



## CORPORATE EARNINGS AND GDP GROWTH FOR INVESTMENT DECISIONS IN INDIA: AN IN-DEPTH LITERATURE REVIEW

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### Abstract

For many years researchers are trying to measure the impact of variation of macroeconomic variable on the earning of company and the market return. Out of so many macroeconomic variables GDP is one of the important variable. In the current research, we have tried to identify the views of earlier researcher on the said topic as well as the gap area for the further research. However, there is not much research to find out companies that are able to outperform better than the GDP growth rate and their performance visa vis the market and the respective industry.

**Keywords:** Macroeconomic Variable, GDP, Earnings.

### Introduction

GDP is an important component of an economy. The growth rate of GDP matters to the health of an economy, whether it is developed economy or developing the economy. Despite consistent ups and downs in the global economy due to economic fluctuations, GDP growth rate plays a significant role in shaping global economic development.

During investment decision, the major focus of the present day investor is on the current economic indicators of a nation. The importance of economic indicators cannot be ignored in the investment landscape. The market may defy the underlying fundamentals in the short term, but it is impossible to defy in the long run which makes it essential for the investors to keep track of some of the key economic indicators. In simple words, apart from the industry and company news, investors should also devote time to some economic indicators like GDP growth rate, Inflation Index and Index of Industrial Production (IIP).

### Significance of the Study

Does it make any sense to compare a company's earnings growth with the change in macroeconomic variables of a country? It is advisable that the growth of macroeconomic variables is more conveniently compared with growth of revenue. The earnings are derived from revenues, after deducting different costs. Hence as an output of revenue earnings of a firm can be correlated with macroeconomic variables as the two are partially correlated. The present study aims at identifying the above relationship from the earlier research.

### Literature Review

In a competitive economy technological change largely benefits consumers through a higher standard of living, rather than benefiting the owners of capital. Increase in individuals' savings and investment is able to increase in real wage rates, resulting less benefit to the owners. Economic growth does assure a better standard of living, higher dividend and wealth maximization through higher present value of return (Warren Buffet, 1999; Jeremy Siegel 1999, 2000). In East Asia due to increase in employment, socio-economic condition and personal savings of individuals the overall economic growth is too high (Krugman 1994, and Young 1995). Chhatoi & Pattanayay (2013a) concluded that the growth of Indian economy is greatly influenced by foreign capital. The impact of FDI was more than the impact of FII for growth of the economy. Further, on 'openness' of economy Chhatoi & Pattanayay (2013 b) concluded that openness as a macroeconomic variable have a positive relation on growth of Indian economy. They also suggested that the capital inadequacy in developing countries can mitigate through foreign capital inflow and also drives the growth cart. All the above statements indicate importance of macroeconomic environment across the world.

### Impact of FDI on Economic Growth

Dasgupta, (2005) revisited the role of different sectors on economic development. He compares the impact of manufacturing and services on economic development. He identified in few developing countries the growth of service sector is faster than manufacturing sector whereas other follow 'de-industrialization' for higher growth in economy. He also pointed out that the developing countries are characterize with low levels of per capita income, growth in unemployment including countries such as India; and a large expansion of the informal sector in developing countries.

Chandana, (2008) conduct a research on flow of FDI to specific sectors with the help of Granger causality on a panel data. He pointed out that the flow of FDI varies across the sectors. The higher flow of FDI is to the manufacturing sector which leads to higher growth in this sector. The FDI flow is negligible to the primary sector but the FDI flow to the service sector is able to increase the growth rate of service sector as well as catalyst for the growth in the manufacturing sector and other sectors.



Lall (2004) analysed the role of multinational enterprises (MNEs) in industrial development in a 'learning system' perspective. They also studied the policy tools available for using FDI for economic development in a liberalising, post-World Trade Organization world, and the constraints to doing this. They concluded that multinational enterprises are a promising debate for the open of economy and an easy way to cope with increasing pace of complexities of globalization.

Alfaro (2004), tested interdependency among foreign direct investment (FDI), financial markets, and economic growth. They explored whether countries with better financial systems can exploit FDI more efficiently. They showed that flow FDI greatly dependent on a well developed financial market of a country. FDI is responsible for the development of economy but it depends on the development of financial market in an economy.

Mohammad (1983), examined the survival of 'monopolistic advantages' of multinationals in a closed economy like India considering only the largest corporate. He concluded that foreign ownership is not the only factor for growth in export but also the Govt. policies in India. He identified a foreign ownership as well as Govt. policy had a positive impact on export performance.

Chowdhury (2003), find out the causal relationship between FDI and economic growth by using time-series data covering over a period of 1969- 2000 developing countries like, namely Chile, Malaysia and Thailand. They concluded that, for the developing country like Chile, GDP causes FDI but not FDI causes GDP. But in case of Malaysia and Thailand, GDP causes FDI as well as FDI cause GDP.

