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## Article

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Pakistan Journal of Commerce and Social Sciences (PJCSS)

## Provided in Cooperation with:

Johar Education Society, Pakistan (JESPK)

*Suggested Citation:* Kanasro, Hakim Ali; Junejo, Mumtaz Ali; Junejo, Mansoor Ahmed (2011) : Analyzing the stock markets role as a source of capital formation in Pakistan, Pakistan Journal of Commerce and Social Sciences (PJCSS), ISSN 2309-8619, Johar Education Society, Pakistan (JESPK), Lahore, Vol. 5, Iss. 2, pp. 273-282

This Version is available at:

<https://hdl.handle.net/10419/188030>

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## **Analyzing the Stock Markets Role as a Source of Capital Formation in Pakistan**

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### **Abstract**

This paper is to examine the stock markets role in the capital formation in Pakistan from the period 1st January 2001 to 31<sup>st</sup> December 2008. This analytical study is based on the data collected from the secondary sources such as State Bank of Pakistan and three stock exchanges; Karachi, Lahore and Islamabad Stock exchanges. The stock market size of capital, number of listed companies and liquidity positions has been examined in the study. The study reveals that Karachi Stock exchange is the oldest and biggest Stock exchange of Pakistan and it is the first mover to adapt institutional developments, new policies and procedures in the business of securities exchange and shares a big role in the capital formation in Pakistan. In recent years all stock exchanges have implemented the advanced technology and fully automated trading systems. This has changed the stock markets role in the capital formation as great boom has been observed during the study period.

**Keywords:** Stock Exchange, Investment, Capitalization, Economic growth, Financial Institutions.

### **1. Introduction**

Stock markets are crucial in mobilizing domestic and foreign capital resources and channeling that capital efficiently to the most productive usage for a country. The role of stock markets as major component of financial market is very high in economically developed world but its need is even more felt in the developed economies.

As economies grow the specialized financial intermediaries and equity markets developments becomes necessary. An efficient capital market usually attracts saving and provide facilities to the domestic and foreign individuals and institutional investors.

## Stock Markets Role as a Source of Capital Formation

The financial markets' tends to develop as per-capita income grows and financial reforms progresses. The stock market growth depends on the good legal and social system developed in the society.

In Pakistan the capital market consists of (i) a dominant non-securities market with well established commercial banks, development financial institutions (DFIs) and specialized banks/ institutions for industry, agriculture, housing and small businesses; and (ii) a rapidly developing security markets with three organized stock exchanges namely; Karachi Stock Exchange (KSE) Ltd, Lahore Stock Exchange (LSE) Ltd and Islamabad Stock Exchange (ISE) Ltd.

Karachi Stock Exchange was established on September 18, 1947 and it was converted into a registered company by guarantee on March 10, 1949 with only 13 listed companies on it. The Karachi stock exchange emerged as fast developing stock market in the region and as industrial reforms took place in the Pakistan, this exchange grown as leading stock market of the country in early 60s 70s and 80s. The Karachi Stock Exchange is located in the big commercial city Karachi which is also a plus point for its development. Presently, there are 652 listed companies at KSE with market capitalization of US\$ 26.48 billion in December 2008 ([www.kse.com.pk](http://www.kse.com.pk)).

KSE is owned by 200 members/brokers with 1950 trading terminals and maintain 4 indices namely; KSE-100, All Shares Index, KSE-30 Index and KMI-30 Index. KSE-100 Index is the benchmark of the Karachi Stock Exchange to compare price over the period of time to determine the representative of higher market capitalization of the listed companies. This Index achieved a high level of its peak first time in the history when it reached at 15,737 points on April 20, 2008 with an increase of 7.4 per cent enabling this stock market as best among the emerging markets. ([www.kse.com.pk](http://www.kse.com.pk)). However this index was 9,672 on January 2, 2006. After this period there was a continuously increase in the KSE-100 Index and in April 2008 after reaching at above mentioned high peak it started to drop due to the Global Financial crises and country's economic and political turmoil found in after the assassination of Mohtarma Benazir Bhutto in December 2007. Some of these developments caused a great damage to the KSE-100 Index and big market crash was noticed as under:

Date	KSE-100 Index	Volume
01/04/2008	15,210.17	218,399,820
02/05/2008	14,956.82	257,965,456
02/06/2008	12,281.20	169,125,456
01/07/2008	12,221.53	60,751,820
01/08/2008	10,171.39	72,835,000
01/09/2008	9,210.15	23,691,000
06/10/2008	9,178.97	1,560,000
03/11/2008	9,183.14	457,000

The Security Exchange Commission of Pakistan (SECP) started to regulate stock exchanges by structural changes with the consultation of brokers and changed the circuit breakers from their -5 to +5 percentage to -10 to +10 percentage creating an asymmetric

system of breakers but there was an increase in price risk to liquidity risk as an average daily volume fell to 10-year low to around 20 million share a day ([www.mca.gov.pk](http://www.mca.gov.pk)).

