

EFFECT OF EXCHANGE RATES ON STOCK RETUN

SUBMITTED BY

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INTRODUCTION

The relationship between stock prices and exchange rates is important for a few reasons. First, it affect decisions about monetary and fiscal policy. Second, usually currency is more being included as an asset in investment funds' portfolios. Knowledge about the relation between currency rates and other assets in a portfolio is important for the performance of the fund. But first we are going to explain exchange rate its mechanism and determinants.

1. Exchange rate

The rate at which one country currency is converted into another country currency is called exchange rate. It is the minimum number of unit of a country currency required to buy one unit of another country currency. The main objective of exchange rate is to see whether it has positive or negative impact on the country trade balance. A stable exchange rate help enterprise and financial institutions in evaluating the performance of investments, financing and hedging and so reducing their operational risks.

1 USD = 100 PKR

1 USD = Base currency

100 PKR = Quoted currency

It is direct quotation which involves fix unit of foreign currency against some variable unit of home currency. Government (State Bank of Pakistan) manage its exchange rate through two main system.

- Fixed exchange rate system
- Floated/Flexible exchange rate system]

1.1.1 Fixed exchange rate system

It is also called Pegged exchange rate system. In fixed exchange rate system, the Central Bank exchange local and foreign currency at pre-announced rate. Government officially ties its exchange rate with foreign currency. The basic motives of the fixed exchange rate system to facilitate the trade and investments of the country.

1.1.2 Floated / Flexible exchange rate system

It is fluctuated according to market forces which means it depends upon market forces. It is the rate which determined by market force of supply and demand exchange market. Many countries have flexible exchange rate system. Like the USA, Canada.

1.2 Determinants of Foreign exchange rate

1.2.1 Interest rate

When there is an increase in interest rate there will be increase in investment which will result in decrease demand for foreign currency and home currency will appreciate. It means that when interest rate of home country is higher than other, it will attract foreign investors to invest more and more in home country to earn money. In this situation demand for home currency will increase and may cause to appreciate.

1.2.2 Balance of Trade

If export is greater than import we will call it surplus balance of payment of a country. When export is more than import, importers will sell foreign currency which is received by exporters that may cause Increase demand for home currency and home currency appreciates.

1.2.3 Money Supply and Inflation

If state bank of any country print more money, the supply of currency will increase in the market which means circulation money will increase. If people have more money, it means that the purchasing power of people or customer increases but it may cause inflation. Inflation and currency are inversely related to each other. If supply of currency will increase the value of a currency will be depreciated.

1.2.4 National Income

An increase in the national income will cause to rise in investment or in consumption and accordingly its effect on the exchange rate will change.

1.2.5 Central bank intervention

If state bank of any country will buy or sell foreign currency in the market for the sake of increasing demand or supply affecting exchange rate, is called intervention.

1.2.6 Political factors

A situation of war and terror like now a days in Pakistan, oil price will increase, announcement of result will cause exchange rate affect.

1.3 Purpose of the Study

The purpose of the study is to find out the relationship between stock exchange rate and shares prices. Whether increase in shares prices have any affect from foreign exchange fluctuations and vice versa. If this kind of relationship exists, is it positive or negative?

1.4 Market

A market is the way through which buyers and sellers are brought together to aid in the sale and purchase of goods or Services. First, it is not must that market have a physical location but It is only necessary that the sellers can communicate about the relevant aspects of the transaction. Second, the market does not necessarily own the goods or services. For a good market, ownership is not involved; the important measure is the smooth, cheap transfer of goods and services. In most financial markets, those who establish and administer the market do not own the assets but simply provide a physical location or an electronic system that allows potential buyers and sellers to interact. They help the market function by providing information and facilities to aid in the transfer of ownership.

The following is the characteristics of a good market for goods and services.

Timely and accurate information is available about price and volume of past transactions and the prevailing bid and ask prices. Prices rapidly adjusted to new information; so, the prevailing price is fair because it reflects all available information regarding the asset.