Srinivasan, (2010) investigated the causal nexus between Foreign Direct Investment (FDI) and economic growth in Association of Southeast Asian Nations (ASEAN) economies. The Johansen Co-integration result established a long-run relationship between FDI and Gross Domestic Product (GDP).

Tang,(2008) showed that while there was a bi-directional causality between domestic investment and economic growth, there was only a single-directional causality from FDI to domestic investment and to economic growth. Rather than crowding out domestic investment, FDI was found to be complementary with domestic investment. Thus, FDI had not only assisted in overcoming the shortage of capital, it had also stimulated economic growth through complementing domestic investment in China.

Yao, (2006) focused on the effect of exports and foreign direct investments FDI on economic performance, using a large panel data set encompassing 28 Chinese provinces over the period 1978–2000. Adopting Pedroni's panel unit root test and Arellano and Bond's dynamic panel data estimating technique, it was found that both exports and FDI had a strong and positive effect on economic growth. The results suggested that two development policies adopted in China were useful for other developing and transitional economies: export promotion and adoption of world technology and business practices.

Chakraborty, (2002) suggested the two-way link between foreign direct investment and growth for India was explored using a structural cointegration model with vector error correction mechanism. The existence of two cointegrating vectors between GDP, FDI, the unit labour cost and the share of import duty in tax revenue was found, which captured the long-run relationship between FDI and GDP. A parsimonious vector error correction model (VECM) was then estimated to find the short run dynamics of FDI and growth. There VECM model revealed three important features: GDP in India was not Granger caused by FDI; the causality runs more from GDP to FDI; Trade liberalization policy of the Indian government had some positive short-run impact on FDI flow, and FDI tended to lower the unit labour cost suggesting that FDI in India was labour displacing.

### **Economic Growth and Foreign Investment**

Samal (1997) conducted a study on the consequent problem due to the hot money movement by FIIs and concluded that there was a steady integration of the Indian stock market with the global market. Pal (1998) suggested that inflow of FIIs has failed to strengthen the stock market, and his study did not support the view that FIIs inflows leads to economic development in India. K. S. Chalapati Rao et.al., (1999) found that net FII investments influence stock prices in India as it traces the relationship to the sectoral level and the heavy emphasis on computer software and consumer goods was observed in the Indian stock market for the period from 1994-99.

Pethe and Karnik (2000) in their study attempted to analyze how the stock market indices are affected by macroeconomic variables in India. In their study, they ran causality tests in an error correction framework on non-co-integrated variables. The study found a weak causality running from IIP to share price index (Sensex and Nifty). They held the view that the state of the economy affects stock prices.



Chakrabarti (2001) has observed that foreign institutional investors and domestic investors are at par with each other as far as the access to knowledge is concerned in the Indian markets. He has taken a monthly data set for the period May 1993 to December 1999 and found that FII net inflows are the effect of the Indian stock market returns rather than the cause of returns. On the contrary, Mukherjee, Bose and Coondoo (2002) suggest that FII flows to and from the Indian market are caused by returns in the domestic equity market.

Bhattacharya and Mukherjee (2002) in their study used the Granger causality test to examine the causal relationships between Sensex and five macroeconomic variables such as Inflation, IIP, Interest Rate, National Income, and Money Supply for the period from 1992-93 to 2000-01. From their study, they found that IIP affects the fluctuations in the Sensex and there exists a bi-directional causality between the Rate of inflation and the Sensex.

According to Bengoa and Sanchez-Robles (2003), FDI has a positive association with economic growth, provided the host country must have human capital, economic stability and liberalized markets in order to benefit from long-term FDI inflows. The study by Durham (2004) finds a negative association between FDI and economic growth; but suggests that the effects of FDI are contingent on the absorptive capability of host countries. Bende-Nabende et al. (2003) find significant positive association between FDI and economic growth in the country like Philippines and Thailand and negative association between the two in the country like Japan and Taiwan. This is mostly due to more absorptive capabilities of Japan and Taiwan in contrast to Philippines and Thailand. The negative association between FDI and economic growth also find by Germidis (1977), Mansfield and Romeo (1980), Haddad and Harrison (1993).

Further, Bose and Coondoo (2004) have found evidence of bi-directional causality between returns on the BSE stock index and FII net inflows. According to them, this causality is due to increase in FII inflows caused by an upsurge in global equity markets.

