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Impact of Internal and External Debts on Financial Markets

Chaudhry Abdullah Imran Sahi[1], Muhammed Nauman Malik[2], Mehboob Alam[3]

The University of Lahore, School of Accountancy and Finance, Lahore[123], *Corresponding author:* abdullahsahi@uolcc.edu.pk

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External Debts, Internal Debts, Debt Servicing, Foreign Direct Investments and Crude oil Prices, Stock Market Capitalization

ABSTRACT

The empirical study explores the Impact of external debts, internal debts, foreign direct investments, Crude oil prices and debt servicing on Stock markets of Pakistan by using time series data from 1994 to 2018 on annual basis. Purpose of study is to investigate impact of debts on Pakistan stock market. External debts, internal debts, foreign direct investments, Crude oil and debt servicing are independent variables while Stock market capitalization is dependent variable. In this empirical study regression analysis model is applied. Model summary results shows that there is a significant impact of independent variables on dependent variable which give acceptance to alternative hypothesis. Value of R indicates that there is strong correlation of 97% between independent and dependent variables. Value of R square that shows that independent variable is strongly explaining variance in dependent variable by 95%. In model summery Durban Watson test shows value of 2.10 which indicates no auto correlation between variables. Correlation coefficients results show that there is a short term positive and significant impact of internal debts on stock market. Foreign direct investments also showed positive and significant impact on stock market capitalization while external debts servicing and crude oil have insignificant negative impact on stock market capitalization. This research will play a very beneficial role for developing countries and will attract wide audience including economists, equity analysts, investors and institutional investors to analyze their investment risk. This empirical research shows insignificant impact of external debts on stock market of Pakistan. Which implies that governments of developing countries can obtain internal debts on easier financial terms; which enhance liquidity and spending of developing countries. Consequently, more spending on infrastructure, power projects and availability of seaports and dry ports enhances the performance of business. Therefore, internal debt contributes toward the growth of financial market of Pakistan.

I. Introduction

Soludo (2005, p.3) said that development in secondary market is a sign of stability in market which will increase the participation of investor in market because security risk is mitigated. According to Alfaro (2003), FDI plays a primary role in economy and can have a negative effect on economic growth but it has positive relationship when these investments are made in manufacturing sector. FDI contributes positively to economic growth but its overall impact on economic growth may not be important and the constituents of FDI can impact economy positively. Many factors effecting stock markets capitalization can be found in literature. These factors include Gross Domestic Products, Foreign Direct investment, Crude oil, Exchange rates, Political instability and debt servicing, Consumers price index and many more. But not much focus was given to external debts. This may be due to that mostly countries in the world have no external debt issue like we have in Pakistan, so those researchers pay less attention in study of external debts and its impact on stock market.

Pakistan is a developing country in Asia with the population of 217 million and sixth most populated country in the world. It has a GDP of 278 billion dollars. According to financial year 2019 statics Pakistan has annual exports of 24.2 billion dollars with the import of 52.44 billion dollars. Pakistan is facing problems to meet its expenditures. It approached to IMF second time in this year.

Objective of research is to analyze the impact of internal debts, external debts, debts servicing crude oil and foreign direct investment on financial market of Pakistan.

- Do External debt, internal debts, foreign direct investment, Crude oil and debt servicing have impact on Pakistan stock market from 1994 to 2019?
- Do External debt, internal debts, foreign direct investment, Crude oil and debt servicing have insignificant impact on Pakistan stock market from 1994 to 2019?

Variables selected for this study are External debts, Internal Debts, Debt Servicing, Foreign direct investments and crude oil. Reason for selecting these variables will be explained one by one. External debts play a major role to get economy back to the track. These loans can be taken from other countries or from international financial institutions who grant these loans on different interest rates and conditions, External debts are considered because the condition imposed by these lenders are mostly very tough and difficult to implement so this can affect positively or negatively to stock market. Internal debts are also source of financing within a country by government. These loans are taken by countries to fulfill emergency needs. Government gets financed by issuing bonds and notes etc. Internal debts are considered in research because investor thinks rational and may go towards government bonds which will impact stock market. Debt servicing is also important because when government pay interest on debts to foreign countries or institutions foreign reserves start decreasing which impact stock market indirectly by inflation. Foreign direct investments also have an impact on stock market because this investment is mostly used in industries. Crude oil can also have impact on stock markets because it is widely used in industries and also in transportation.