However, in spite of this, KSE is progressing towards the fulfillment of its vision and mission and striving hard to provide quality and value-added services to the people of Pakistan. Before reforms (1990 onward) the Karachi Stock Exchange lacked the proper infrastructure for trading and settlement. The study reveals that in particular, trading was carried out through open outcry system. Due to lack of automation, turnover remained very low and in the absence of a depository company, investors had to take physical delivery of shares and moreover all financial institutions in Pakistan were involved in the securities business. Despite the active participation of these institutions (more than 62.4% of total volume was shared by 10 big companies at KSE), the equity market in Pakistan remained small (Economic Survey 2005-06 pp 108). Since the corporate sector was relying more on DFIs for their financing needs, this did not allow equity market to develop significantly. The cost of equity was significantly higher than the debt as dividends were paid out of after tax profits while interest on loans, invariably subsidized, was tax deductible. The sponsors (DFIs) were generally able to finance projects with very low equity shares.

But after the infrastructure and institutional reforms, the capital market in Pakistan has been very active. The expansion of the capital market activity resulted from a broad-based liberalization of the economy including in particular the opening up of foreign sector, specially the direct foreign investment policy. The Karachi Stock Exchange institutional development after the reforms is very good and at par with world markets but its low size of market, low liquidity, low turnover ratio, high volatility, and high concentration has kept away this market from the success.

Lahore Stock Exchange is the second largest stock exchange of Pakistan which was established in October, 1970 in Lahore, Punjab under the securities and exchange ordinance, 1969 of Government of Pakistan. The membership was raised from 83 to 150 over a period of 25 years upto 1994 as individual and corporate members and it was shifted from Bank Squire a very congested area to its present location at 19-Khayaban-e-Aiwan-e-Iqbal, Lahore. Lahore stock exchange significantly has increased its facilities to compete with other stock exchanges of the country.

Islamabad Stock Exchange Ltd is the third stock exchange established as a guarantee limited company on October 25, 1989 in Islamabad. The purpose of this exchange was to bring the less developed northern area at par with other parts of country in investment and economic activities. ISE has set highest levels of standards and a promising atmosphere for investors. 104 corporate members out of 118 is the specialty of this exchange.

## **2. Literature Review**

The stable microeconomic policies create a better environment for development of stock markets. These developments stable the growth of the real sector which ensures a good business environment and higher investment return (Greenwood and Smith 1997). Mekinnon (1973) concluded that the stock market development stimulates economic growth through its positive impact on savings, productivity of capital and investment.

The relationship between economic growth and stock exchange developments are also studied by Pagano 1993, Levine and Zarvos 1996, and Petelis 1997, by using different economic indicators and variable their findings are mixed in nature. Majority of these studies found a positive relationship between stock market development and economic growth. The relaxation of capital controls is viewed as a channel to attract foreign capital which is necessary to finance economic growth and also enhance the equity markets (Kim and Singal 2000).

Levine and Zarvos 1996 demonstrate that the stock market's liquidity and banking development positively predict growth. They attempt to qualify the role of stock market development in economic growth by long-run economic growth.

Nishat and Saghir (1991) investigated whether the stock market has important links to aggregate economic activity in Pakistan. They highlighted the role of capital market in general and equity market in particular towards the development of economy of Pakistan.

Some of the studies are taken by the consideration of relationship between turnover determinants of domestic trading with the capitalization of economy ( Demowitz, Glen and Madhawan 2001).

Some of the studies carried by Nishat(199, 2000) and Nishat and Mustafa, 2007) in studying of the behavior of KSE shows some non-synchronous effect and observed anomalies after financial reforms of 1990s. Though these studies proves that the financial reforms provided depth and breadth and shift in the pattern of stock indicators and created an environment of competition amongst the investors in Pakistan (Nishat 2001).

