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IMPACT OF CONSUMER PRICE INDEX, REAL EFFECTIVE EXCHANGE RATE INDEX, PER CAPITA INCOME AND DISCOUNT RATE ON PAKISTAN'S STOCK MARKET INDEX

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ABSTRACT

Stock market indexes and macro-economic variables have significant relationship and it has been a topic of keen interest for researchers, academics and professionals all over the world. Various studies on this topic have been conducted and revealed a little ambiguous but more well-known relationship of macro-economic variables with stock exchanges. This study focuses upon the relationship of macro-economic variables and their impact on Karachi Stock Exchange index (KSE100). The study is about explaining the impacts of four independent macro-economic variables i.e. real effective exchange rate index, discount rate, per capita income and consumer price index on a dependent variable KSE 100 index. The study covers the time period from 1992 to 2012 and data analysis has been performed by Statistical Package for Social Sciences (SPSS) on time series data of 21 years. The results of the study explain a positive impact of consumer price index and effective real exchange rate index on KSE 100 index. Negative impact has been manifested by discount rate and consumer price index (inflation) on KSE 100 index. Independent variables of the model explain 92% of variation on stock market at high level of significance. The study also suggests that government should take remedial measures to control inflation and discount rate in favor of economy. Government should announce such monetary policy that could control inflation and discount rate for long-run benefit of country. Government should also take measures to stop the currency depreciation to boost economy and KSE index. Policies for appreciation of currency lead the country towards high rate of capital flow from abroad that is a key issue in any developing capitalistic economy like Pakistan.

KEYWORDS

Pakistan Stock Market Index, Macroeconomic Variables, Time Series Data, Currency Appreciation, Consumer Price Index, Real Effective Exchange Rate, Per Capita Income.

INTRODUCTION

The role of stock markets is considered indispensable in the development and growth of any modern economy. It is hard for an economy to prosper in the absence of stock markets. These markets help an economy towards the mobilization of its domestic resources and channelize them towards the productive investment (Comincioli, 1995). The performance of stock market is gauged by looking at the movements in its index, which is affected by multiple factors. These factors may include companies' specific, domestic (macroeconomic, social & political) and international factors.

The focus of this particular study is to identify the impact of certain macroeconomic variables on the stock market index of Pakistan. Currently, three stock exchanges are functioning in Pakistan named as Karachi Stock Exchange (KSE), Lahore stock Exchange (LSE) and Islamabad Stock Exchange (ISE). For conducting this study, KSE-100 index has been taken as sample. Karachi Stock Exchange (KSE) was inaugurated in 1947 but KSE-100 index was introduced in 1991 which transferred on electronic processing system in 1998 later on.

There are multiple macroeconomic variables that can leave impacts on stock market index of Pakistan such as inflation, exchange rates, gross domestic products (GDP), interest rates, foreign exchange remittances, domestic & international oil prices, money supply, trade balances, country reserves, foreign direct investment etc. Most significant and vital economic variables that may affect the developing countries including Pakistan are Consumer Price Index, Real effective Exchange Rate Index, Per Capita Income and Discount rate. There are a number of studies, which have revealed the impact of these variables on stock market index but this particular research will focus to trace down the effects of some of these variables specifically on KSE-100 index. The relationship between macroeconomic variables and stock market index has always been a source of immense attraction for finance practitioners since many years.

An upward movement in price of goods and services in an economy is termed as Inflation. It generally occurs due to increasing demand of goods and services exceeding their money supply. The purchasing power of people is affected by inflation, which results in less saving leading to an increased money supply. As a matter of fact, limited savings decrease the economic growth by restricting the investment in the economy. For assessing the impact of inflation on the economy, Consumer Price Index (CPI) has been used in this study. The weighted average of prices of consumer goods and services is termed as CPI. It is calculated by using changes in prices for each item and then averaging them.

Real effective Exchange Rate Indexes the weighted average of a country's currency adjusted for the effects of inflation relative to an index or basket of other major currencies. The weights are determined by comparing the relative trade balances with each other country within the index in terms of one country's currency.

Per Capita Income is a measure of the amount of money earned per person in a certain country. It is used as a means of evaluating the quality of life and living conditions in different areas of the country. It can be calculated by dividing a country's national income by its population.

Discount rate is the interest rate central banks charge to commercial banks for providing credit/loan to commercial banks. In order to control inflation, it is used as a tool of monetary policy i.e. central bank increases the discount rate for commercial banks in the times of elevated inflation. It is used for controlling excessive money supply in the country. The banks cut down the provision of loans to the customers when they are left with limited funds, which ultimately affect further businesses and investments. This study will assess how discount rate can have an impact on investment in stock market and how it is related to stock market index.

