Review Journal of Social Psychology & Social Works

http://socialworksreview.com

ISSN-E: 3006-4724 Volume: 3
ISSN-P: 3006-4716 Issue: 3 (July - September, 2025)

Relationship between the Financial Market Growth, FDI, Trade Openness, with Economic Growth in Pakistan

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DOI: https://doi.org/10.71145/rjsp.v3i3.362

Abstract

This study attempts to analyze the relationship between FDI, financial market growth, and trade openness with economic growth by using annual time series data (1989-2013). The second is the meta-analysis using NVivo software for the interpretation of different past studies. A multiple regression test has been applied to check the cause-and-effect relationship between these variables. The results support a strong positive impact of trade openness and FDI, and a negative with financial market growth on economic growth in the long run. For achieving higher economic growth in Pakistan, attention must be directed towards decisive economic policies related to liberalizing trade and utilizing maximum resources for the growth of the financial market and Trade openness in Pakistan. The results are valuable for both academics and investors.

Keywords: FDI, GDP, Trade Openness, Financial Market, Economic Growth

Introduction

Many studies have found a strong relationship between stock market growth and economic growth, with individuals and groups shaped in different periods of time. Levine and Zervos (1998) measured stock market development with aggregate market capitalization to GDP and listed firms (size, liquidity, integration with world capital markets, and volatility). The results provide a strong and significant relationship between stock market development and economic growth. In significant analysis, there is a long debate on the financial market's growth and economic growth. Faster-growing countries have greater and more efficient market growth and development due to an increase in GDP ratio and an effective financial system. Also, in these countries, the financial policies and economic indicators cause an increase in industrializing the country's growth. There is a persuasive impact of the role and persistence of financial markets on industrialization and economic growth. All developed countries have formal financial policies and a stock exchange role in their development and growth. In the nineteenth century, the Industrial Revolution and industrial financing became increasingly important. The relationship between the stock market and GDP in France was found to be positive and statistically significant at the 5% level. The stock market development does significantly "Granger-cause" economic growth in France and the United Kingdom. The results corroborate existing empirical works (Levine, 1997; Mauro, 2000;

De Gregorio & Guidotti, 1995; RSOY & Al-Aali, 2000). Bencivenga et al. (1996) maintain that equity markets can increase the average productivity of capital and, in turn, positively affect growth by decreasing liquidity costs. Stock market liquidity does help to improve the future economy. The causality has been observed only in countries where the stock market is significantly active and highly liquid. More precisely, the causality runs from stock market proxies to economic growth, showing a significant relation between market capitalization, total trade value, and turnover ratio on the GDP and FDI (Boubakari, 2010). Further, Levine and Zervos (1998) contributed that there is a strong and positive relationship between growth and financial market development. The result of Filer et al., (1999) study shows that there is a positive causal correlation between stock market development and economic activity. Rajan and Zingales (1998) argued that the growth of financially dependent firms directly causes an increase in financial market development, and in turn, financial market development increases economic development (Levine, 1996; Garcia & Liu, 1999). Mauro (2000) concluded that in emerging economies the stock market is the emerging key to economic growth. Levine (1997) showed the positive effect of the financial market on economic growth.

The link between financial development and economic growth is not a new theme in the economics literature. Ninety years ago, Schumpeter (1934) observed that the channeling of funds between the parties and firms in the financial markets plays an important and diversified role. Schumpeter's view was that financial development leads to economic growth. Robinson (1952), however, argued that due to economic prosperity, economic funds increase the financial development and, in turn, increase the economic growth. While the debate on causality is still unsettled, existing historical and econometric evidence suggests that better functioning financial markets, i.e., the needs of savers and investors are efficiently met by the financial markets, have a positive effect on future economic growth (Levine, 1997). Asian countries have more advanced financial systems. As in Africa, foreign banks have enhanced foreign trade and helped finance internal trade. Most Asian countries also have a well-developed ethnic banking system, with commercial banks, supportive credit societies, and informal bankers and moneylenders. India has a refined ethnic banking structure. In developing countries, the financial system is oriented toward exports, foreign trade, and production. In Africa and Asia, financial systems were provided principally to emigrant communities. Other factors have compounded bankers' reluctance to lend to small firms in developing countries. After 1960, developing policies influenced the shape of the financial system. In many countries, government involvement has made the financial system policies directed towards the direct debt of the priority sectors and offering lower interest rates. Nowadays, countries and policymakers have made the financial system more and more effective in respect of the factors affecting the markets. The changes in policies, systems, and institutions make the countries more effective in growth for the fulfillment of future needs. Pakistan's stock market focuses more on its developments. Although the Pakistan Stock market is smaller in size, its trade activities are higher than those of other markets. This is due to the high capital gains and market liquidity. Short-term trading trends in Pakistan also make its stock market more liquid. Pakistan is now using a more efficient market structure with effective information for both investors and capitalists for decision-making, making a timely manner with accuracy and accountability. Fair trading has been made more and more effective due to changes in corporate ethical standards and rules and regulations. In many aspects, Pakistan's stock market appears to be operating as a typical emerging market with high returns, high volatility, high market concentration, and relative inability to mobilize new investment. Pakistan's market is relatively segmented from the major