**3. Data Analysis**

The data which is used in this analysis has been taken from the official web sites of the three stock exchanges and the economic surveys of the government of Pakistan from the period 2000-2001 to 2007-2008.

Following table-1 shows the listed companies at Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange during the period from 2000-2001 to 2007-2008.

Table 1: Listed Companies at KSE, LSE and ISE (Source: KSE, LSE and ISE Websites)

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	Total	Average
Karachi Stock Exchange	747	712	702	668	659	658	658	652	5456	682
Lahore Stock Exchange	614	581	561	647	524	518	520	514	4479	560
Islamabad Stock Exchange	281	267	260	251	232	240	246	247	2024	253

It is clear from the above table-1 that listed companies at KSE, LSE and ISE during showed increasing and decreasing trends. According to the data presented in the table-1 KSE stands high with 747 listed companies, LSE stands with 614 listed companies and ISE with 281 listed companies during the year 2000-2001. (The percentage of each stock exchange in total listed companies during the year 2000-2001 was that KSE 45.49% , LSE 37.39% and ISE 17.11%) The year 2001-2002 witnessed a decline in the listing of companies at KSE as the listing was 712, at KSE 581 and at ISE it became 267.

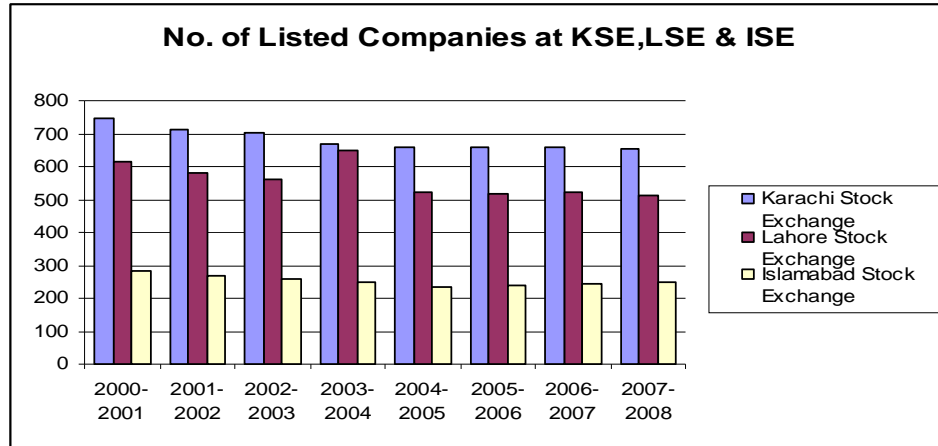


Figure-1: No. of Listed Companies

The number of listed companies is also evidence from the figure-1 which shows the position of three stock exchanges in Pakistan during the study period 2000-2008. It is clear that there is a declining trend witnessed in Pakistan’s stock market in the listed companies during this period except the year 2003-2004 which shows an increase in the listed companies in Lahore Stock Exchange. The percent of KSE in listed companies was 46.14%, LSE 36.38% and ISE 17.48%.

Table 2: New Companies listed at KSE, LSE and ISE

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	Total	Average
Karachi Stock Exchange	4	4	2	16	15	14	12	5	72	9.0
Lahore Stock Exchange	3	3	2	18	5	6	8	2	47	5.9
Islamabad Stock Exchange	5	3	1	8	5	2	7	3	34	4.3

Source: KSE, LSE and ISE Websites

## Stock Markets Role as a Source of Capital Formation

Table-2 shows the listing of new companies at KSE, LSE and ISE. The year 2003-2004 witnessed a high jump in listing of new companies as 16 new companies were listed at KSE 18 new companies were listed at LSE and 8 new companies got listed at ISE simultaneously. The average listing of new companies remained as averagely 9 companies were listed at KSE, 5.9 companies at LSE and 4.3 companies got listed at ISE.