This will play a very beneficial role for developing countries and will attract wide audience including economists, equity analysts, investors and institutional investors. Because their work is closely linked with stock market and they must think on various factors while making any decision and stock market is most complicated one. Research would be useful for lending Institutions including World Bank, Asian Development Bank, China Construction Bank and International Monetary Funds.

II. Literature Review

Matelis (2014) examined the impact of external debt on different economic sectors in Latin America. He took data of the 12 countries which are members of South America. Data has been taken from agricultural, manufacturing and service sector. The key variable used for analysis was External debt, economic sectors, agriculture, manufacturing, services, macroeconomic, panel data. The methodology used for analysis was regression analysis, time series analysis, panel data analysis and dynamic time series analysis to understand the correlation between variables. The finding showed that external debt has negative effect on agriculture and positive effect on services industry and negative impact on manufacturing industry. He suggested that there is need of balanced external debt management to ovoid the negative effect.

Siddique et al. (2015) investigated the impact of foreign debt on economic growth: empirical evidence from highly indebted poor countries. The analysis cover 93 indebted countries from 1969 to 1998. The key variables used for study was Economic growth, External debt, highly indebted poor countries and Debt relief. The study analyzed the effect of debt, capital formation and population increase on economic growth. They used Auto regressive distributive lag model for study. They found that external debt has negative impact on GDP, population increase, and capital formation have positive impact on economic growth.

Shahzad et al. (2014) examined the impact of external debt on economic growth: a case study of Pakistan. Data taken for analysis starts from 1980 to 2013.The variables used for analysis was external debt, GDP, Adjusting savings and exports. The methodology used was ADF test and multiple regression results found that external debt has negative relation with GDP. Researcher concluded that country should find other ways of financing and use private channel to increase exports.

Ould and Mahmoud (2015) studied the role of external debt on economic growth evidence from Mauritania. GDP, external debt and debt servicing was the variables used. They use ADF root test, OLS test and Johnson co-integration test in analysis found that external debt has negative impact on economic growth further suggested that data debt should be managed in a productive way and to ovoid use of debts for the personal benefits of officers or leaders.

Shah et al. (2015) examined FDI, external debt and their impact on economic growth of Pakistan examining data from 1970-2015.FDI and external debt was the variables used for analysis. The methodology used was ARDL and bound test approach of co-integration found that external debt has negative impact on economic growth and FDI has positive impact on economic growth in short run. Researchers further recommended that there is need of structural reforms and political stability to get benefit from FDI in long run.

Ayyoub et al. (2009) examined the debt burden of Pakistan its impact and remedies. The time frame selected for analysis from 1989 to 2009. Data used for variables has been taken from manufacturing sector, GDP and unemployment and debt. Methodology used was Ordinary Least Square (OLS) method and Durban Watson (DW) test statics by using secondary data. They revealed that external debt and liability have positive relation with manufacturing sector growth and weak but positive relation with GDP and unemployment but with actual debt and extra variable it shows negative results. Researchers further suggested that debt servicing should be controlled with better and skilled negotiation of experts with financial institutions.

Qayyum and Haider (2008) studied the institution quality role in external debt, foreign aid and economic nexus in low- income countries. Data from 1984 to 2008 was collected from sixty developing countries' panel. Variables use was external debt, foreign aid, governance and economic growth. They used the growth model of Solow-Swan model and hausman test in analysis found that governance has positive impact on all. And external debt has negative impact on output. Researcher found that foreign debts has governance issue and extra burden on developing countries and further suggested that government should go for foreign aid instead of foreign debt.

Ciftcloglu and Sokhanvar (2018) examined the impact of external debt on economic growth of central Eastern European countries with the time period of 1995 to 2014.The sample has been taken from 12 developing countries of central eastern European countries. Variables selected were GDP growth, external debt, inflation, investment and trade openness. The methodologies used were Panel regression analysis and causality test. researchers found that external debt and economic growth are negatively correlated and increase in external debt cause retardation of economy. They further suggested that external debt contract should be carefully negotiated.