markets, providing a potential venue for diversification. Mehmood (2012) argues that FDI has positive consequences for Pakistan's economy by increasing economic growth directly and indirectly by reducing poverty, improving labor productivity, generating employment, increasing domestic investment, exports, and tax revenue, and reducing imports. However, it has negative consequences through increased environmental degradation and income inequality. Trade openness, education, and health all have a favorable impact on economic growth, whereas income inequality has a negative impact on it.

Literature Review

The development of the financial markets and their role in economic development in the country attracts investors and policymakers at every stage of the economy. Previous studies have shown that the financial markets have a greater role and broader effects on the country's economic growth (Levine, Loayza, and Beck 2000; Beck, Levine, and Loayza 1999; King and Levine 1993a, 1993b). The studies have shown that financial development has powerful and emerging effects on the economic growth of the country. These studies' results showed a causal relationship between financial growths with economic growth in a positive way. (King and Levine (1993a, 1993b). There are two basic linkages between economic growths: the first is the financial development, and the second is the intermediation that affects the financial development and indirectly the economic growth. Gelbard and Leite (1999) the conventional indicators that cause economic growth are investment, human capital, and initial income. These results have shown in studies in Africa have shown that financial development has a positive effect on economic growth. One of the oldest questions in development economics is what determines growth and how economic policy can influence it. Traditional neoclassical growth models predict that a country's per capita growth rate is inversely related to its initial level of income per person and that the output growth rate is determined by exogenously given technological changes. Solow (1956), Kaldor (1957), Caes (1965), and Koormans (1965). Foreign direct investment has a regular and interdependent role in the economy, especially the foreign banks after the 2000 era. They played a major role in the backbone of the economy of Pakistan. The foreign banks' relationship having FDI in Pakistan has an emerging growth in the banking sector. Ahmad (2008) studied the efficiencies of commercial banks in Pakistan by using an output-oriented approach. The study showed a positive relationship with assets, markup rates, earnings, and a negative relationship with liability and expenses. The main conclusion of the research was that increasing the profit ratio in relation to expenditures would enhance efficiency and promote economic development. The foreign banks must be incorporated in Pakistan to attain FDI, which is the main factor of economic growth. Hussain (2012) used auto auto-aggressive distributed lag approach to determine the relationship between fiscal strategies for growth and employment generation in Pakistan. The study showed a positive relationship between fiscal growth, which is the dependent variable, and both productive and unproductive expenditures, which are the independent variables. Also, the research shows aggregated and disaggregated forms of various fiscal variables and their effect on growth and employment in the short and long run. Private expenditures and taxation, although they have a weak impact but have a positive relationship towards economic growth.

Sausa (2010) describes the field by using empirical studies and theoretical recognition that entrepreneurship is an important driver of economic growth, employment, innovation, and productivity. The research in the field, though abundant, is quite elusive. This largely reflects the considerable confusion in the way researchers, analysts, and policymakers use the term entrepreneurship. This is a necessary precondition for a better understanding of the nexus between