Like all other types of markets, stock market is a collecting of buyers and sellers where they buy and sell securities of companies.

1.5 Stock Market

Stock market is a formal organization having tangible physical location where already issued securities are traded. Stock market established the rules and regulation for rational trading practice and regularities. The trading activities of its members according to those rules.

Stock index

It shows the performance of specific stock exchange. For example KSE 100 index. It shows performance of top 100 companies of KSE.

1.6 Equity Securities

Represents the shareholder's investment in the company. It includes both preferred and common stock. There are further two types of shares that a company can issue

1.6.1 Common Stock

Common stock holders are

- Owners of a company
- Having voting rights
- Receiving income in form of dividend
- Residual claim on assets at time of liquidation
- Participate in profit and loss
- They are risk bears

1.6.2 Preferred Stock

It is the hybrid financing security having characteristics of both common stock and bond. Stocks that have usually some preference over other shares is called preferred stock. Preferred stock holders

- Having partial ownership
- They are receiving income in form of fixed dividend.
- They have no voting right
- Preference over common stock on assets at the time of liquidation.

Preferred stock may also be issued in a form known as convertible preferred stock. It means that the preferred stock may be converted into common stock. When a convertible preferred stock is issued it usually has voting rights equal to the terms of convertibility.

1.7.1 Debt Securities

Debt financing is a type of finance in which a company borrow funds from different source that must be paid.it can be note and bond. In this type of security they paid interest.

1.7.1 Bonds

- It is a long term debt instrument issued be company
- Bond holders are creditors of company
- They are receiving income in form of fixed interest.
- They having no voting right
- Preference over common stock and preferred stock at the time of liquidation.
- They are not risk bears

1.8 Objectives and Description

The primary objective of the KSE100 index is to have a benchmark by which the stock price performance can be compared over a period of time. In particular, the KSE 100 is designed to provide investors with a sense of how the Pakistan equity market is performing. Thus, the KSE 100 is similar to other indicators that track various sector of the Pakistan economic activity such

as the gross national product, consumer price index, etc. These averages tell you the general health of stock prices as a whole. If the economy is “doing well,” then the prices of stocks as a group tend to rise in what is referred to as a “bull market.” If it is “doing poorly,” prices as a group tend to fall in what is called a “bear market.” The averages reveal these tendencies in the market as a whole.

CHAPTER # 2

THE CAPITAL MARKETS

Capital market is the core and backbone of the financial segment. It is a way upon capital is installed from sources where it is in surplus to the bases where it is in little quantity. The capital market facilitates; (i) utilization and intermediation of reserved savings, and (ii) provision of intermediate and lasting financial funds for investment through a range of debt and equity devices of both private and communal sectors. It plays a critical role in activating local incomes and in guiding them professionally to the most creative investments. The level of capital market growth is thus an important factor of a country’s level of savings, efficiency of investment, and finally of its rate of economic growth. An effective capital market can also provide an extensive range of striking opportunities for both the local and foreign investors.

Inside money and capital markets there occurs both Primary and Secondary markets:

A Primacy Market is a “new issues’ market. Where companies can raise lasting funds for their operations by issuing shares (and other securities) to investors.

In Subordinate Market, existing securities are bought and sold. Dealings in these already existing securities do not provide additional funds to finance capital investment.

However, the existence of a practical secondary market increases the liquidity of securities already remaining. A Company that wishes to set up a new business or increase its existing business can advance the capital it requires also by borrowing money or by issuing shares to investors. The savers become stockholders in the Company, sense they are part owners of the Company and share in its profits and progress.