Kharusi and Ada (2015) examined the impact of external debt on economic growth of emerging countries like Oman. Data is taken from timeframe of 1990 to 2015.study include external debt, economic growth, government investment and public investment of Oman. They use Auto Regressive distributive lag (ARLD) methodology for analysis. Result showed that there is a negative relation between external debt and economic growth. Researcher further suggested that Oman needs to manage its debt in a sound way and to use it for more productive resources.

Jilenga et al. (2016) examined the impact of foreign aid and external debt on the economy of Tanzania. Time period for data start from 1971 to 2011.the study includes variables External Debt, FDI and economic growth of Tanzania. They use Auto Regressive distributive lab model and bound test approach of co-integration. Study reveals that long term economic has positive impact on economic growth while FDI has negative impact on economic growth. They suggest that country should balance its long-term external debt and policies should be made for FDI to make a win-win situation in both cases.

Atique and Malik (2012) examined the impact of external and domestic debt on economic growth of Pakistan. Data has been taken from time period of 1980 to 2010.key variables used for study were External debt, debt servicing, inflation, investments and labor Force. They use least square method for co-integration, URT, SCT and CUSUM test of stability. Study revealed that there is inverse relationship between debt and economic growth. They further added that internal debt is better than external debt because external debt slows down the economic growth.

Jebran et al. (2012) examined the effect of public debt on economic growth of Pakistan in the time period of 1972 to 2012.Auto regressive Distributive lag methodology is used for the analysis of variables like public debt, GDP, GNP and economic debt. Study revealed that Public debt has negative impact on GDP and GNP in both long and short run period, but domestic debt has no effect on economic growth. They further suggested that reliance on debt should be minimized for the growth of economy.

Akram (2013) examined the relationship between debt and economic growth in south Asian countries. Data was taken with the time period of 1975 to 2011. They used economic growth, panel data, investment and public debt data for analysis by using panel data technique result showed that debt and debt servicing negatively affect the economic growth and investment of company due to high debt servicing.

Luqman et al. (2013) examined the foreign aid and macroeconomic factor performance and role of local sector institutions using the data of human capital, Foreign Aid, economic growth and effectiveness from time period of 1972-2011 and Auto Regressive Distributive Lag testing approach was used. Results revealed that foreign aid has positive relation with economic growth and financial sector play an important role to make foreign aid more effective for country and further added that both human and physical capital plays a vital role for the growth of economy in long run.

Ali et al (2016) studied the relationship between foreign aid, trade openness and growth with respect to Pakistan with the approach of Auto regressive Distributive lag and co-integration causality test on the selected variable external debt, economic growth, Foreign Aid investment and trade openness by taking data from time period of 1974-2016.Study revealed that economic growth have inverse relation between external debt and capital formation and positively related with trade openness and foreign direct investment. They further argued that a country should utilize it domestic resources by foreign aid or private investment to increase economic growth.

Forgha et al. (2014) examined the impact of external debt and domestic investment on economic growth in Cameroon. Data has been taken from external debt, domestic investment, economic growth and productive sector of Cameroon from the time period of 1980 to 2013 by using system estimation approach and two square least estimation techniques. Results revealed that external debt decrease the economic growth while domestic investment increases economic growth. They further recommended that country should manage its debt by making appropriate policy.

Chaudhry et al. (2009) examined the impact of foreign debt on the investment of Pakistan. Annual data of GDP, Debt, saving and investment was taken from the time period of 1973-2006.Multi regressive model was used for analysis. Results concluded that foreign debt has partially positive relation with investment and saving.it also revealed that external debt should be managed in a proper way because they have impact on investment and savings.

Sajjad (2018) studied the impact of external debt on the economic growth of Pakistan using the time period of !980-2016.Variables External debt, economic growth and export of Pakistan was analyzed by using Augmented Dickey Fuller test. Results indicated that external debt has negative impact on economic growth while exports and foreign direct investment have positive impact on economy so they suggested that government should try to ovoid foreign debt.

Lashari et al. (2016) investigated the choice between external and internal debt in consequences of Pakistan by using annual data of External Debt, GDP, Debt Servicing and economic Growth from the time period of 1972-2010. Auto Regressive Distributive Lag (ARDL) approach was used. They found that both foreign and domestic debt has negative impact on economic growth so policy makers should use alternative sources for revenue instead of relying on debt.