entrepreneurship and economic growth, which, in turn, is a necessary condition to develop better entrepreneurship policy recommendations targeted to foster economic growth either at the regional or national level. Mehmood (2012). The study focuses on the consequences of FDI in Pakistan. For this purpose, it utilizes the data of aggregate FDI, sector-specific FDI, and country-specific FDI. The results show that FDI has a positive impact on economic growth, labor, the FDI as independent variable and economic growth, productivity, employment, domestic investment, tax revenue, international trade, poverty and income inequality, environment as dependent variables showed that FDI has a negative and significant impact on poverty. FDI has a positive and significant impact on income inequality and carbon dioxide emissions. As FDI has a positive impact on economic growth, this growth occurs with income inequality and environmental degradation. Asghar and Awa, and Rehman (2011), by applying Econometric Methodology, describe the relationship between trade openness, income inequality, education, and health, all have a positive relationship. Trade openness, education, and health all have a favorable impact on economic growth, whereas income inequality has a negative impact on economic growth. Two bi-directional and five unidirectional causations are confirmed through the Toda-Yamamoto causality test. The results of this study led to the formulating of an export expansion policy for getting maximum benefits from international trade through competitiveness. There is a need to tackle the problems of income inequality. For this purpose, effective policies need to be followed that ensure the fair distribution of wealth. The government should introduce a policy for encouraging the private sector to invest more in education and health, and the government should allocate more resources to the social sector for raising labor productivity. Rehman (2010) studied the Impact of foreign direct investment (FDI) inflows on the equilibrium real exchange rate of Pakistan using econometric techniques, taking the Equilibrium real exchange rate and foreign direct investment as variables, which showed a positive relationship. Additionally, the results show that foreign exchange inflows in the form of FDI and workers' remittances appreciate the equilibrium real exchange rate in Pakistan. FDI inflows in Pakistan appreciate the equilibrium real exchange rate, which reflects the existence of 'Dutch Disease'. Remittance inflows also appreciate the real exchange rate in Pakistan. Further, the economic slowdown in the last few years has not affected their growth rate, which has created several questions. Real exchange rate misalignment is a better indicator of external competitiveness than the actual real effective exchange rate.

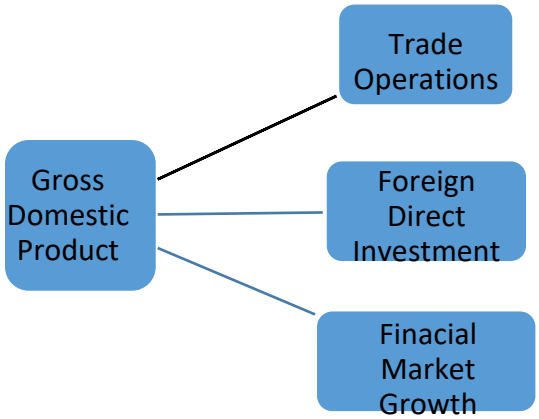
Kemal (2005) studied the Exchange rate instability and trade in the case of Pakistan. The discussion is about the association of exchange rate instability with exports and imports. Analysis is based on a simultaneous equations model using the 3SLS technique. The study considers four risk variables, i.e., exchange rate instability, agriculture manufacturing instability, growth instability, and exports instability. It is concluded that exchange rate instability affects exports positively and imports negatively, which implies that it helps in improving the trade balance. Imports and exports have a positive and significant association with each other, which shows that Pakistan is significantly following the policies that are coherent with WTO agreements. Consumer goods imports have a direct contemporaneous association with exports, while intermediate capital goods imports, which mainly include machinery, have a two-period lagged impact on exports. Exchange rate instability also affects the real exchange rate movements, and it is concluded that initially, in response to some shock exchange rate depreciates more than it should and then adjusts to its equilibrium level. However, controlling the exchange rate by intervention is against the policy of inflation targeting, which we have adopted recently. Moreover, it is also good if we can check the relationship between exchange rate instability and trade balance in the post 9/11 period, in which the appreciation of the exchange rate created problems for the

Methodology and data analysis

Data Set and Sources of the Variables

This study uses annual time series data from 1989 to 2013 to explore the linkages among economic growth, Trade Openness, and Financial Market Growth in Pakistan. We have sourced data from Pakistan economic surveys, various issues, and World Development Indicators.