Bhat et al., (2004); Kohpaiboon, (2006) suggested that Foreign Direct Investment (FDI) plays very key role in development. Its role is manifold and can be analyzed under two different conditions: first, the determinants of FDI on development; second, causality between FDI and development. In the first case, the role of FDI is country specific and can be positive, negative or insignificant, depending on the economic, institutional and technological conditions in the recipient economy

Sharma and Singh (2007) examined the significance of the variables like Foreign Exchange Reserves, Claims on the Private Sector, Wholesale Price Index, Call Money Rate, Index of Industrial Production, Exchange Rate and Broad Money on the Sensex. They used the monthly data horizon from April 1986 to March 2005. In their study, they used multiple regression analysis. From their study, they found that variables like IIP, Foreign Exchange Reserve, claims on the Private Sector, Exchange Rate and Money Supply had a considerable influence on the stock market movement. Very few variables like Interest Rate and Wholesale Price Index showed a very negligible influence on the stock market.

Padhan, (2007) stated that this can be an eye-opener for policymakers and regulators to understand the balancing act for developing economic activity and at the same time, controlling foreign institutional investment into the Indian stock market.

Kanakaraj et al. (2008) examined the trend of the stock prices and the various macroeconomic variables for the time horizon from the year 1997 to 2007. In their study, they said that the boom in stock market for the period from 2003 to 2007 can be explained in terms of macroeconomic fundamentals.

Nidheesh (2008) studied the impact of foreign institutional investment in India and its impact on the BSE and NSE and also addressed various issues. In his research, he observed that the FIIs have been significant in bringing about an the improvement in the trade practices of the stock market since liberalization, but at the same time, this advantage turns into a disadvantage in terms of destabilization of the market because of the trading pattern of FIIs in India.

Rajkumar and Gupta (2010) also found from their empirical study that FIIs affect the Indian market for their own interest and returns and the risk in international markets are the two major driving factors for the inflow of FIIs into India.

Singh (2011) attempted to explore the causal relationship between stock market indices and three macroeconomic variables of the Indian economy - Index of Industrial Product (IIP), Wholesale Price Index (WPI) and Exchange Rate. In his study, the researcher found that Indian stock market was approaching towards informational efficiency at least with respect to two macroeconomic variables such as Exchange Rate and Inflation.

Gupta (2011) rightly observed that whereas the boom in the capital markets could only be possible because of the FIIs, nevertheless, the crash of the capital markets is also attributed to the sudden withdrawal by this category of investors.



Chaturvedi, (2011), studied the sector wise and country wise FDI inflow in India and found that Mauritius, Singapore, USA and UK are the countries showing much interest to invest in India and maximum FDI has taken place in the service sector, computer hardware and telecommunication sectors.

### **Stock Price, Earnings and Economic Growth**

Romer (2000) argues that higher growth should lead to higher discount rates because people are less willing to defer current consumption for future consumption when they will be wealthier. This effect would result in more conservative valuations when long-run growth is expected to be high. Indeed, the effect of an unanticipated change in growth prospects would be to lower stock prices as multiples contract.

Diamond (1965) adds the effect of taxes on the capital stock and differentiates between public external and internal debt. He concludes that, through the impact of taxes needed to finance the interest payments, both types of public debt reduce the available lifetime consumption of taxpayers, as well as their saving, and thus the capital stock. In addition, he contends that internal debt can produce a further reduction in the capital stock arising from the substitution of government debt for physical capital in individual portfolios.

Adam and Bevan (2005) find interaction effects between deficits and debt stocks, with high debt stocks exacerbating the adverse consequences of high deficits. In a simple theoretical model integrating the government budget constraint and debt financing, they find that an increase in productive government expenditure, financed out of a rise in the tax rate, will be growth-enhancing only if the level of (domestic) public debt is sufficiently low.

Barro and Ursúa (2009) made a broad-based study of 30 countries on stock market crashes and depression up to the year 2006 and produced interesting results: the likelihood of a depression (defined as a decline of Real GDP by at least 10%) increases by 20% in a stock market crash (defined as an index decline of at least 25%). A depression is highly unlikely in the absence of stock market crash. The sample consisted of 209 stock market crashes and 59 depressions during peace times.

Dimson, Marsh and Staunton (2010), studied 83 countries over 110 years (The year 1900 to 2009), and they found no evidence that investing in growth economies produced superior returns. However, they found that stock markets incorporate predictions of future economic growth. When markets recover, economies tend to follow.

O'Neill (2011) analysed to reveal that the link between GDP growth and equity returns is, in fact, very strong. He concluded that equity markets are a lead indicator of GDP growth and react strongly to expectations about the future. Changes in consensus GDP expectations are likely to influence equity prices. While there is considerable diversity across countries, in general, the sensitivity of equity returns to future growth forecast revisions appears to be much higher in the growth markets than in the advanced world.

Sandte (2012) takes a fresh look at the relationship between GDP growth and stock markets. The relationship remains complicated, because of the interwoven effects of multiple and time-variant factors, which differ from one country to next. While accurate economic forecasts are helpful for stock investing, he argues that investors should relinquish any hopes of finding a single economic indicator that will predict future market developments early and reliably. His study suggests that high growth rates do not necessarily correlate with the highest long-term stock market returns. Nevertheless, major stock market movements, as per him may contain valuable information for economic forecasters.

