

Foreign Direct Investment and Stock Market Development: Evidence from Asia

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Abstract: This paper examines how foreign direct investment impacts stock market development in the South Asia region. FDI is considered an independent variable, whereas the stock market is considered a dependent variable, while interest rate, exchange rate, and inflation are control variables. The data is collected from World Bank indicators, and stock index data is collected from stock exchange websites of South Asian countries. The twenty-one years of data, beginning in 2001 to 2021, are used for the analysis through STATA software. This study used (OLS) the ordinary least square method, to check the relationship between SMD and FDI in South Asian countries. The results show that foreign direct investment has a positive impact on the development of the stock market. The results of this study give insightful direction for investors, showing that the stock market and FDI are related positively. Governments should think about incorporating environmental concerns and sustainable development goals into their FDI promotion policies.

Keywords: Foreign Direct Investment, Stock Market Development, Interest Rate, Exchange Rate, Inflation

Introduction

Foreign direct investment is a vital source of assets and capital influxes for the countries in South Asia. Research in this field involves analyzing direct foreign investment trends and identifying factors that affect the flow of investment, evaluating the consequences of investment on local stock markets, and exploring its impact on the growth of the overall economy. Direct foreign investment plays an important role and is a significant contributor to investment inflows in developing nations. It serves as a gateway for introducing know-how, managerial skills, and mortal resources to the host country. Stock market development as a dependent variable refers to the growth, efficiency, and sophistication of a country's financial market where stocks and other financial instruments are traded. It is characterized by factors such as increased market capitalization, liquidity, the number of listed companies, and the presence of well-functioning institutions and regulations. A well-developed stock market plays a crucial role in facilitating capital allocation, mobilizing savings, and providing opportunities for investment and wealth creation. It serves as a barometer of the overall economic health and attractiveness of a nation to investors, promoting economic growth and fostering financial stability.

A well-developed stock market can serve as a vital source of capital for companies, encourage entrepreneurship, and contribute to overall economic development. However, the impact of FDI on stock market development depends on many factors. One challenge is that the presence of foreign investors can introduce volatility and potential risks to the stock market. Sudden capital outflows or shifts in investor sentiment can lead to significant fluctuations in stock prices and destabilize the market. This research

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paper analyzes data from 2001 to 2021. In general, FDI direct foreign investment has a positive contribution to the stock market's development. However, it is essential to establish a favorable environment for FDI, implement the regulatory frameworks, and adopt effective measures for investor protection.

According to this study by Ahmed Kiani (2016), direct foreign investment has an impact on the expansion of stock markets in South Asian nations, including Bangladesh, Pakistan, Sri Lanka, and India. It discovered a significant and favorable association between FDI and the expansion of stock markets. The researchers propose that FDI entries add to working on the general financial states of the nation, prompting expanded financial backer certainty and interest in the securities exchange.

This study advances knowledge of the connection between FDI influx, controlling variables, and the performance of the stock market utilizing data from 2001 to 2021. Examining the impact of FDI on stock market development in six South Asian countries. This study analyzes twenty-one years of data. FDI inflows create optimism about a country's economic prospects and business environment. Boosts investor confidence and overall market growth. The dependent and independent variables of twenty-one years of data are analyzed in this study. Policymakers and regulators may assess the efficacy of present rules and pinpoint areas that need improvement for analysis of how FDI affects stock market development. Additionally, this will support investors in their decision-making process. FDI inflows can encourage the growth of South Asian stock markets. The local stock market experiences a rise in liquidity, trading activity, and market capitalization as a result of the capital inflow and participation of international investors. This, in turn, draws domestic and foreign investors, expanding the depth and breadth of the market. FDI inflows represent optimism over a nation's economic prospects and business environment. Increased investor confidence and an increase in domestic investors can both result from the presence of international investors. Positive investor mood can influence market growth overall, as well as trading volume, share price, and volume of transactions.

The research objective is to analyze the impact Of FDI on stock market development in South Asia. The research object of this study is to examine the impact of Foreign Direct Investment (FDI) on stock market development. The study aims to investigate how FDI inflows influence the growth and performance of the stock market in a specific country or region. The control variables in this research include the exchange rate, interest rate, and inflation. These control variables are essential to assess their potential effects on the relationship between FDI and stock market development.