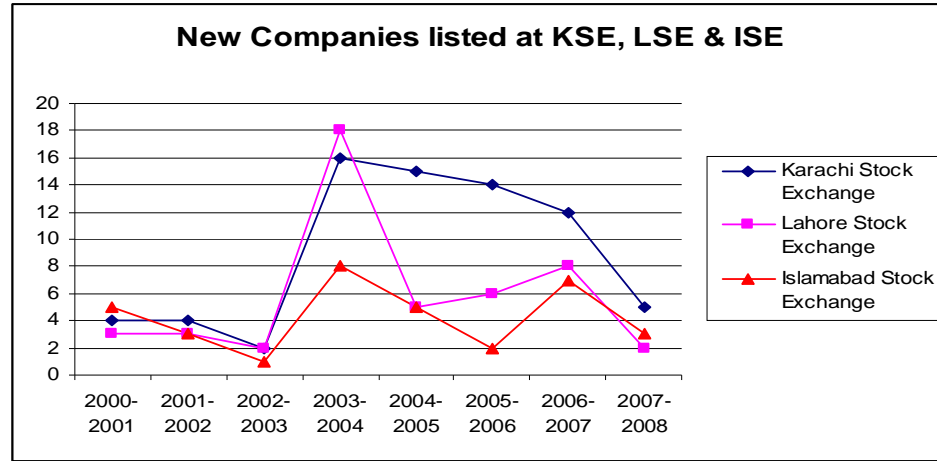


Figure 2: New Listed Companies at KSE, LSE and ISE

Figure-2 also shows the trends in the listing of new companies at three stock exchanges of Pakistan. During the year 2000-2001 to 2002-2003 there is decline in listing of new companies, however, the only increase has been witnessed in all three exchanges during the year 2003-2004 in listing of new companies. But after this KSE have been seen a decline in new listing and LSE and ISE have seen some inclination in the listing of new companies up to year 2006-2007. It is clear from the table-2 and figure-2 given above that there is sharp decline in the listing of new companies' at all three stock exchanges of the country. It is happened even after the introduction of State-of-the-art trading system at all the three stock exchanges in year 2001-2002.

Table 3: Funds Mobilized (Rs.billion) at KSE, LSE and ISE (Source: KSE, LSE and ISE Websites)

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	Total	Average
Karachi Stock Exchange	3.6	15.2	23.8	4.2	54	41.4	49.7	49.2	241.1	30.1375
Lahore Stock Exchange	2.5	14.2	4.1	3.1	42.1	24.5	38.8	28.1	157.4	19.675
Islamabad Stock Exchange	0.8	3.7	11.5	2.6	27.6	5.2	30.7	28.1	110.2	13.775

Table-3 shows the position of funds mobilized at three stock exchanges as follow: the KSE has seen a high average in its funds mobilized which is an average of Rs. 30.1375 billion per annum during the study period. Simultaneously Lahore Stock Exchange has mobilized the with an annual average of Rs. 19.675 billion and Islamabad Stock Exchange Rs. 13.775 billion average per annum during the study period from 2000-2001 to 2007-2008.

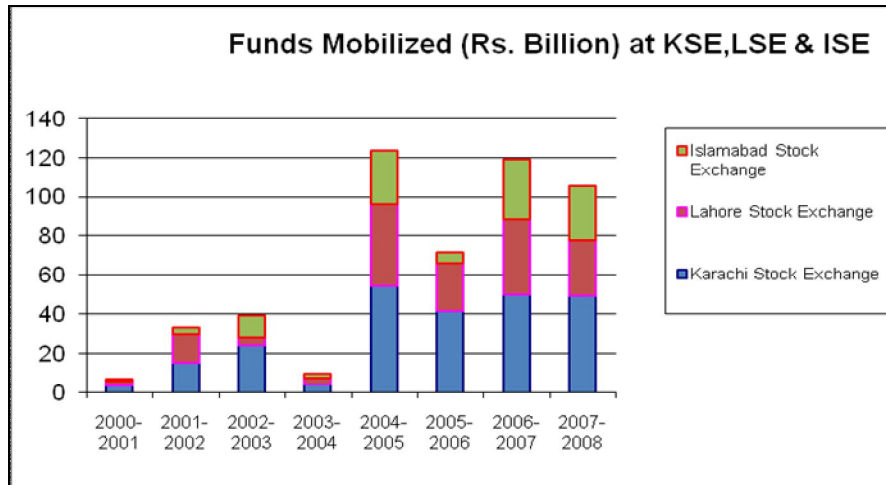


Figure 3: Fund Mobilized

The above figure is also showing the trends in the funds mobilized through KSE, LSE and ISE during the study period.