Kumar et al.(2019) investigated the impact of external debt and exchange rate volatility on domestic consumption of Pakistan using data from time period of 1980-2014.They applied error testing model and bound test approach for analysis and found that interest rate and exchange rate has positive while exchange rate volatility has negative impact on domestic consumption of Pakistan.

Scott and Ovuefeyen (2014) studied the impact the impact of government expenditure and debts on Nigerian stock market. The variables selected for analysis was Nigerian stock exchange, stock market development, Government expenditures and government debts. They use co-integration methodology and error mechanism to study the impact of debts and government spending on Nigerian stock market. They used data of Nigerian central bank. Results revealed that external and internal debts have no impact on stock market. Currency depreciation has positive impact on stock markets. Government capital expenditure adversely affects stock market. Trade openness has significantly negative impact on stock market and commercial bank increasing interest rate has adverse effect on stock market. They recommended that government should ovoid overvaluation of currency and to decrease the interest rates by using monitory policy and should manage capital expenditure in a efficient way to increase economic growth.

Richard and Filicia (2018) examined foreign direct investments and development of stock market capitalization in Sub-Saharan Africa. Variables used for analysis was Foreign direct investments, Stock market capitalization and Stock market developments by using time series from 1984 to 2015They selected three major countries of sub –Saharan Africa namely Nigeria, South Africa and Kenya. They get data from IMF and central banks of those countries. They used unit root test least square regression model and panel data for analysis. Results shows that foreign direct investments have significant impact on stock market capitalization and further recommended that government should provide a safe and attractive environment to foreign investors to get maximum benefits.

Rai and Bairagi (2014) examined the impact of changing in oil prices on Indian stock market. Variables used for analysis was oil prices, BSE-Sensex and India. Time frame for data was from 2003to2012 in monthly time series data. They used regression model, trend analysis and correlation analysis to check the impact. Results indicated they oil prices and stock market has weak but significant impact on stock markets.

Pervaiz et al. (2018) studied the impact of macroeconomic variables on Karachi stock exchange returns. Variables used for analysis was KSE returns, Macroeconomic variables and stock prices. Time frame for study was from 2007-2017.Return were calculated from opening and closing of market. They use inflation, exchange rates and interest rates as independent variables. Model used for analysis was Regression model. They found that stock market has negative relation with stock price and inflation and exchange rates have no significant impact on stock market returns.

Alraimony et al. (2012) examined the impact of macroeconomic variables on Amman stock market. Variables used for analysis was Jordan stock exchange, macroeconomic variables and stock returns. Monthly data was taken with the timeframe of 1991-2010.macro-economic variables included real gross domestic products, consumer price index, Real money supply, weighted average interest rates on loans and advances and dummy variables. They applied unit test and normality test. Results indicated that money supply, exchange rates and inflation have negative impact on stock market where real gross domestic products have positive role on stock market. Moreover, they suggested that government should make better monitory policy.

Ready (2012) examined the relationship between oil prices and stock market. Data used for analysis was from 1983 to 2012.results indicated that oil prices have significant impact on stock market capitalization of US and other stock prices. He found a low correlation between variables. He said that this impact is higher in countries who import oil from other countries.

Agarwal et al. (2018) examined the impact of oil prices on Indian stock market. The variables used for analysis was crude oil, prices, stock market, great economic depression and liquid gold. They took data of 25 years from 1987 to 2012 for analysis, they used regression analysis to check the impact. Results revealed that crude oil has a significant impact on Indian stock markets.

Amjad and Malik (2013) studied on foreign direct investment and stock market. They used secondary data from 985 to 2011. They used Johnson co-integration approach to find out relation between foreign direct investment and stock market. They found that foreign direct investments and stock market has positive and significant relationship.

Ahmad and Raza et al. (2012) examined the role of foreign direct investment in stock market development in Pakistan. They used annual data from 988 to 2009.They apply ordinary least square method to check the role of foreign direct investment in Pakistan stock market. The result indicated positive impact of foreign direct investments in Pakistan stock market.