The study examined how Foreign Direct Investment (FDI) encouraged the growth of stock markets in South Asian countries. The study found a significant positive relationship between FDI inflow and stock market growth after analyzing data from 2001 to 2021 and taking into account control variables such as exchange rates, interest rates, and inflation. FDI inflows were discovered to boost investor confidence and overall market expansion by fostering optimism about the economy's future. The study emphasizes how important it is to create an atmosphere that encourages FDI, strengthens regulatory frameworks, and safeguards investors in order to increase the favorable effects of FDI on the development of the stock market.

Literature Review

This chapter contains the theoretical underpinnings of ongoing research as well as a review of earlier work about the effects of FDI on the growth of the stock market. According to Monier, El-Mekabaty, Abdel-Latif, and Mert (2020), the halo theory proposes that foreign direct investment (FDI) from developed countries can play a positive role in mitigating CO2 emissions in emerging nations. This theory emphasizes that FDI has the potential to introduce advanced technologies and environmentally conscious manufacturing practices to developing nations, resulting in reduced CO2 emissions. However, it is important to note that the halo theory primarily addresses the environmental implications of FDI rather than its direct association with the stock market development. Although FDI can contribute to economic growth and progress, its influence on the development of the stock market can be influenced by factors such as the regulatory framework, market conditions, and investor sentiment.

Raza and Ahmed (2012) work on empirically analyzing the role of FDI in a developing country's stock market and its relationship with other factors, including domestic saving, inflation rate, and ER (exchange rate) in Pakistan's quickly fluctuating political situation. The OLS technique of regression is used in this study utilizing yearly time series from 1988 to 2009. This results in a positive impact of FDI on the development of Pakistan's stock exchange, along with explanatory variables. This study emphasizes the direct connection between FDI and Pakistan's SMD. According to Adam and Tweneboah (2009), multivariate integration and error correction models were used in the 1991 to 2006 quarterly data to observe the effect of direct foreign investment on the growth of the stock market in Ghana. According to the analysis, the development of Ghana's stock market, nominal exchange rate, and direct foreign investment are all linked over time. Agarwal (2001) studied nine African countries and examined the relationship between SMD and economic development. The study employs time-series cross-section data from 1992 to 1997, and the consequences show a favorable correlation between several stock market performance measures and economic development.

Haider, Khan, Saddique, and Hashmi (2017) Utilizing data from the 2007 to 2015 quarterly time series, The goal of the study is to ascertain how China's foreign portfolio investment (FPI) is affected by inflation and stock market performance. The authors analyze the connection between FPI, stock market prices, and inflation using an ARDL model. The Outcomes demonstrate that the performance of the stock market has a strong favorable influence on FPI; FPI, on the other hand, is found to be negatively correlated with inflation. The report also demonstrates how key historical occurrences of foreign portfolio investment in China were impacted by events like the Shanghai Composite Stock Index Crash of 2015 and the Asian Financial Crisis of 2008. DAKU (2023), between 1975 and 2020, looked into the effects of direct foreign investment (FDI) and SMD on the development of the economy in South Africa. In order to evaluate the integration of variables, the author utilizes data from the webpage, including worldwide bank data, together with the ARDL bound and Granger correlation tests. According to the report, South Africa's economic growth is significantly and favorably influenced by the stock market, FDI, and gross domestic savings. The Granger causation test reveals that there is a causative connection between market capitalization and FDI. The consequences suggest that strategies to encourage FDI may not be effective if it is assumed that FDI will automatically lead to economic progress.

Forson and Janrattanagul (2014) analyze the lasting correlations between the Thailand Stock Exchange Index (SETI) and numerous macroeconomic factors during a 20-year period (1990–2009), such as the rate of interest, supply of money, and industrial output index. The lasting links between the index of consumer price and industrial production index show an adverse relationship and the long-standing link between the money supply and the SET Index is substantially positive. The study also identifies bilateral causal connections between industrial production and the supply of money, as well as independent causal relationships between CPI and IR, IP and CPI, MS and CPI, and IP and SETI. Son and Moon, (2021). They found that North Korean threats increased capital inflows under liberal regimes or before parliamentary elections by analyzing monthly data on the Korean stock market from 2000 to 2018.