2.1 Functions of Capital Market

By acting two main jobs of deployment of savings and the guiding of investment into productive enterprises, capital market supports to rush the rate of economic development, hereby collective the production of goods and services organized with the increase in the per capita income. However, generally speaking, following are the main functions of the capital market:

The owners of share certificates or shareholders are entitled to certain rights defined in the Memorandum and Articles of Association of a company. Classically, these includes the rights to dividends, right to elect directors and approve, fundamental commercial changes, examination of books of the company and less-frequently the pro-active right to promise to new issues of shares.

Stock exchange is a planned market that provides the capability of central trading in securities. The investor in this market can earn or loss capital gains on their purchase securities in addition to dividend paid by the issuing companies. The stock exchanges from an vital part of a company's capital market. A constant and well-regulated stock market, therefore, enables those in need of capital to more suitably rise their finances from small savers with the expectations that the latter can make smart gains by selling their securities in the stock exchanges. So, in simple words, securities market comprises of stock exchanges.

The securities market in Pakistan comprise of the following three stock exchanges:

- Karachi Stock. Exchange
- Lahore Stock Exchange
- Islamabad Stock Exchange
- Taurus Securities (Pvt) Limited. (Peshawar).

The non-securities market provides inflexible medium and long-term debt funds. It consists of number of financial intermediaries. Financial intermediaries are defined as the "Economic units whose principal function is managing financial assets of other economic units-business concerns and individuals. Thus they bring savers. And borrowers together by selling securities to savers formono' and lending that money to borrowers."

Following are the main components of the non-securities market in Pakistan:Central Bank

State Bank of Pakistan Scheduled Commercial Banks Muslim Commercial Bank Allied Bank of Pakistan Habib Bank Ltd.

United Bank Ltd.

National Bank of Pakistan

Scheduled Specialized Banks

Agricultural Development Bank of Pakistan Industrial Development Bank of Pakistan

Non-Bank Development Financial Institutions National Development Finance Corporation House Building Finance Corporation

Small Business Finance Corporation

Pakistan Industrial Credit and Investment Corporation Bankers Equity Ltd.

Equity Institutions

Investment Corporation of Pakistan National Investment Trust

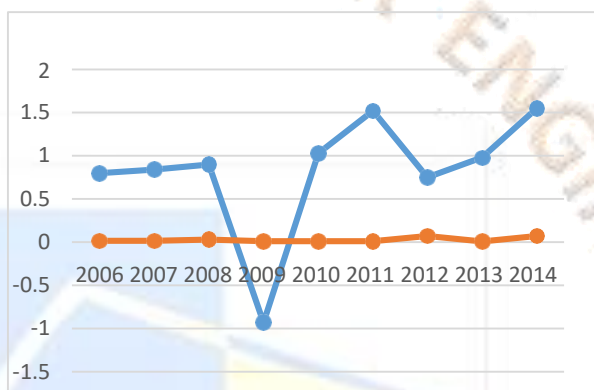
CHAPTER # 3

ANALYSIS

In this chapter we discuss the relation of exchange rate with profitability, EPS, and share prices of the oil companies, means the impact of exchange rate on profitability, EPS, and share prices. We showed the relation through graph.

Relationship between exchange rate and profitability

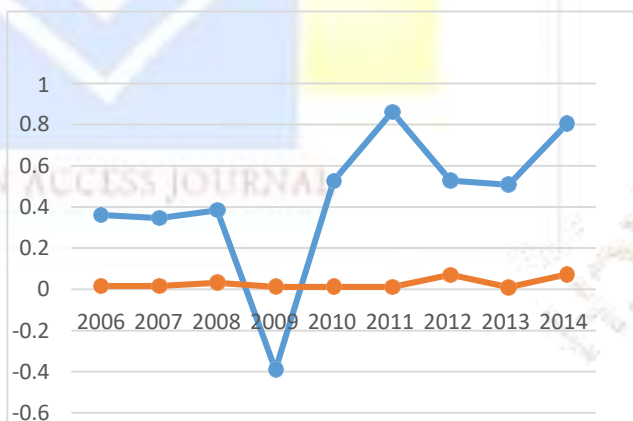
Year	X	Y
2006	0.0165	0.8
2007	0.0164	0.84
2008	0.0125	0.9
2009	0.0124	-0.93
2010	0.0117	1.03
2011	0.0116	1.52
2012	0.0105	0.75
2013	0.011	0.98
2014	0.012	1.55



