CHAPTER TWO: LITERATURE REVIEW

Introduction

This research paper focuses on the impact of Macroeconomic Indicators on the financial performance of firms. The literature review is divided into nine sections. It covers the introduction to the importance of these indicators on the overall performance and productivity of the firm. In the section after that, we will be discussing the external factors influencing the business of the firm. Moreover, the effect of these macroeconomic indicators on inflation, political stability exchange rate, interest rate, GDP, firm size and money supply are defined in detail below. Following that is the performance of the firm. The most important are the factors affecting a firm's performance in earnings per share, return on assets, return on equity and the earnings before interest and taxes. In the seventh section of this research paper, we discuss the past studies conducted on this topic and review them in detail. In the last conceptual framework is given to map out the actions required in the course relating them to the past studies. The last heading of the literature review summarizes the overall discussion and findings of the topic.

Importance of Macroeconomic Indicators for Organization

Microeconomic and macroeconomic indicators both create an impact on the growth of the country as well as the performance of the organization. The organizations are aware of these indicators to decrease the influence of these on profitability and cash flow. The key macroeconomic indicators are the rate of unemployment in-country, GDP, political stability, inflation rate, and growth of economic, interest rate and balance of payment.

The indicators of macroeconomic have a direct impact on an organization's performance Such as fluctuation in interest rate, taxation at the national level, cost of raw material and currencies which have a great influence on a firm's profitability. (Mwangi, 2017)

The profitability of an organization depends upon the interest rate which is related to its borrowing of cash and deposit. The increase and decrease in interest rate would create an impact on the performance of the organization. Performance of the organization is abilities are to produce and retain revenue, the stability of firm and growth of the firm. The performance of an organization is measured with the help of growth and measurement of macroeconomic indicators. It is also evaluated from investment and adequacy of capital, assets, cash flow, liabilities, size of employee and other measures. The ROE return on equity is also a way to evaluate the level of efficiency within the Organization. It shows that how efficiently the Organization able to get shareholders (Mugge, 2016). The growth of country and rate of GDP gross domestic product also responsible for organization's growth, it allows to management to evaluate the impact of monetary policy and fiscal policy on firm's revenue along with that it contributed in a business process cycle (Ashraf, 2017).

External Factors Influencing the Business

The organizations affected by the external factors which may influence the entrepreneurship, innovativeness and internationalism of organization. It is clearly examined that the external environment is necessary for every organization's change but also analyses the growth of the business. The external factors also directly or

indirectly impact the operations and decision of the firm. The external factors which may influence the business are included: political, social, technological, environmental and legal. The external factors have created a major influence on business by influence on the structure of supply and demand. Organizations need to monitor the macroeconomic indicators after some time (Adeoye, 2012).

These factors provide both assisting and the influence on a firm's performance. The performance discusses the point from where organization achieves its strategic goal, input, outcomes and output. It is the real outcome which evaluates against predicted goals. Firms have better insight about its affecting external factors to attain competitive advantage.

Some macroeconomic and political indicators effect on business such as the economy of country, rate of inflation in-country, availability of human resource for Organization, availability of resources for company's operations, rate of taxation in-country, competition in between industries, political stability, democratic system of politics and freedom for entrepreneurs, actions of government directly or indirectly for entrance in market , legal requirement for the protection of property, fiscal and monetary policy, immigration policies in country. All these political and economically affected the performance and growth of the business because they create a favorable environment for the development of business (CHITECHI, 2014).

Macroeconomic Indicators

Inflation

Inflation is one of the most imperative factors that may lead to having an impact on the financial performance of the firm. It could be considered as the rise in prices and a decrease in the purchasing value of money. Once inflation takes place in an economy, it becomes difficult for businesses to purchase the raw materials and other required goods in a feasible price range (Gali, 2015). The price hike augments the cost of production and firms are eventually forced to increase the final price of their products. Moro (2012) has discussed that increase in prices lead to having a negative impact on the behavior of customers, further leading to lower sales and revenues of firms. These changed prices then lead to having a negative impact on the behavior of customers further leading to lower sales and revenues of firms. Inflation is one of the core aspects that governments must need to focus upon in order to promote the corporate sector. With the increase in prices of goods, customers will not be able to buy the required products and services having lesser buying power (Moro, 2012).