III. Research Methodology

In this research we will use deductive research approach for analysis. Deductive research approach is use in case of quantitative data. This approach is used to find if there is any relation between variables. Deductive research approach moves from hypothesis to conclusion.in other words deductive research approach move from specific to general.

Do external debts, internal debts, foreign direct investments, Debt Servicing and Crude oil have impact on Pakistan stock market from 1994 to 2018?

H_0: External debts, internal debts, foreign direct investments, Debt Servicing and crude oil have insignificant impact on Pakistan stock market**.**

H_1: External debts, internal debts, foreign direct investments, Debt Servicing and crude oil have no impact on Pakistan financial market**.**

Explanatory studies are used in research it is also known as casual study.it shows the effect and relation of one variable over another. In explanatory research historical data is used which is very easy to access and give us a significant result. Secondary data is used for analysis.

External debt plays an important role for the growth of economy in developing countries. With the help of external debt, a country can use its internal sources more effectively. But external debt is only beneficial when there are appropriate conditions for the repayment of debt. External debts should be used in a productive way. Foreign direct investment means investment of foreign countries or people directly to other country. Foreign direct investment can be beneficial for both investor country and the country whom investment is made but to increase foreign direct investment a developing country should take steps to make investor confident that his investment will safe.

Internal debts mean a debt which a country gets from its internal sources for their financial needs. These debts are mostly obtained from public, banks and other financial institutions. Government should properly analyses the need and use of this debt before taking any debt because if debts are not used in productive way there are chances of extra loss which lead a country to financial distress.

Debt servicing means that extra amount is interest on principle amount borrower must pay on use of debts. Before taking any debt, a country should negotiate the terms of repayment and interest more carefully because if you must pay more interest than the actual benefits gained from use of debt then there will be no benefit of debt.

Oil is the major source of energy in mostly countries and countries spend a large amount of money on purchasing the oil so increase or decrease in oil prices has big impact on economy of country.

Stock market is the one of the biggest indicators of economy of country. Stock market capitalization means the total amount of money invested in the markets. Stock market capitalization is calculated by adding all the market capitalization of companies listed in stock exchange. Stock market also indicates the economic stability of country.

In this research multiple regression analysis technique will be used. Regression analysis methodology is used to measure impact of one variable over another.

Regress analysis equation

$$Y= \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \in$$

Where

Y=Stock market Capitalization

X_1=External Debt

X_2=Internal Debt

X_3=Foreign Direct investment

X_4=Debt Servicing

X_5=Crude oil price

IV. Analysis

First and foremost, thing we must check after getting results is Multi-collinearity issue (if any). Multi-collinearity statics is used in regression analysis to check if there is any high correlation between at least one independent variable with combination of other independent variables. Multi-collinearity value should be less than 10. if it is more than 10 then there is a multi-collinearity issue in data, and we must remove it.

Table 1: Multicollinearity

Variables	Tolerance	VIF
External Debts	.716	1.396
Internal Debts	.118	8.458
Foreign Direct Investments	.388	2.581
Log of Crude oil	.507	1.973
Debt Servicing	.147	6.794

As we can see from results above that all the values in VIF table are less than 9.0 and no value is more than 9.0. So, we can say that there is no multi-collinearity issue in the variables.

Table 2: *Model Summary*

R	R square	Sig F change	Durban Watson
.979	.959	.000	2.100

Model summery consist of R, R-square, Sig F change and Durban Watson. Explanation for all columns is as follow:

R represents the simple correlation of all the independent variables with dependent variables. Here value of R is 97.7% which indicates that independent variables have a strong correlation with dependent variable. Value of R square indicates to what extend independent variable is explaining variance in dependent variables. In our case R square value is 95.9%. It is very high and shows that independent variable is strongly explaining variation in dependent variable. Sig F change explains the acceptance and rejection of null and alternative hypothesis. If value of sig F change is less than 5% it indicates the rejection of null hypothesis and vice versa. In our case as F value significance is less than 5% so alternative hypotheses is accepted. It indicates that independent variables have significant impact on dependent variable. Durban Watson is a test used to check autocorrelation between variable. Durban Watson has value between 1.5 and 2.5 indicates no autocorrelation. In our case we can see that value is 2.1. Which indicate a no autocorrelation between variables.