Gay (2016) examines the connection between pricing for stock market indexes, currency exchange rates, and oil prices in BRIC countries using the Box-Jenkins ARIMA model. From 1999:03 to 2006:06, BIRC has monthly statistics available for the stock market price index, the currency exchange rate, and the oil price. The results suggest no significant relationship between the two macroeconomic variables and the index of stock market prices of the nations studied, and a weak form of market efficacy is exhibited. However, additional studies are necessary to determine how other local and global macroeconomic issues affect stock market results. Wahhab, Gatea, and Mohammed Abd Ali (2020) observe the connection between Iraq's credit rating and FDI flows from 2010 to 2018. The study uses data from official sources such as the World Bank, IMF, and Iraq Stock Exchange. The findings indicate that the credit rating is a crucial factor affecting FDI flows, and countries with a high credit rating receive more investments. Additionally, the study identifies three factors that control foreign investment, including credit rating, bilateral agreements, and regional/geographical location.

Algarini's (2020) study analyzes the short-term and long-term relationships between macroeconomic variables (GDP, FDI, inflation rate, and rate of interest) and values of the stock market (MV) in Saudi Arabia

from 1993 through 2018, utilizing yearly time series data. , All of the macroeconomic variables are found to be motionless in the first difference and co-integrated with MV, according to the results. All macroeconomic factors, including GDP and all other variables, have a long-time link with MV. However, among all the factors in the lag period, there is only one short-term association between the values of stock markets. Ho and Odhiambo (2018) analyze the variables that have impacted the expansion of the Philippine stock market from 2001Q4 to 2016Q4. The research looks at how several macroeconomic variables, like the expansion of the funding industry, inflation, the value of the currency, economic growth, openness to trading, and stock market liquidity, influenced the growth of the Philippine stock market. The findings of the ARDL bounds testing process show that while the expansion of the exchange rate and banking sector have favorable effects on the short-term growth of the Philippine stock exchange, openness to trade has had a detrimental influence on its long-term growth. The findings remain consistent across alternative model specifications. Vo (2021) examines the relationship between Vietnam, a significant recipient of foreign direct investment (FDI), and its major investors with regard to the stock index. The research analyzes data from July 20, 2010, to August 1, 2019. The results indicate that the strength of the linkages depends on the position and changes in FDI inflows. The findings reveal that the dependence on FDI investors can be positive, negative, or both. Therefore Khodaparasti (2014) examines the impact of macroeconomic factors, particularly inflation, the ER, private sector liquidity, and the index of manufacturing production, on the Iranian stock market between 2007 and 2011. The effect of these variables on the oscillation of the stock market is investigated using the variance analysis approach in the study. The above study reveals that the stock market has a greater influence on MI, ER, and industrial index than the other two. The study's findings reveal that there is a correlation between macro variables and the stock market, with currency and the industrial index having a bigger influence.

Furqan, Zeb, and Subhani (2023) work on focusing on the macroeconomic variable effect on the performance of the stock market of South Asian countries. In this study, the data set started from 2010 to 2020 and screened four major South Asian countries. The finding indicates that an increase in FDI significantly increases the SMP and shows that SMP improves with a higher exchange rate. The stock markets of middle MENA nations were found to have a strong positive correlation with FATF, According to our findings. A rise in the FATF country risk rating is negative for investors. Which in turn reduces capital flow to South Asian nations. According to Koojaroenprasit(2012) find out how FDI affects economic development. This study was conducted in South Korea. The Independent variable in this paper is domestic investment, FDI, export, employment, and human assets, and the dependent variable is economic growth. The data time series of 1980 to 2009. The result indicates that FDI, export, employment, and Positive effects of human capital on the economic expansion of South Korea, but FDI strong and other factors significantly impact development. Economic growth is not impacted much by domestic investment. Transferring knowledge and cutting-edge technology has a negative influence on Korea's economic development.