Political Stability

Political stability is one of the other essential external factors that impact businesses and their performance. For firms to operate and function in an adequate manner, it is important that a feasible working environment is provided to them along with favorable conditions. Through political instability, businesses become insecure to conduct their activities and this eventually develops an adverse effect on their

performance (Causevic and Lynch, 2013). In this regard, Asongu and Nwachukwu (2015) have mentioned that customers are also influenced by political stability as they tend to spend less and restrict their buying patterns in poor political conditions. The instability in political situation makes the consumers vulnerable and this eventually is observed through lowered demand for products and services. Customers, on the other hand, are also influenced by political stability as they tend to spend less and restrict their buying patterns in poor conditions. On the other hand, investors in unstable political situations become hesitant and reluctant in proceeding with their investment decisions and become more conscious regarding their capital being stuck. It, therefore, could be understood that political stability is one of the major factors that may limit the performance and output of organizations in varied industries (Asongu and Nwachukwu, 2015).

Exchange Rate

The exchange rate leads to having an effect on the surplus or deficit on trade. It could be understood that a weaker domestic currency stimulates exports further making the imports more expensive. This defines a situation in which the local production of a country is higher and imports are lesser. Businesses involved in trade with other countries are significantly impacted by the exchange rate as it leads to having an effect on the purchasing power of firms (Bown and Crowley, 2012). With a weaker exchange rate, the firms in the home country may find it difficult to develop feasible circumstance for trade and vice versa. On the other hand, unexpected currency fluctuations have a considerable impact on the market value and cash flows. These unanticipated

exchange rates may generally affect the competitive position of the organization even if it is not operating in overseas markets (Nicita, 2013).

Interest Rate

Interest rate is a critical aspect that impacts businesses in varied ways. It is regarded as the proportion of a loan that is charged as interest to the borrowers. In a time of low-interest rates, it becomes feasible for businesses to borrow money from banks and other financial institutes in order to invest in growth-related projects (Asiedu et al, 2012). Another study by Gilchrist and Zakrajsek (2012) have stated that lower interest rates are considered as favorable conditions for firms that are willing to enhance their operations and business activities specifically in terms of business expansion. It has been defined in this study that with lower interest rates, the firms tend to approach the financial institutes for taking assistance. Lower interest rates are usually regarded as favorable conditions for firms that are willing to enhance their operations and business activities specifically in terms of business expansion. If the interest rates are higher, companies may not find it useful and relevant to borrow money and use it for their desired purpose. On the other hand, if organizations are interested in investing money in the time of increased interest rates they may benefit from higher returns in such situations (Gilchrist and Zakrajsek, 2012).

GDP

The gross domestic product defines the total value of final goods and services produced within a specific time period. When the GDP growth is strong, businesses are inclined towards hiring more workers and can better afford to pay higher wages and salaries. Once this situation is created, consumers have more to spend on goods and services eventually leading to the development of an overall positive condition (Coyle, 2015). Wade and May (2013) have presented in their study that GDP leads to depict the financial condition of an economy and high GDP could lead to the development of favorable operating circumstances for firms. The GDP further depicts the financial position of an economy and high GDP could lead to the development of favorable operating circumstances for firms. With an overall improved economy, the customers would be more inclined towards spending more along with saving and this would develop a positive scenario for organizations in terms of sales and performance (Wade and May 2013).

Firm Size

Different businesses are operating on varied scales and sizes which define different working conditions and situations for them. The size of the firm has an impact on the financial performance of the firm as larger companies have more capital to be used and invested in business activities. On the other hand, smaller companies have lesser capital to be utilized and so their returns are also in accordance (Roberts and Grover, 2012). Moreover, Zadeh and Eskandari (2012) have presented in their study that while

huge companies are operating at higher risks, their ratio and profitability are also more as compared to smaller sized firms. This leads to define that the aspect of firm size could be a critical macroeconomic indicator which needs to be rightly assessed. While huge companies have higher risks, their ratio and profitability are also more as compared to smaller sized firms. Even though there are certain adversities associated with large-scale firms as well, their revenue generation is also much higher. The size of the firm could, therefore, be considered as a factor which may lead to affect the business variedly, developing different opportunities for businesses to optimize upon (Zadeh and Eskandari, 2012).

Money Supply

A higher supply of money usually lower interest rates which further leads to generate higher investments and putting more money in the hands of consumers Considering that consumers have more money in hand, their spending patterns and behaviors are positively impacted and they get more inclined towards being involved in purchases of varied products and services. Businesses also usually respond to higher money supply through increasing production and increasing sales due to higher availability of capital for all such transactions (Coghlan, 2014). With lower interest rates, businesses are further given an opportunity to also borrow money from respective institutes and use it for planning further growth and expansion. This association with interest rates, therefore, allows companies to optimize on the given opportunities and incline towards augmenting the size of the business (Simwaka et al, 2012).