Estrada (2012) in his research concluded that even though everybody loves a growth story, investors should care ultimately about the returns they pocket from their investments and the risk they have to bear while exposed to those investments. And from that point of view, growth provides an incomplete and misleading story. Blinded by growth, investors often fail to see this fact. Neither fast economic growth nor fast corporate growth guarantees high returns in the pocket of investors. The reasons are many and varied, but valuation plays a critical role. Although it is not entirely clear whether the value is riskier than growth, it is quite clear that in the long term; value investing clearly outperforms growth investing.

### **Inflation and Stock Price**

Wei, (2006), used VAR results to advocate in inflation illusion as the explanation for the positive association between in inflation and the dividend yield. Contrary to their results, we find that a fully rational dynamic general equilibrium model can generate a positive correlation between the dividend yield and inflation of comparable size to its data counterpart. The model results support a proxy hypothesis, according to which, a third factor, which in our model represents technology shocks, moves both inflation and the dividend yield in the same direction, resulting in a positive correlation between the two. The VAR structure of our model solutions makes it possible to decompose the dividend yield into the long-run expected dividend growth rate and the discount rate components so that their relative importance can be studied.



Boucher, (2004), considers a new perspective on the relationship between stock prices and inflation, by estimating the common long-term trend in real stock prices, as reflected in the earning price ratio, and both expected and realised inflation. He studies the role of the transitory deviations from the common trend in the earning price ratio and realised inflation for predicting stock market fluctuations. In particular, he finds that these deviations exhibit substantial in the sample and out-of-sample forecasting abilities for both real stock returns and excess returns. Moreover, he finds that this variable provides information about future stock returns at short and intermediate horizons that are not captured by other popular forecasting variables.

Inflation rate affects stock prices in different economies but the relationship between unexpected inflation and stock prices is unclear. (Fama and Schwert 1977) and (Fama 1981) found a significant negative relationship between stock market and inflation. However, Hardouvelis (1988) found no significant relationship between the two variables. Since the relationship between inflation and stock prices is not clear, it is important for the researcher to find out the behavior of different variables. (Fisher 1930) studied that the expected rate of inflation is composed of real return and expected rate of inflation. The Fisher hypothesis concludes that there is no relationship between real return and monetary sector. The Fisher hypothesis was applied to stock returns and most of the studies give an inverse relationship between stock return to expected and unexpected inflation (Nelson 1976; Geske and Roll 1981). Results from previous research study conclude that there is a negative relationship between stock returns and inflation (Fama and Schwert 1977); (Fama 1981). Fama (1981) discusses that stock return is negatively related to inflation due to the reason that stock return are positively related to the real activity and the real activity is negatively related to the change in the level of prices. Though, the theory suggests that equities are a good hedge against inflation that's why the rate of return may be unaffected by inflation.

Spyrou (2001) examines the relationship between stock returns and the inflation rate in Greek by using monthly data from January 1990 to June 2000. The result for the period 1995-2000 shows a negative but insignificant relationship, while for the period 1990- 1995 there is a significantly negative relationship. A possible explanation is that there is a negative correlation between inflation and real output growth (Fama 1981). Omran and Pointon (2001) use cointegration analysis and error correction model to analyse the impact of the inflation rate on the Egyptian stock market. The results show that the inflation rate has a definite impact on the stock market in Egyptian. Greenspan and Allen (1995) examined that the inflationary expectations may have countervailing effects on equity prices. For example, an increase in inflationary expectations may benefit equity prices by decreasing the real value of corporate debt, thus increasing the firm's value. This may be particularly true because private debt is rarely effectively indexed to inflation. Conversely, a decrease in the future inflation rate may reduce equity values because the real value of debt rises, reducing the firm's value. Furthermore, a decrease in inflationary expectations decreases nominal interest rates which may cause stock prices to go up because lower rates mean a higher present value of the future stream of corporate earnings. But lower inflationary expectations may also lower the expected future stream of earnings which could lower stock prices. So the inflationary expectation effect on stock prices may be neutral or indeterminate. Finally, Gallagher and Taylor (2002) describe the hypothesis of (Fama 1981) by looking at the relationship between stock return and inflation using multivariate innovation decomposition. The results show a strong support for the hypothesis in the US.

### **Gap and Conclusion**

Plenty of research work has been made at international level and national level on the relationship of change in macroeconomic volatility and overall economic growth and the conclusions as seen from above literature review are mixed. However, there is not much research to find out companies that are able to outperform than the GDP growth rate and their performance visa vis the market and the respective industry. Hence, further research may be conducted on the gap area.

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