From 2006 to 2008 and a half there is a little bit movement has seen in the exchange rate, while profitability started from 0.0165 to 0.0125, which means depreciation in exchange rate brought positive effect in profitability, profitability increased. In 2009 dollar has appreciated which resulted in decrease in profitability. While in rest of the years up and down has been observed.

EXCHANGE RATE AND EARNING PER SHARE

Year	exchange rate (x)	EPS(Y)
2006	0.0165	0.3612
2007	0.0164	0.3462
2008	0.0125	0.3833
2009	0.0124	-0.3905
2010	0.0117	0.5276
2011	0.0116	0.8617
2012	0.0105	0.528
2013	0.011	0.5084
2014	0.012	0.8031



Exchange rate and earning per share has the same relation and effect, as the profitability and exchange rate.

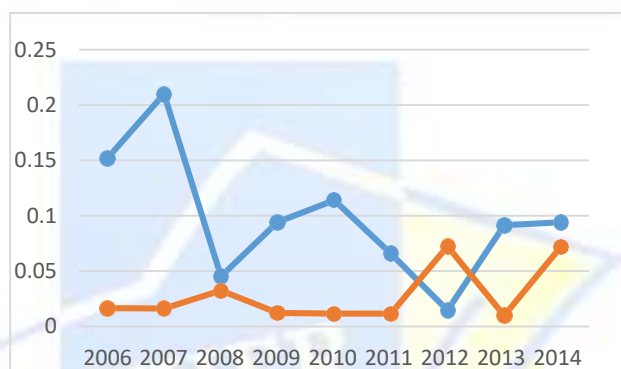
EXCHANGE RATE AND COMPANIES SHARE PRICE

NAME OF COMPANY	2006	2007	2008	2009	2010	2011	2012	2013	2014
BYCO	15.19	21	4.54	9.44	11.42	6.58	14.51	9.15	9.4
PSO	292.72	406	144.58	298.33	296.22	226.11	232.26	332.43	360.75
ATTOCK	360	376.6	574.45	180.55	350	389.8	408.6	488	432
MARRI	112.97	127.36	291.49	79.14	116.2	86	93	160.26	470.51
N.R.L	228.05	291.95	295.3	305.4	319.32	270.21	279.87	306.4	319
BURSHANE	73	48.11	84.2	66.72	89.99	80.11	73.67	87.12	110.83
EXCHANG RATE	0.0165	0.0164	0.0125	0.0124	0.0117	0.0116	0.0105	0.011	0.012

RELATIONSHIP BETWEEN EXCHANGE AND BYCO SHARE PRICE

BYCO

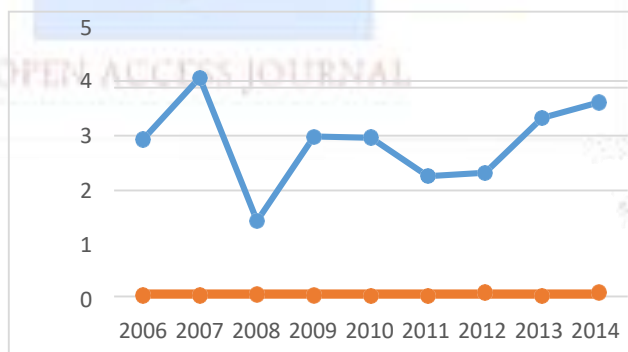
YEAR	X	Y
2006	0.0165	0.1519
2007	0.0164	0.21
2008	0.0125	0.0454
2009	0.0124	0.0944
2010	0.0117	0.1142
2011	0.0116	0.0658
2012	0.0105	0.01451
2013	0.011	0.0915
2014	0.012	0.094