Firm’s Performance

The theory of firm performance has to be differentiating from the concept of an organization’s effectiveness. The area of an organization’s effectiveness contains the performance of the business which further includes the financial performance of the firm. The performance of the firm covers the other sides related to the organization’s operations such as legal activities, acquisition of resource and achievement of goals. The performance of the firm is considered as the strategic and combined approach to developing the effectiveness of business by enhancing the performance of employees and building the capabilities among employees (Santos, 2012). The effectiveness of organizational performance depends upon the macroeconomic indicators such as the increase rate of taxation would affect the business revenue, political instability, law and order situation restrict investors from investment.

Factors Affecting Firm Performance

Earnings per Share

The profitability of the company is indicated by the earning per share. In reference to the research study conducted by Bonaime et al. (2019), it has been stated that adjusted for potential share dilution and extraordinary items, it is common for the company in order to report earnings per share. The earning per share is calculated by dividing the profit of the company with the outstanding shares in the common stock. In the determination of share’s price, the earning per share is considered as one of the most significant variables. According to Agrawal, Catalini and Goldfarb (2015), in absolute terms, the comparison of earning per share may not provide much meaning to the investors.

Return on Assets

Return on assets is considered as the profitability ratio for the company. In reference to the research study conducted by Sucuahi and Cambarihan (2016), it has been stated that the ability of the company in order to generate the profits from its assets is regarded as the return on assets. This shows the efficiency of the company in order to generate the earnings from the number of resources available in terms of assets on their balance sheets. The return on assets of the company is calculated with the help of dividing the net income of the company with the average of total assets available for the company.

Return on Equity

It is necessary for companies in order to measure their financial performance in the industry. In reference to the research study conducted by Purnamasari (2015) that in relation to the equity, the measure of the profitability of the business is regarded as the return on equity. This helps the company in order to identify the measure of how the company has utilized the investments in order to generate growth on earnings. The return on equity is calculated with the help of dividing the net income with the shareholder’s equity.

Earnings before Interest and Taxation

Earnings before interest and taxation in the field of finance and accounting are regarded as the measure of profit of the firm. In reference to the research study conducted by Caglio et al. (2016), it has been stated that all the expenses and incomes that are either non-operating or operating are included in the earnings before interest and taxation. However, the income tax expenses along with the interest expenses are excluded from the earnings before interest and taxation. If the firms do not have non-operating and operating expenses, then the operating profit and operating income are also used as the synonym to earnings before interest and taxation.

Empirical Reviews

According to the study conducted by Haider et al. (2018), there is a negative relation of the macroeconomic relations with the gross profit margin, return on assets and return on equity. On the other hand, it was identified in this study that there is a positive relation of inflation with the return on equity while having a negative relation with the gross profit margin and return on assets. The financial statements of the companies that are listed in the stock exchange of Pakistan operating in the automobile sector of Pakistan were used from the period of 2007 to 2016. The technique which was used by the researcher in order to analyses the data was GMM and descriptive analysis.

In another study conducted by NDEGWA (2017) it has been identified that there is an influence of inflation rate on the performance of the firms. This depicts those high-interest rates results in the negative influence on the performance of the firm. The

results have been analyzed by the researcher with the help of descriptive stats, correlation analysis and regression analysis. The data was collected from the secondary sources from the reports of banks, magazines, journals, property reports and previous studies. The population for this study was 445 registered real estate agents and firms and was obtained from the year 1997 to 2016.

Overview of Automobile industry in Pakistan

Since the arrival of the new government, the automobile industry has experienced downturns as the fluctuations in the macro-economic front have proven to be unfavorable for the automobile producers in Pakistan (Ahmed and Batool, 2017). The depreciation of Pakistan rupee against US dollar has led to existing automobile producers increasing their retail prices. Looking at the statistics, the sales of the automobile industry has dropped by 28% (Mettis Global, 2018). The major three automobile producers in Pakistan, Indus motors, Pak Suzuki and Honda Atlas had experienced a decline in their earnings due to several changes in the country.

The depreciation of Pakistan Rupee has made imported car parts expensive, increasing the cost of production and causing a reduction in the demand for automobiles. The increase in interest rates in Pakistan has made car financing less tempting for the consumers and a ban on non-tax files has influenced the sales of automobile producers (Mettis Global, 2018). In the previous year, Honda Atlas had increased their vehicle prices by 30% whereas Indus motor and Pak Suzuki increased their prices by 20%.