The motive of the paper is to explore the influence of selected macroeconomic variables i.e. inflation, Real effective Exchange Rate Index, Per Capita Income and Discount rate on KSE 100 index. Various studies have been conducted in the past in order to identify the relationships by using different macroeconomic variables according to researchers' choice like Taulbee (2001), Nishat & Shaheen (2004), Sing (2009), Sohail and Hussain (2011) and Ali (2011). However, it is continuing discussion whether macroeconomic variables significantly affect the stock market index or not.

LITERATURE REVIEW

Findings of a study by Nishat and Shaheen (2004) revealed a relationship between specific macroeconomic variables and the performance of KSE. For this purpose, they took the data of Karachi Stock Exchange from 1973 to 2004. They employed the vector error correction model to find out the relationship

between the macroeconomic variables and KSE performance. They found a causality relationship between economy and the stock market. Analysis of results indicated that inflation had a negative impact whereas industrial production had a positive impact on the prices of stocks in Pakistan.

Ahmad Z, Ahmad Z, Khan S and Javaid U (2011) conducted a study to find out the relevant variables that causes the stock price movements in KSE. For this purpose, they build ARIMA model to identify the relevant macroeconomic variables and their impacts on stock price movement. They used time series data from 1961 to 2009, which was collected from World Economic Indicators. The result of the Study showed a negative and significant impact of inflation and exchange rate on the stock prices and a positive but weak (insignificant) influence of economic growth on the equity prices KSE.

Ali et al (2009) conducted a study to test the causal relationship between equity prices and some macroeconomic variables in Pakistani stock exchanges. For study purpose, they took data from Federal Bureau of Statistics of Pakistan and KSE from June 1990 to December 2008 in order to analyze the causal relationship between selected macro-economic variables (indicator) and equity prices. They adopted different statistical techniques including unit root ADF test, Granger's causality test and Johansen's co-integration test. The result of the study showed co-integration between stock exchange prices and industrial production index. However, there was not found any causal relationship between exchange rate, inflation and stock exchange prices in Pakistan.

Leea C, Doong S and Choua P examined the relationship between equity price and currency exchange rate along with the exploration of their correlation influenced by the stock market volatility. For this purpose, they used Conditional Correlation and Generalized Autoregressive Conditional Heteroscedasticity methods. They took the weekly data from Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand for the period 2000 to 2008. The study found out that there were significant price spillovers from stock market to foreign exchange market in Indonesia, Korea, Malaysia, Thailand and Taiwan. The correlation between stock market and foreign exchange market was found affected by the stock market volatility. It was analyzed that the correlations used to become higher in Asian emerging countries except in Philippines when their stock market became volatile.

T. Patra and S. Poshakwale (2006) conducted a study to examine the short run as well as the long run equilibrium relationship between a set of macroeconomic variables (trading volume, money supply, inflation and exchange rate) and equity prices in the emerging Greek stock market. Granger causality, Co-integration methods and the Error-Correction Model were used to find out the relationship. For this purpose they took the data of Greek stock market from 1990 to 1999.

It was cleared from analysis that trading volume, money supply and inflation have prominent short run as well as long run equilibrium relationship with equity prices in stock exchange of Athens. There was no causal relationship witnessed between the exchange rates and stock prices. It was also found that the inflation had a negative impact on the equity prices and the exchange rate had a weak relationship with stock prices.

Pal K and Mittal R (2011) conducted a study to test the long-term association between selected macroeconomic variables (exchange rate, interest rate, inflation rate, and gross domestic savings) and capital markets of India. For this purpose, they used the quarterly data from January 1995 to December 2008. Statistical techniques of Unit root test, the co-integration test and error correction mechanism (ECM) were applied in order to determine the relationship. The results of the study revealed that inflation, foreign exchange rate and interest rate have significant impact on Indian stock markets but GDS was observed as insignificant on the other hand.

Akbar et al (2012) conducted a study to examine the relationships between KSE100 index and some specific macroeconomic variables. For this purpose, they gather the data for period starting from 1999 to 2008. They used error correction model (ECR), analyzed and filtered the data by different statistical techniques like granger causality test to make the relationship clear between macro-economic variables and stock prices in KSE100 index. As a result of sophisticated statistical techniques on this data researcher found macro-economic variables and equity prices were unidirectional causality. It was obvious that Stock price were positively related with M2 (money supply) and interest rate whereas foreign currency exchange reserve and inflation were negatively related.