According to Sobirov (2021), the factors of FDI in Uzbekistan panels of data from 2019 to 2021 were observed. The results reveal that the size of the market and population growth have a significant influence on direct foreign investment. This study emphasizes the significance of comprehending investment-related issues, which play an important role in understanding economic processes. The paper highlights the importance of understanding economic processes and investment matters to promote FDI inflows. The research indicates the significance of comprehending the correlation among inflation rate, exchange rate, income, FDI, GDP, and division, awareness as dependent variables, and Indigenous variables. However, Mohsen (2015) analyzes the relationship between trade openness, GDP, and investment from the private sector, as well as openness to trade in Syria from 1980 to 2010. The study finds that all variables are through the ADF test, and a positive and substantial long-run connection exists between GDP, trade openness, and private sector investment as per the Johansen integration test. The Investment in the private sector is a dependent variable, while the GDP and openness in trade are independent variables. Therefore, Al-Abdallah and Aljarayesh (2017) examined the impact of inflation, ER, and IR (interest rates) on ASE stock returns from 2005 to 2015 using monthly data. The multiple analysis of regression. Results showed that the independent variables GDP, balance of payments, and real money supply had little impact on the dependent variable. According to the research, inflation and stock returns are positively correlated,

whereas interest rates and stock returns are not. The exchange rate is zero, and Stock returns are the dependent variable, with rates of interest and inflation acting as independent factors.

Awwad and Razia (2021) examined the efficiency of the money market in Palestine by analyzing the variables of Market return, Market capital ratio, Rate of stock turnover, and Degree of market concentration. The study used data from 48 listed companies on the stock exchange of Palestine from 2010 to 2018. Results indicated a negative coefficient between the stock turnover rate and market return, suggesting that dealers play an important role in supplying liquidity in the financial and capital markets of Palestine. Wong, Penm, and Terrell (2004) investigate the subject of stock market co-movement between developing markets in Asia and large industrialized nations to investigate the advantages of global diversification. The study also notes that since the collapse of the stock market in 1987, which was exacerbated by the 1997 Asian Financial Crisis, the most developed and emerging economies are increasingly dependent on one another. The paper contends that the growing correlation between established and developing stock markets limits the advantages of international diversification.

Hypothesis: FDI positively impacts Stock Market Development.

Methodology

In this chapter we provide the information to reader on the relationship between FDI and stock market development. Additionally, the chapter explains the methodology use in this study. In this research the data variables consist of a dependent variable which is stock market development refers to the growth, efficiency, and sophistication of a country's financial market where stocks and other financial instruments are traded. It is characterized by factors such as increased market capitalization, liquidity, the number of listed companies, and the presence of well-functioning institutions and regulations.

We gathered secondary data for this research from the World Bank and official website (stock exchange) of South Asian country. These websites are authentic and reliable source for achieving accurate result. We were able to obtain validated data that could yield generalizable, unquestionable and solid result. For the period 2001-2021, South Asian countries will be subject to specialized research.

Research is primarily quantitative in nature. The purpose of this study is to providing the validity of the proposed hypothesis with empirical results. The study analyzed the causal effect of FDI on the growth of the stock market.

Operationalization of Variables

Table 1

Variable	Dimension	Acronym	Operationalization	Source
Stock market development (SMD)	Stock Market Index	SMD	Composite index measuring the size, liquidity, and efficiency of the stock market.	WDI
Foreign Direct Investment (FDI)	Net inflow and outflow	FDI	Net inflows of foreign investment into the economy(%GDP)	WDI
Control Variables	Inflation	INF	The annual rate of change of consumer price index (%GDP)	WDI
	Exchange rate	EXR	The price of one currency in the term of another (%GDP)	WDI
	Interest rate	IR	The average interest rate on loans and deposits for commercial banks (%GDP)	WDI

Base Line Equation

The baseline equation for the relationship between developments of the stock market (SMD) and its independent variables, FDI and control variables (CV), can be written as follows:

$$SMD_{it} = \beta_0 + \beta_1 FDI_{it} + \beta_2 INF_{it} + \beta_3 EXR_{it} + \beta_4 IR_{it} + \epsilon_i$$

Where:
SMD is a Stock market development.
 β_0 is the intercept term representing the baseline level of SMD when FDI and all CVs are zero.
 β_1 is the coefficient of FDI
 β_2 is a coefficient representing the impact of inflation,
 β_3 is a coefficient representing the impact of exchange rate
 β_4 is a coefficient representing the impact of interest rates,
 ε is the error term representing the unexplained variation in SMD. The baseline equation allows us to estimate the impact of FDI and CVs on SMD.