Table 3: *Coefficients*

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3560.85	7298.64		0.48	.631
External debts	-5.22	10.73	-.027	-0.48	.632
Internal debts	413.59	48.18	1.16	8.58	.000
Debts Servicing	-5336.93	6062.13	-.107	-0.88	.390
Crude oil	-3270.47	1792.42	-.120	-1.82	.084
Foreign direct investments	1099.85	433.84	.190	2.53	.020

Beta coefficient explains impact of change in dependent variable by independent variable. Results shows external debts, debts servicing and crude oil has insignificant and negative impact on stock market capitalization while internal debts have short term significant and positive impact on stock market. Foreign direct investment also have significant and positive impact on stock market capitalization it means that with the increase in internal debts or foreign direct investments stock market capitalization will also increase and vice versa.

V. Conclusion

Regression analysis model is applied to check impact of external debts, internal debts, debt servicing, Crude oil and foreign direct investments on Pakistan stock market. Time frame for research is (1994-2019). Model summary results shows that there is a significant impact of independent variables on dependent variable which give acceptance to alternative hypothesis(H_1). Value of R indicate that there is 97% correlation between variables. And in R square independent variable is explaining dependent variable by 95%. In model summery Durban Watson test shows value of 2.10 which indicates no auto correlation between variables. Correlation coefficients results showed that there is a short term positive and significant impact of internal debts on stock market. Foreign direct investments also show significant positive impact on stock market capitalization while Debts servicing, external debts and crude oil have insignificant negative impact on stock market capitalization.

In generally and previous studies it is observed that external and internal debts both have no impact on stock markets like "(scott and ovuefeyen, 2014) study on external debts and internal debts in Nigeria indicated that external and internal debts have no impact on impact on stock markets". Felicia & Richard (2018) study on foreign direct investment and stock market in Africa showed that foreign direct investment has significant impact on stock markets. Mauraya (2016) studied the impact of foreign direct investments on Indian stock market and found that foreign direct investments have significant impact on Pakistan stock market. But these results can be different in different countries because these debts are used for different purposes. In Pakistan external debts has no impact on stock markets because these debts are mostly used in debt servicing and have no impact for a short terms on the other hand these debts are mostly used in big projects which give fruit after long time mostly these projects take many years.so we can say that external debts has no impact on stock market for short term. Debt servicing is also linked with external that and most part of external debt goes towards debt servicing therefore debt servicing also have on impact on stock market. Debt servicing doesn't play any significant role in growth of economy and rotation of capital because most of this capital goes outside the country which can only cause reduction of foreign reserves. Foreign direct investments have significant impact on stock markets. FDI play a vital role in progress of economy in country. Foreign direct investments can only be attracted when there is economic and political stability in a country and the opportunities which attract an investor. Internal debts have significant impact on stock market because these debts are mostly used for operational and emergency use. As this money is used inside the country to fulfill any gap or need of country which cause the rotation of capital in the country and this rotation of capital ultimately results in increase of stock market capitalization. But internal debts benefits are short term which adversely effect economy in long term.

Although internal debts have significant impact on stock market, but this impact is for short term. In a short run stock market might increase but internal debts adversely effect economy in long run because by the use of more internal debts it can cause inflation in country and high inflation cause high interest and as a result high interest rates cause the contraction of economy.so we should not encourage internal debts .Foreign direct investments is very beneficial for economic growth of developing countries. It can bring a major change in economy and stock market. Foreign investors can only invest when there are favorable conditions for them and low risk. Government should take steps to avoid political and economic instability to attract foreign investors and to encourage them to invest in our country.

Implication of Research

Research is beneficial for developing countries and will attract wide audience including economists, equity analysts, investors and institutional investors. They will be able to emphasize on major factors which can impact on stock market. Research would be useful for lending Institutions including World Bank, Asian Development Bank, China Construction Bank and International Monetary Funds. This empirical research shows significant impact of internal debts on stock market of Pakistan. Which implies that governments of developing countries can obtain internal debts on easier financial terms; which enhance liquidity and spending of developing countries. Consequently, more spending on infrastructure, power projects and availability of seaports and dry port enhances the performance of business. Therefore, internal debt contributes toward the growth of financial market of Pakistan.

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