Akmal S (2007) conducted this study to investigate the relationship between inflation and stock market price. For this purpose, data was collected about the variables from 1971 to 2006. ARDL, co-integration, Error Correction Approach technique was used to analysis the data. The study showed that the stock prices are hedged against inflation in long-run but in short-run this practice did not prevail.

Abdalla I and Murinde V (2010) conducted the research to find out the interaction between stock prices and exchange rates in emerging financial markets. The researchers take the data from Philippines, Pakistan, Korea, and India. For the purpose of study data has been taken from IFC stock price index and the real effective exchange rate over 1985:01 to 1994:07. They applied some new econometric techniques to a BVAR model of stock prices and exchange rates in order to test for Granger-causality between the two variables. The results have found that exchange rate impact the stock prices in Korea, Pakistan and India. Whereas stock prices Granger-cause exchange rates in the Philippines.

Kolari j and Anari A (2001) conducted a study to examine the fisher effect on the stock prices. They used stock and goods price data from six industrial economies. They used different statistical techniques to analysis the data. The study revealed that long-run elasticity of stock prices with respect to goods prices remained above and range of the price is from 1.04 to 1.65 that supported the Fisher effect. It ultimately led us to conclude that inflation has a short-run negative impact on stock returns but chances of positive in long run.

OBJECTIVES

Objectives of this paper are to trace association between macro-economic variables and KSE 100 index by using regression technique. The paper will also focus on determining the nature and strength of relationship between macro-economic variables and KSE 100 index along with tendency of their movements.

METHODOLOGY

Time series data of selected variables has been gathered on annual basis from 1991 to 2012 in this analysis. This paper traces the effects of independent variables (consumer price index, per capital income, discount rate and real effective exchange rate index) on dependent variable (KSE 100 index). It is assumed in this study that all other variables, which can influence KSE 100 index, remain constant during the analysis time period. This assumption will also guide for better understanding of OLS technique. Least Squares (NLS and ARMA) technique has been used in my quantitative analysis.

DATA COLLECTION SOURCES

The time series analysis in the study is based on secondary data retrieved from different reliable sources, which has been used to trace and compile the data for analysis. Real exchange rate index and CPI data has been taken form World Bank Indicators (WDI) of Pakistan published by World Bank. Discount rate average data has been gathered from SBP and Federal Bureau of Statistics. KSE index data has been retrieved from KSE website and SBP published reports. The year 2005 has been taken as base year for CPI and Real Exchange Rate Index whereas KSE 100 index is monthly average data of financial year.

MODEL SPECIFICATION

$$KSEI = \alpha + \beta_1 PCI + \beta_2 Dis + \beta_3 REXI + \beta_4 CPI + \epsilon$$

KSEI = Karachi stock exchange index (base year 1991)

PCI = Per Capita income % of GDP of Pakistan

Dis = Discount Rate

REXI = Real Exchange Rate Index (base year 2005)

CPI = consumer price index (inflation level, base year 2005)

ϵ = error term

Validity of instrument and reliability of data are key issues in secondary data analysis. Reliability and validity are pillars upon which Research Empire is built and generalization foster afterwards. High Value of Durban Watson (2.23) shows that there is no issue of auto correlation among residuals. It may also be inferred from the result that data is unbiased form autocorrelation problem. There is a strong position to claim that residuals have also normal distributions, which have been measured by K-S test. Value of K-S test (67%) is more than the level of significance (alpha), hence confirms the test result.

Another test of homoscedasticity reveals that residual have zero mean value. Extensive quantitative data reliability techniques confirm the claim of unbiasedness.

HYPOTHESIS

Null hypothesis: REX index, CPI, Dis and PCI have no significant impact on KSE 100 index

P. value is less than 1% in the analysis, which refers to the failure of acceptance of null hypothesis. So, it can be said that independent variables in the study have significant impact on KSE 100 index.

E-Views software has been used to ascertain the stationarity issue in the data by implying unit root test. All the independent variables in the analysis are stationary at some level i.e. first level of difference or on second level of difference. Major data analysis has been performed by statistical Package for Social Sciences (SPSS) i.e. normality test, autocorrelation testing, homoscedasticity at 5% of level of significance that is norm of good secondary data analysis.

DATA ANALYSIS

The model in our study is based on classical linear regression and provides satisfactory unbiased results by fulfilling its assumptions. These assumptions have also been tested by various tests i.e. K-S test, Normality test, Durban Watson tests and unit root tests. Therefore, it can be concluded that:

- Model has linearity in the parameters
- Model has no multicollinearity issue
- All the variables are stationary

EMPIRICAL FINDINGS

Data in table 1 reveals that the model under study is statistically significant. P value of model is less than 1% at high level of significance.