By analyzing the graph we have observed that whenever the exchange rate appreciated share prices decreased, vice versa

RELATION BETWEEN EXCHANGE AND PSO SHARE PRICE

YEAR	X	Y
2006	0.0165	2.9272
2007	0.0164	4.06
2008	0.0125	1.4458
2009	0.0124	2.9833
2010	0.0117	2.9622
2011	0.0116	2.2611
2012	0.0105	2.3226
2013	0.011	3.3243
2014	0.012	3.6075

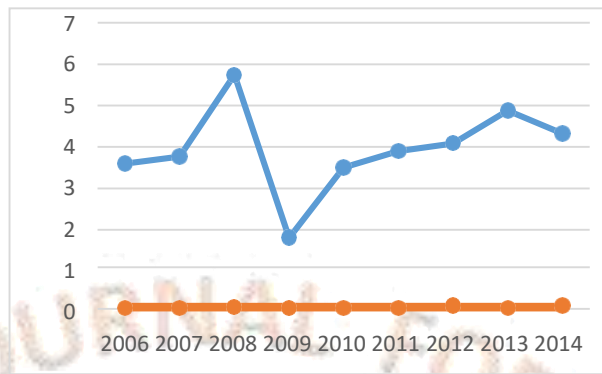


A fluctuation in the exchange rate has brought greater change in the share prices, because PSO has got the high share prices, that's why a little fluctuation in exchange rate effects the share price considerably

RELATION BETWEEN EXCHANGE AND ATTOCK SHARE PRICE

ATTOCK

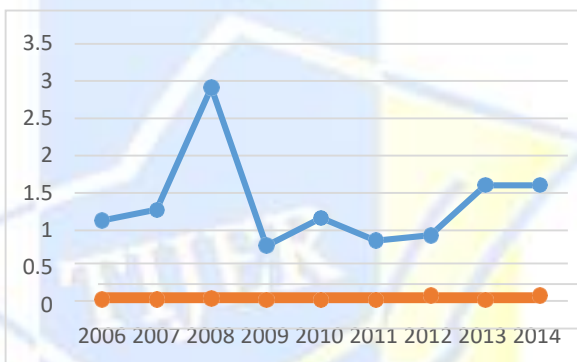
YEAR	X	Y
2006	0.0165	3.6
2007	0.0164	3.766
2008	0.0125	5.7445
2009	0.0124	1.8055
2010	0.0117	3.5
2011	0.0116	3.898
2012	0.0105	4.086
2013	0.011	4.88
2014	0.012	4.32



The same analysis is for the ATTOCK Company, whenever we see the dollar appreciation, it brought much increase in the share price of ATTOCK Company, vice versa

RELATIONSHIP BETWEEN EXCHANGE AND MARI SHARE PRICE

YEAR	X	Y
2006	0.0165	1.1297
2007	0.0164	1.2736
2008	0.0125	2.9149
2009	0.0124	0.7914
2010	0.0117	1.162
2011	0.0116	0.86
2012	0.0105	0.93
2013	0.011	1.6026
2014	0.012	1.6026

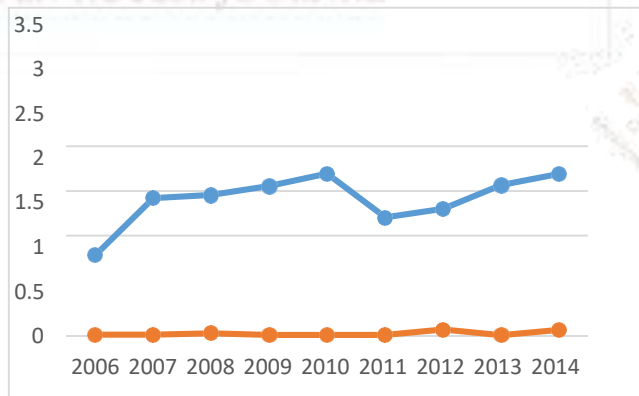


Appreciation of the dollar has brought the positive impact in the share prices in many cases, but we have seen inverse relation as well

