient explain that the factors are influencing the KSE 100 Index. Since the independent variables are of different nature and have different units of measure so Standardized Coefficients will be considered. The beta value (-0.208) with sig value =0.275 shows that there is insignificant relationship b/w interest rates and KSE because the P-value 0.275 > 0.05.

Achsaani & Strohi's (2002) investigation resulted in a negative relation b/w inflation rates and share prices. Though, it was found that the share prices are positively correlated with GDP, rates of exchange and with supply of money. Besides they were unable to notice any significant relation b/w interest rates and share prices. The beta value (0.051) with sig value =0.79 shows that there is insignificant relationship b/w inflation rates and KSE because the P-value 0.79 > 0.05.

Achsane & Stcohi (2002) studied small local markets including Norway and Indonesia and stated that share return reacts negatively to changes in interest rates, whereas with real-economic activities and oil prices the reaction is positive. But the share prices' relation with inflation rates is vague. The beta value (-0.69) with sig value =0.001 shows that there is a significant negative relationship b/w Exchange rates and KSE because the P-value 0.001 < 0.05. And a unit increase in the rate of exchange will bring about 0.69 units decrease in the KSE and vice versa.

The beta value (-0.40) with sig value =0.030 shows that there is a significant negative relationship b/w GDP and KSE because the P-value 0.030 < 0.05. And a unit increase in the GDP will bring about 0.40 units decrease in the KSE and vice versa.

CONCLUSION

Stock exchange is considered as the backbone of economy. Currently Pakistan has three active stock exchanges known as KSE, LSE and ISE (Karachi stock exchange, Lahore stock exchange and Islamabad stock exchange respectively). There are many factors which affect the function of Stock market within a country; due one reason or another, research could not cover all of them.

17 years' secondary data was taken into consideration (1994-2010) and on year basis. By looking at the Adjusted R2 value 65.7%, it was conclude that model is significant and the 65.7% variation in dependent variable is because of the independent variables.

Findings of the study shows that there is a significant relationship exist between Exchange rate and GDP. While there is a insignificant relationship exist between KSE100 index and inflation & Interest rate. Study suggest that inflation, interest rate and should be control as it has negative relationship with KSE 100 index so controlling interest rate, Exchange rate and GDP will lead positive change in KSE 100 index. So these three factors are important to be controlled, if their positive impact is needed in a economy. While inflation have already positive significant impact on KSE 100 index.

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