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	75.7224	11279.2891	4941.6186	4169.86225	21
Residual	-3272.86328	2497.68408	.00000	1215.80515	21
Std. Predicted Value	-1.167	1.520	.000	1.000	21
Std. Residual	-2.408	1.837	.000	.894	21

a. Dependent Variable: KSEI

This result clearly shows that the independent variables have significant impact on Karachi stock market index.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.960 ^a	.922	.902	1359.31148	2.234

a. Predictors: (Constant), CPI, Dis, Rex, PCI
b. Dependent Variable: KSEI

This model has also high explanatory power of .92, which means that 92% of variation of index level have been explained by chosen independent variables i.e. REX index, CPI, Dis and PCI. Only 8% variation is caused by other variable that are not included in the model.

HIGHLIGHTS OF RELATIONSHIPS

Per capita income (PCI) and real exchange rate index (REX) have positive relation to KSE 100 index. Inflation (CPI) and Discount rate have negative relationship with KSE 100 index.

Model	Unstandardized Coefficients		Standardized Coefficients		t	Sig.
	B	Std. Error	Beta			
1 (Constant)	-64386.440	11725.860			-5.491	.000
Dis	-699.688	125.950	-.596		-5.555	.000
PCI	122.179	20.992	1.753		5.820	.000
Rex	177.706	58.728	.336		3.026	.008
CPI	-75.134	24.743	-.908		-3.037	.008

a. Dependent Variable: KSEI

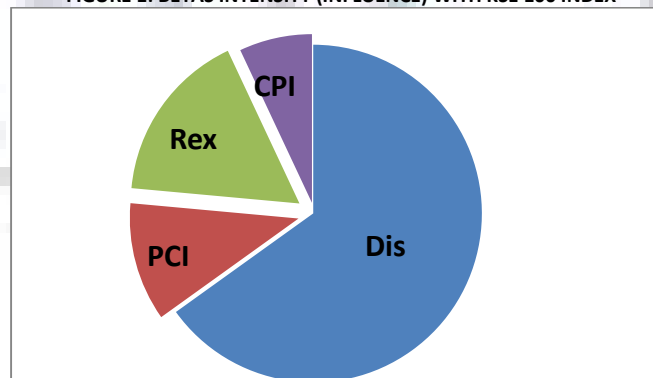
Regression coefficient (Beta) of CPI shows negative relationship with KSE index. One percent increase in inflation can decrease 75 points in index level of market by keeping other market factors constant.

Positive beta of per capita income depicts that 1 dollar increase of PCI of Pakistan can boost the KSE index level up to 122 point.

Positive regression beta of Real Exchange rate index also gives the hint to forecast that 1% increase in currency appreciation can boost 177 points of KSE 100 index.

Most influencing factor in the model is discount rate that can badly affect KSE 100 index. It means that 1% increase in discount rate may decrease 699 points market index.

FIGURE 1: BETAS INTENSITY (INFLUENCE) WITH KSE 100 INDEX



Betas intensity (influence) with KSE 100 index

The estimated regression model is:

$$KSEI = -67917.842 + 122.179 PCI - 699.688 Dis - 177.706 REXI + 75.134 CPI$$

CONCLUSION AND FINDINGS

The key intention of the study is to judge the impact of selected macro-economic variables on Karachi stock exchange 100 indexes. A wide range of statistical data reliability techniques have been utilized in order to get clear-cut picture of the relationship between dependent and independent variables by overcoming all the assumptions of regression analysis and getting resulted values free from biasness. The findings of the study explain the tendency, nature of dependency and strength of relationship among variables.

The study has high value of explanatory power on less than one percentage of P. value, which makes the study more predictable with accuracy. Joint effect of independent variables on dependent variable has been ascertained with the help of F-test. Probability of F-test reveals that independents variables jointly affect the KSE 100 index at very low probability that is desirable in this analysis and give us confidence to predict the effect of findings.

The study reveals that discount rate and inflation have negative relation whereas per capita income and real effective exchange rate have positive relation with KSE 100 index on high level of significance. Discount rate can severely influence KSE index whereas inflation can affect minimal by our findings. Per capita income and real exchange rate index have average influence on KSE 100 index. Therefore the findings of this study help us to conclude how effectively our economy can manage its macro indicators in best interest of stock market’s growth which is most desirable in any capitalistic economy for smooth and progressive operation. My findings would also help monetary policy makers to establish a long run policy by viewing the effects of selected variables on secondary markets. The results of study have been aligned with literature on different market indexes all over the world and researches of this topic verify the nature of relationship that increases the value of the findings.