These prices are expected to increase further by the end of 2019. Pak Suzuki had faced severe competition as United Motors entered into the market, causing Pak Suzuki motors profits to drop by 45% and a reduction stock market price by 62%. With the increasing competition, Indus Motors has announced to invest around Rs.3 billion in order to enhance their yearly production capacity and to improve its performance (Express News, 2018).

However, the automobile policy in Pakistan provides tax incentives to new entering firms in order to encourage them establish their manufacturing operations. Several international automobile makers such as KIA, Renault, Volkswagen and FAW have decided to enter in the Pakistan automobile market (Iqbal, 2019). A total amount of Rs6 billion will be invested in the automobile sector by the new entrants. Ghandhara Nissan has announced to commence the production of Datsun vehicles in Pakistan by the end of year 2019. Renault, a French automobile producer has decided to enter into the Pakistan automobile market and will start its vehicle production in 2020 (Propakistani, 2019). Looking at the various incentives being offered by the auto policy; several Chinese automobile producers are also eager to capture the market share of Pakistan automobile sector. It has been predicted that the existing automobile producers in Pakistan are likely to witness further decline in their revenues as the new entrants will have a competitive advantage through incentives being offered to them.

Impact of Macro-Economic Indicators on Firms' Performance in Pakistan

The objective of conducting this research was to observe the influence of macro-economic variables such as inflation rate, gross domestic product, interest rate, exchange rate on the performance of the firms in Pakistan. The performance of the

firms can be determined through annual earnings per share, earnings before interest and tax, return on equity and return on assets (Barakat, Elgazzar, and Hanafy, 2016). The performance of the firms is often evaluated from the stability of an economy such as variations in interest rate, consumer price index, exchange rate and it has been proven that the fluctuations in the macro-economic variables are much higher in the developing countries than developed countries (Oleka, Eyisi, and Mgbodile, 2014)

Because macro-economic factors are not within the control of the management, these factors could create a negative or positive impact on the performance of the firms (Hunjra, et.al 2014). For example, the monetary policy announced in a country influences the cost of debt and availability of credit of all the industries. This may limit the firms' ability to raise funds through external sources of finance (Jõeveer, 2013). Furthermore, the fiscal policies announced by the government of a country has an impact on the net cash flows, the capital structure and theoretically the demand for the goods of a firm (Kirui, Wawire, and Onono, 2014). Moreover, the growth in nominal interest rates and inflation rates increases the chances of a firm's failure or default.

In majority of the developing economies, such as Pakistan, macro-economic variables such as appreciation of exchange rate (US Dollar against Pakistan rupee) and hyperinflation are the core factors which have an impact on the performance of manufacturing industries of Pakistan, resulting into high costs of production and reduction in consumer spending (Sohail and Hussain, 2009). Many of the strategic, financing and investing decisions of a firm are often moderated by the macro-economic factors of an economy. The variations in the macro-economic factors also creates negative returns for the shareholders of a firm affecting the reputation of the firm. The