Conceptual Framework



Hypothesis

H_1: FDI has a significant relationship with economic growth

H_2: Trade openness has a significant relationship with economic growth

H_3: Financial Market Growth has a significant relationship with economic growth

Model Specification

To check empirical association among said variables following model is formulated.

$$LnGDP=\beta 0 +\beta 1LnTO+\beta 2LnFDI+\beta 3LnFMG+e$$

Where

GDP=Gross Domestic Product (Dependent variable)

Trade Openness=Trade volume as % of GDP (Independent variable)

FDI=Foreign Direct Investment (Independent variable)

FMG financial market growth (Independent variable)

All variables are taken in log form, and expected signs of the variables are given in parentheses.

Data Analysis Method:

Econometric Methodology

Time series data from 1989 and 2013 have been used to analyze the stock market and economic growth relative to the GDP and FDI of Pakistan during the current period 1989-2013.

Multiple regression analysis has been applied to check the correlation and interdependency of the Financial Market and economic growth relative to these variables.

Multiple Linear Regressions

Below is the table showing the results from the multiple linear regression with economic growth as the dependent variable. All results have been summarized in Table III. From this table, the R-Squared (R2) was 0.842. This result indicates that 84% of the variance in GDP (economic

development) was significantly explained by the three independent variables, which are FDI, Trade, and Stock. The remaining 16% was explained by other factors that were not included in this study. The value of the F distribution is 44.373, and the P-value is 0.000 < 0.01 in the table supports that the relationship is significant. Thus, the finding accepts all the hypotheses. The following findings and analysis will interpret the results for the independent variables and test the hypothesis. Based on the analysis of FDI and economic growth in Table III, this study found a significant relationship between FDI and economic growth, with a t-stat value of 8.706, more than 2, based on their rule of thumb. The significant value stands at 0.000 at the 5% significant level. The finding hereby accepts Hypothesis H1 for FDI. It also explained that there is a significant relationship between FDI and economic development.

Meanwhile, analysis between trade openness and economic growth in Table III, this study found that there is a significant relationship between trade openness and economic growth, with a t-stat value is 3.356 more than 2 based on their rule of thumb. In contrast, the significant value stands at 0.003 at 5% significant level. The finding hereby accepts Hypothesis H2 for trade openness. It also explained that there is a significant relationship between trade openness and Economic development.

Model Summary

F=44.373		R Square=0.842		
Variable	Coefficient	Beta (□)	t-Statistic	Prob
FDI	.842	.914	8.706	.000
TRADE	-1.732	-.326	-3.356	.003
Stock	-.036	-.132	-1.081	.290
Constant	14.599	-	8.065	.000

a. Predictors: (Constant), Stock, Trade Openness, FDI

b. Dependent Variable: GDP

Lastly, analysis between stock growth and economic growth in Table III, this study found that there is a significant relationship between stock growth and economic growth, with a t-stat value is 1.08 less than 2 based on their rule of thumb. In comparison, the significant value stands not at 0.290 at 5% significant level. The finding hereby will reject hypothesis H3 for stock growth. It also explained that there is no significant relationship between stock growth and Economic development. This study has achieved its objectives. According to the results, FDI and trade openness were significantly related to economic growth in Pakistan. However, Stock growth is not significantly related to economic growth. This means that any changes in these two factors (FDI and trade openness) can reflect changes in the gold price and economic growth, except for stock growth. The past study also found that there is a strong relationship between FDI and Trade openness. The finding shows that the mean, median, skewness, kurtosis, and probability for all three independent variables followed the rules of thumb. According to Table III, FDI has a positive relationship, while trade openness and stock growth have an inverse relationship. A positive relationship means that, when the FDI increases, the economic growth will increase. In addition, meaning negative relationship between Trade and stock growth occurs when an increase will have no effect or negative effect decrease on economic growth.

Data Collection Methods

This study has used two methods: secondary or time series data about Trade openness from the World Bank and the State Bank of Pakistan, and a meta-analysis of past research and results about the impact of FDI, Trade Openness, and Stock Market Growth on economic growth.