## Stock Markets Role as a Source of Capital Formation

Table 4: Total Turnover of Shares (In billion) KSE, LSE and ISE

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	Total	Average
Karachi Stock Exchange	29.2	29.1	53.1	97	88.3	104.7	68.8	56.9	527.1	65.9
Lahore Stock Exchange	7.8	18.3	28.2	19.9	17.5	15	8.3	5.4	120.4	15.1
Islamabad Stock Exchange	1.4	2.7	2.1	1.4	0.7	0.4	0.3	0.9	9.9	1.2
<b>Total</b>	<b>38.4</b>	<b>50.1</b>	<b>83.4</b>	<b>118.3</b>	<b>106.5</b>	<b>120.1</b>	<b>77.4</b>	<b>63.2</b>		
<b>Average</b>	<b>12.8</b>	<b>16.7</b>	<b>27.8</b>	<b>39.4</b>	<b>35.5</b>	<b>40.0</b>	<b>25.8</b>	<b>21.1</b>		

Source: KSE, LSE and ISE

Table-4 reveals the yearly total turnover of shares at the KSE, LSE and ISE during the period from 2000-2001 to 2007-2008. The year 2000-2001 shows that the total turnover at Karachi Stock exchange was 21.2 billion shares, at LSE 7.8 billion shares and at ISE 1.4 billion shares. The above table also has depicted the data as KSE witnessed 29.1 billion shares as total turnover, LSE saw 18.3 billion turnover and ISE 2.1 billion turnover during the year 2001-2002, respectively.

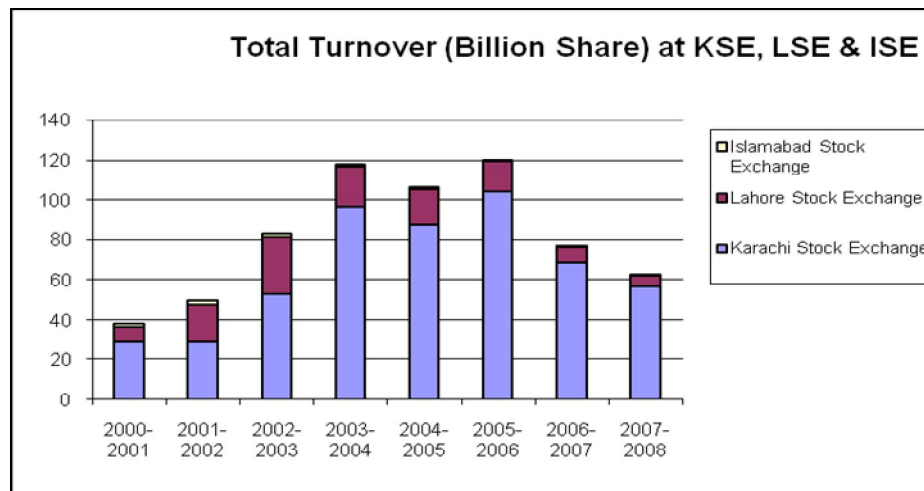


Figure 4: Total Turnover

It is evident from the above figure-4 that the total turnover remained low during the years 2000-2001, year 2001-2002, year 2002-2003 and year 2003-2004 respectively. It is also clear that the year 2004-2005 has witnessed high turnover in the all three stock exchanges of Pakistan. After this period 2005-2006 the stock exchanges have seen a continuously

decline in turnover of shares and as mentioned above the KSE along with LSE and ISE have seen an all the time decline in their Indexes as KSE-100 Index saw high peak (more than 15,700 points in April 2008 and low as 9,183 points in December 2008).

#### 4. Conclusion

In this paper we have analyzed the role of Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange for the period 2000 to 2008. These three stock exchanges are playing a crucial role in improving investment opportunities for the local and foreign investors especially in equity investment. The economy of Pakistan is getting a strong push in capitalization through these exchanges. Karachi Stock Exchange remained number one in its size of listed companies, new listing, and funds mobilized and total turnover of shares throughout the study period but in the year 2008 witnessed much turmoil in the capitalization process as KSE-100 Index is seen all the time ups and downs. The economic and political crises after the Mohtarma Benazir Bhutto's assassination in December 2007 and global financial crises of 2008 put lot of pressure on the investors to rethink about the equity investment and due to this the above conditions accrued. However there is a declining trends have been witnessed throughout the study period in all three exchanges simultaneously which shows the same behavior of the investors across the country.

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