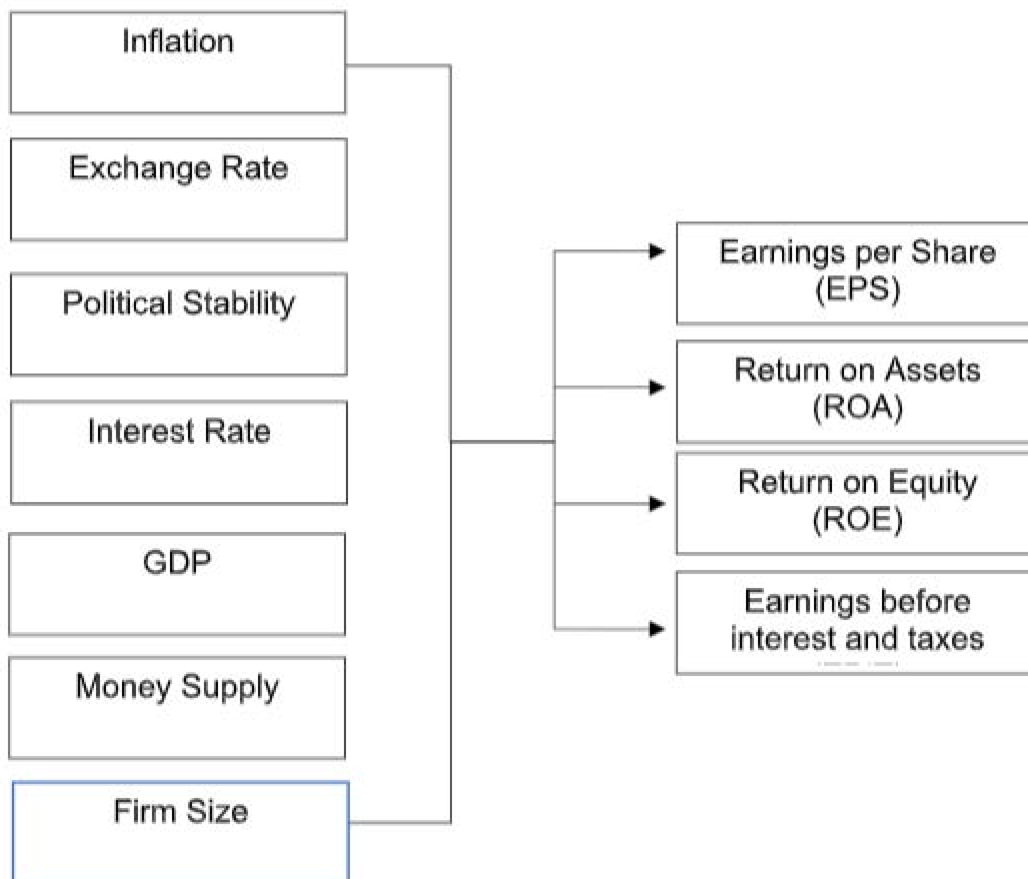
growth and survival of the firms are also contingent on the macro-economic variables. Recent studies have even highlighted that changes in the monetary value of financial assets of a firm are responsive to macro-economic indicators such changes in exchange rate, money supply, interest rate and gross domestic product (Khan et al., 2018)

The previous research studies have established that the macro-economic variables such as gross domestic Product, exchange rate and interest rate have a positive relationship on the performance of the firms whereas inflation rate and money supply in an economy has a negative correlation on the firms’ performance (Kung’u, 2013). The prior studies conducted have also stated that the performance of the firm is highly influenced by gross domestic product and interest rate as compared to other macro-economic factors. Gross domestic product, interest rate and inflation rate has a significant impact on the firms’ return on assets (ROA) and return on equity (ROE). Furthermore, in the manufacturing sector, the exchange rate has a major influence on the profitability of a firm. The fluctuations in the exchange rate of an economy have a substantial impact on the profitability and costs of a firm.

In the past few years, the Pakistan economy has experienced many fluctuations in the macro-economic indicators, the most important being the exchange rate, the interest rate and consumer price inflation. These fluctuations have hampered the performance of manufacturing firms in Pakistan (Pervaiz, Masih and Jian-Zhou, 2018). The government of a country plays a fundamental role on these macro-economic variables. Therefore, the government must ensure that these macro-economic indicators are sustained at controllable levels and henceforth, these macro-economic factors should

also be considered by the shareholders of a firm cautiously when making decisions in order to avoid undesirable returns on their investments.

Conceptual Framework



Chapter Summary

From the above discussion, it can be identified that microeconomic and macroeconomic indicators collectively create an impact on the performance of organizations as well as the growth of the country. The key macroeconomic indicators include the rate of unemployment in-country, GDP, political stability, inflation rate, and growth of economic, interest rate and balance of payment. It has been identified on the basis of literature that the indicators of macroeconomic have a direct impact on an organization's performance. Moreover, it is clearly identified that the external environment is necessary for every organization's change along with the analysis of the growth of the business. The other sides related to the organization's operations such as legal activities, acquisition of resource and achievement of goals is covered by the performance of the firm. The effectiveness of organizational performance is determined by the macroeconomic indicators such as the increase rate of taxation would affect in the business revenue, political instability, law and order situation restrict investors from investment.

The factor that affects the firm performance includes earnings per share, return on assets, return on equity and earnings before interest and taxation. On the other hand, the macroeconomic indicators include inflation, political stability, and exchange rate, interest rate, GDP, firm size and money supply. The profitability of the company is indicated by the earning per share. Moreover, the return on assets shows the efficiency of the company in order to generate the earnings from the number of resources available in terms of assets on their balance sheets. Return on equity helps the company in order to identify the measure of how the company has utilized the

investments in order to generate the growth on earnings. Furthermore, all the expenses and incomes that are either non-operating or operating are included in the earnings before interest and taxation.