RECOMMENDATIONS

The study will help the professionals and policy makers to get further insight of economy by viewing the phenomena through different angels. Macro-economic variables play a role of booster for stock market indexes in any capitalistic economy. By controlling inflation and discount rate, index level can be increased in the economy, which can increase government revenue and provide investor confidence in secondary markets. Growth of any economy is tied up with the stock market of the country in short-run as far as in long-run. So, low inflation and low discount rate announced by government can increase the investment activities in economy along with high level of KSE index that is compulsory for economic development of Pakistan.

Government should adopt the following policies for the betterment of economy and KSE index:

- Interest rate volatility should be reduced by developing a well-designed monetary policy.
- Such policy should be adopted through which per capita income may increase and generate surplus investable wealth.
- Exchange rate fluctuations of Pakistani Rupees (PKR) should be minimized in order to avoid the currency depreciation for meeting short-run objectives.

Long-run currency appreciation will bring foreign direct investment in Pakistan owing to benefits i.e. market return plus currency appreciation return.

In a nutshell, government should pay special attention to selected macro-economic variables i.e. discount rate, inflation, exchange rate and per capita income to boost the KSE index that would ultimately lead the country toward prosperity.

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APPENDIX

TABLE 4: COLLINEARITY DIAGNOSTICS^a

Model	Dimension	Eigenvalue	Condition Index	Variance Proportions			
				(Constant)	Dis	PCI	RexCPI
1	1	4.758	1.000	.00	.00	.00	.00
	2	.205	4.819	.00	.03	.00	.04
	3	.034	11.775	.00	.50	.00	.03
	4	.002	48.582	.03	.21	.09	.66
	5	.000	121.994	.97	.26	.91	.33

Dependent Variable: KSEI

TABLE 5: UNIT ROOT TEST OF REAL EXCHANGE RATE

Null Hypothesis: D(REX) has a unit root		
Exogenous: Constant		
Lag Length: 0 (Automatic - based on SIC, maxlag=4)		
	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-4.123741	0.0054
Test critical values:	1% level	-3.831511
	5% level	-3.029970
	10% level	-2.655194

TABLE 6: UNIT ROOT TEST OF DISCOUNT RATE

Null Hypothesis: D(DIS) has a unit root		
Exogenous: Constant		
Lag Length: 0 (Automatic - based on SIC, maxlag=4)		
	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-3.171543	0.0380
Test critical values:	1% level	-3.831511
	5% level	-3.029970
	10% level	-2.655194

TABLE 7: UNIT ROOT TEST OF PER CAPITA INCOME

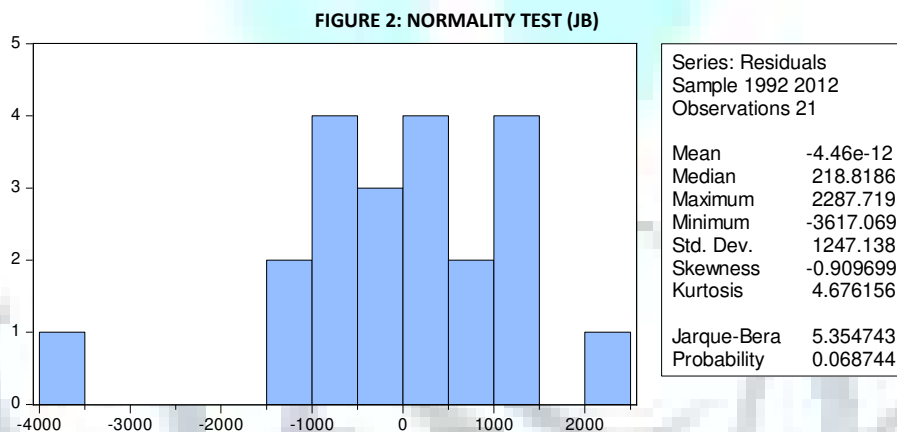
Null Hypothesis: D(PCI,2) has a unit root		
Exogenous: Constant		
Lag Length: 0 (Automatic - based on SIC, maxlag=4)		
	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-5.527987	0.0003
Test critical values:	1% level	-3.857386
	5% level	-3.040391
	10% level	-2.660551

TABLE 8: HETEROSKEDASTICITY TEST: BREUSCH-PAGAN-GODFREY

F-statistic	4.486765	Prob. F(4,16)	0.0127
Obs*R-squared	11.10224	Prob. Chi-Square(4)	0.0254
Scaled explained SS	11.84611	Prob. Chi-Square(4)	0.0185

TABLE 9: BREUSCH-GODFREY SERIAL CORRELATION LM TEST

F-statistic	0.253120	Prob. F(2,14)	0.7799
Obs*R-squared	0.732860	Prob. Chi-Square(2)	0.6932



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