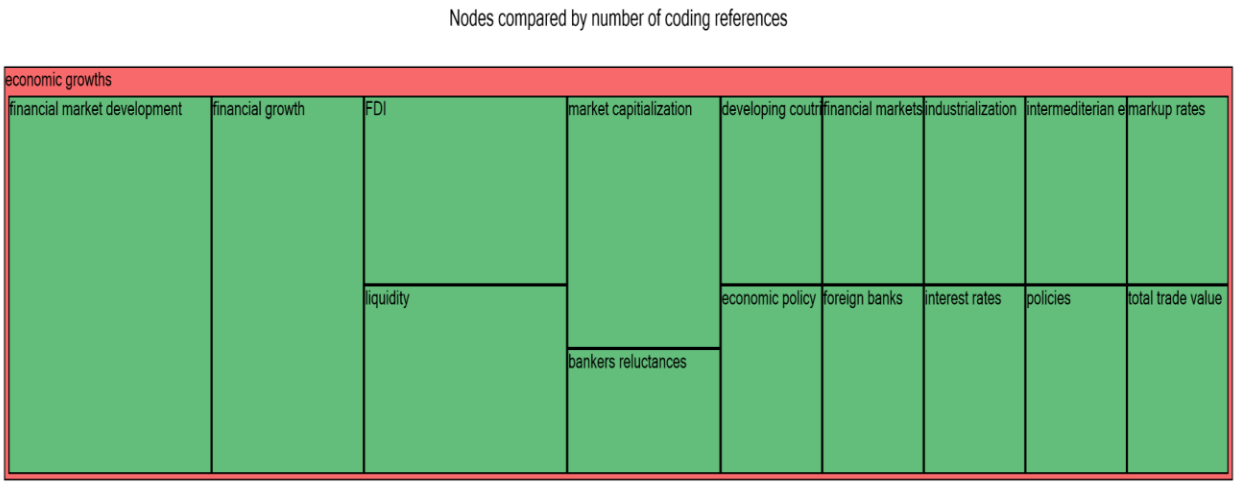
Data analysis & results

Qualitative Results

Meta-analysis

Word Tree Map

Figure 5 shows a Word Tree Map, which shows the extent of the different consequences of economic growth. Figure 5 shows that FDI, Market Capitalization, Financial Growth, and Liquidity are more effective in promoting economic growth because the number of references to these themes is higher compared to other economic growth results. However, industrialization, markup rates, policies, and bankers' reluctant affect economic growth but are weaker than the other variables.



NVivo 10 has been used for applying different qualitative data analysis techniques, including transcribing results and discussions of the different articles studied, thematic analysis, coding of data, cluster analysis, and word frequency analysis techniques. Cluster Analysis describes the number of times the coding has given a reference to a node. Those themes that have similarity in coding are close to each other, and those themes that are different in coding are at a distance. Ozkan (2004) argued that NVivo is very helpful for data arrangement and analysis, but it is still the researcher's effort for data organizing, coding, and analysis.

NVivo Text Analysis feature describes how different people described and explained the different relations and results in the sector with different variables and the same variables. Different graphs, including a tree map, show us the findings and interpretations of the results and variables relationships. Word frequency, text search, and metrics coding queries have been applied to explore the relationship between stock market growth, FDI, and Trade openness with economic growth. Figure 3 shows that the Word Tag Cloud gives us a thematic study about the relationships and their effect on the dependent variables.

Data on stock market growth, GDP, Trade Openness, Financial Market Growth, and FDI will be analyzed using multiple regression using SPSS software. All data will be gathered from the State Bank of Pakistan and the World Bank.

Conclusion:

This study identified the relationship between FDI, Trade Openness, and financial market growth on economic growth within Pakistan. Time series data has been used for quantitative methods, applying simple regression using PSS, and meta-analysis has been used for qualitative methods. NVivo 10 has been used for applying different qualitative data analyses. This study identifies the relationship between FDI, Trade Openness, and Financial Market growth with economic growth. Based on findings through meta-analysis, it can be concluded that FDI and Stock market Growth have a more effective positive relationship with economic Growth. However, an intermediate but strong relationship with Trade openness. Pakistan's economic condition can be made better by employing resources in FDI policies and providing subsidies and tax abatements to foreign investors. However, more and more effective and quick technological changes have been made in the stock exchange, giving investors more confidence and security in investing stock exchange.

Limitations:

The number of readily available variables and the amount of time needed to complete the study limit our research.

This is limited to financial market growth, not the factors affecting market growth or its effects on economic factors.

Future research:

This research will help in the future regarding market trends and their effects on economic growth. Future research can easily be estimated using these factors, in addition to the other factors that are the basis for economic growth in every era of the country's growth.

Future research can use factors affecting the stock market and FDI to compare their relationships with economic growth.

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