RELATION BETWEEN EXCHANGE AND N.R.L SHARE PRICE

N.R.L

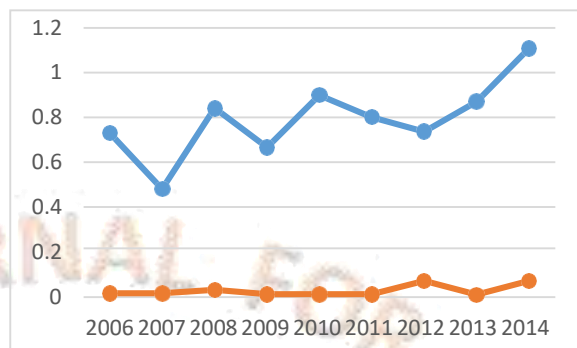
YEAR	X	Y
2006	0.0165	2.2805
2007	0.0164	2.9195
2008	0.0125	2.953
2009	0.0124	3.054
2010	0.0117	3.1932
2011	0.0116	2.7021
2012	0.0105	2.7987
2013	0.011	3.064
2014	0.012	3.19



The same is the case for NRL, appreciation in the exchange rate brought positive change in the share prices, while depreciation brought negative change in share prices

RELATION BETWEEN EXCHANGE AND BURSHANE SHARE PRICE

YEAR	X	Y
2006	0.0165	0.73
2007	0.0164	0.4811
2008	0.0125	0.842
2009	0.0124	0.6672
2010	0.0117	0.8999
2011	0.0116	0.8011
2012	0.0105	0.7367
2013	0.011	0.8712
2014	0.012	1.1083



Burshane has got the random walk in its share prices, increase in the exchange rate brought increase in the share prices while decrease in the exchange rate brought decrease in share prices

CONCLUSION

The research work has been done to find out the relationship between exchange rates and stock prices. As in Pakistan the exchange rates is changing in a very rapid manner and in huge differences. This volatility has very deep effects on stock market, particularly Oil and Gas companies. Due to these fluctuations the investors avoid to invest in the market. Stock price has been used as dependent variable and exchange rate has been used as independent variable in the study. In this work it has been concluded that exchange rate has effect on stock price. Means that independent variable has effect on dependent variable. We have seen that those oil companies has been affected that got the high share prices often, but some time inverse relation has also been observed

Interactions are investigated between exchange rates and stock prices in the emerging financial markets of Pakistan. The motivation is to establish the causal linkages between leading prices in the foreign exchange market and the stock market, the linkages have implications for the ongoing attempts to develop stock markets in emerging economies simultaneously with a policy shift towards independently floating exchange rates. This finding has policy implications, it suggests that government should be cautious in their implementation of exchange rate policies, given that such policies have consequences on their stock markets.

Some other studies have found that there is positive relationship between stock prices and exchange rate, while other determined that there is negative relationship between stock prices and exchange rates.

Whatever we found that is there is a significant relationship between stock prices and exchange rate, in Pakistan foreign exchange market is not effective as compared to other countries, that's why it is effecting the stock returns.

Limitations of the Study

The following are the limitations for my research study.

- Time is the main factor that limit me to the circle and not to expand.
- The results will be apply only to the 100 index.
- There is no primary data in this study so I will be limited to secondary data only.

RECOMMENDATION

Based on the results of the research, the following recommendations has been put forward.

- The government should take measures to stabilize the exchange rates.
- The government should aware the investors about the fluctuations in the exchange rates.
- The stock exchange should provide support for the newly entered investors in the market.
- The State bank of Pakistan should update the firms about changes in the interest rates, exchange rates and other economy factors changes, so that new investors may not suffer losses in the stock market.

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