The purpose of the study is to determine the relationship between FDI and Stock exchange return. The study will use multiple regression analysis to estimate the impact of FDI and control variables on SMD. The regression model will include FDI as the main independent variable and the control variables as additional independent variables. The regression model's coefficients, which account for the influence of the control variables, will reveal the nature and direction of the association between FDI and SMD. The OLS regression analysis will provide a quantitative estimate of the impact of FDI and control variables on SMD, allowing researchers to test the hypothesis.

Data Analysis

The chapter provides insights into the statistical and theoretical framework. The impact of Direct Foreign Investment (FDI) on the development of the stock market can be analyzed from various perspectives. This chapter discusses the relationship between direct foreign investment and the stock market.the data for statistical analysis has been collect from WDI and from different websites of south asia countries from 2001 to 2021.

Table 2

Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Stock returns	126	0.915	0.858	0.741	0.973
Fdi	126	.142	.291	-.026	1.606
Er	126	75.215	40.934	12.242	198.764
int rate	126	2.886	4.884	-27.417	12.935
Inflation	126	6.394	3.903	-1.685	22.564

Descriptive statistics provide a summary or description of the features present in a given dataset. In Table 1, stock returns have 126 observations. The mean return is 0.915, indicating an average positive return on stocks. The standard deviation of 0.858 suggests that the returns have a variant close to the mean. FDI may be directed inflow or outflow. Investments made in a country from another country are measured by inflow FDI. Outflow FDI tracks investments made by domestic businesses in international markets. The mean FDI is 0.142, suggesting a relatively low average level of foreign investment. The standard deviation of 0.291 indicates that the data are closer to the mean of the FDI. The minimum value of FDI is -0.026, suggesting that there may be negative investment where the value of direct foreign investment has decreased. The maximum value of 1.606 indicates a relatively high level of foreign direct investment in certain instances.

Table 3

Matrix of Correlations

Variables	(1)	(2)	(3)	(4)	(5)
(1) l_stock	1.000				
(2) fdi	0.390	1.000			
(3) er	0.518	-0.164	1.000		
(4) int_rate	-0.090	0.080	-0.226	1.000	
(5) inflation	0.228	0.098	0.238	-0.392	1.000

A correlation analysis can highlight significant relationships between several data or groups of measurements. Knowing more about these connections might provide new viewpoints and emphasize

interrelationships. Table 2 shows a correlation between stock and other variables. The result indicates a value of 1.000, suggesting a perfect positive correlation between the stock sand itself. The value 0.390 indicates a moderately positive correlation between stock and FDI. The correlation between stock return and exchange rate, which we will now discuss, is found to be positively 0.518. However, the correlation between stock and interest rate is -0.090. This negative correlation reveals a negative association between the stock market's value and the interest rate, indicating that the stock market's value tends to decline somewhat when the interest rate rises. The correlation coefficient, on the other hand, is close to zero, indicating a weak connection. This positive correlation implies a sluggishly positive association between stock and inflation, suggesting that as inflation rises, the stock market's value tends to rise a little. The coefficient is nearly zero, though, just like the weak connection, showing a tenuous association. The connection between FDI and stock is positive. Exchange rate and stock have a moderately positive association. Rate of Interest and stock have an adverse association with one another. Inflation and stock have a comparatively weak positive association. It's crucial to remember that correlation does not indicate causation, and these findings simply reveal the variable's linear connection. FDI and exchange have a negative correlation. Interest rates and inflation have also negatively correlated with stock market development.

Table 4
Regression Analysis

	OLS	Random Effect	Fixed Effect Model
Fdi	2.883*** (0.443)	0.447*** (0.0550)	0.420* (0.218)
Er	0.0246*** (0.00316)	0.0222*** (0.00465)	0.0221*** (0.00221)
int_rate	0.0110 (0.0351)	0.0247** (0.0111)	0.0251** (0.0123)
Inflation	-0.0226 (0.0366)	-0.0328 (0.0213)	-0.0331** (0.0136)
Constant	5.545*** (0.390)	6.527*** (0.829)	6.586*** (0.229)
F-Stats(P Value)	0.000		0.000
Wald Test(P value)		0.000	
Observations	102	102	102
R-squared	0.502	0.3135	0.581
Number of ids		6	6

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Table 4 represents the following model results: OLS (ordinary least square method), Random effect, and fixed effect model.OLS (Ordinary Least Squares) is a basic linear regression model that assumes a linear relationship between the dependent variable and the independent variables. It estimates the coefficients by minimizing the sum of squared residuals. The coefficient for Fdi is 2.883, with three asterisks (***) indicating statistical significance at the 1% level. This means that a one-unit increase in Fdi is associated with a 2.883-unit increase in the dependent variable. The standard error of this coefficient is 0.443.

Random Effect Model is a panel data regression model that accounts for unobserved heterogeneity across individual units (e.g., countries, firms) by assuming random effects. It allows the coefficients to vary across different units.: The coefficient for Fdi is 0.447 with three asterisks (***) indicating statistical significance at the 1% level. A one-unit increase in Fdi is associated with a 0.447-unit increase in the dependent variable. The standard error of this coefficient is 0.0550.

The fixed Effect Model is also a panel data regression model that addresses unobserved heterogeneity by including fixed effects for each individual unit. It assumes that the coefficients of the independent variables are constant across different units.: The coefficient for Fdi is 0.447, with three asterisks (***) indicating statistical significance at the 1% level. A one-unit increase in Fdi is associated with a 0.420-unit increase in the dependent variable. The standard error of this coefficient is 0.218. In summary, the three models suggest that FDI has a positive and statistically significant relationship with the stock market index. The Fixed Effect model has the highest R-squared value, indicating the best fit among the three models, while the Random Effect Model has the lowest R-squared.

Conclusion

The goal of this study is to examine how stock market development (SMD) and foreign direct investment (FDI) inflows have affected South Asian nations. Inflation, currency rates, domestic saving, trade, GDP, and interest rates are some of the numerous control factors used in the study to analyze how FDI affects the growth and performance of stock markets. The study aims to offer insights into the overall impact of FDI on stock market development in the area by analyzing data from 2001 to 2021. FDI has a statistically substantial beneficial influence on the growth of the stock market in South Asia throughout the stipulated time, according to a regression analysis of the data. All three models OLS, Random Effect, and Fixed Effect—showed a consistent positive and statistically significant coefficient for FDI. This shows that a rise in FDI is linked to a rise in the region's stock market index.

The study's conclusions have a number of significance for investors, governments, and other stakeholders. This study demonstrates how the beneficial effects of FDI and stock market development may be seen in several South Asian nations, which implies that luring FDI can aid in the development and growth of the stock market. This suggests that governments should concentrate on establishing supportive regulatory frameworks, assuring investor protection, and fostering economic stability in order to facilitate FDI. This study also emphasizes the significance of considering control factors when analyzing the link between FDI and SMD, such as inflation, currency rate, interest rate, domestic saving, GDP, and trade. These variables can have a big impact on how the stock market reacts to FDI inflows, so policymakers need to consider them.

Even though this study offers insightful contributions, it's crucial to recognize its limits. The conclusions of this study may not apply to other geographical areas because it concentrated on South Asian nations. Additionally, because this study depended on secondary data sources, primary data collecting might improve the validity of the results. The research only took a few control variables into account. Therefore, there may be more variables that have an impact on the FDI-SMD link. Due to Bhutan's stock market's very tiny size, statistics from it are not accessible for this study. It would be good to include information from Bhutan's stock market, if available, in order to better understand the relationship between FDI and stock market development in the whole area.

The suggestions are put out in light of the study's conclusions and implications. By creating regulations that are attractive to investors, maintaining investor protection, and fostering economic stability, policymakers should place a high priority on fostering an environment that is beneficial for FDI. This will attract more direct foreign investment and potentially contribute to the development of the stock market. Governments should think about incorporating environmental concerns and sustainable development goals into their FDI promotion policies. Future research should think about gathering primary data to improve the quality and dependability of the results. Primary data collection can capture the subtleties of the various economic circumstances and offer more thorough insights into the FDI-SMD relationship. Future studies should consider more control variables, such as political stability, institutional quality, and sector-specific factors, to provide a more thorough examination of the factors impacting the FDI-SMD link. Overall, this study aims to further knowledge of the connection between FDI inflows and stock market development in South Asian nations, delivering insightful information to key players and fostering regional economic progress.

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