The intention of this study is to investigate the relationship between the stock prices of Karachi Stock Exchange and macroeconomic variables in Pakistan. The monthly data of all macroeconomic variables and stock prices was taken from January 2001 to May 2012. In this study, the variables which have not been previously studied by the researchers in Pakistan were also included. This study also incorporated the effect of market crash 2008 and its implicationsfor Karachi Stock Exchange. The statistical techniques, which were employed in this study, include Johansen Co-integration test, Vector Error Correction Model (VECM) and Granger Causality test. The results of the study revealed the presence of long-run association between macroeconomics variables and stock prices.

Exports, Exchange Rate and Money Supply showed a positive and significant relationship with stock prices, Inflation and Discount Rate indicated a negative and significant impact on stock prices whereas index of industrial production had a positive but insignificant relationship with stock prices. Market crash had a significant negative relationship with stock prices and prolonged crises affected the stock prices significantly. The error correction term was resulted from VECM which was significant and indicated short term adjustments towards the equilibrium path. The results of Granger Causality Test showed a unidirectional relationship between CPI, ER, D and KSE, no causal relationship between EX, i and KSE, unidirectional causal relationship between KSE and IIP as only KSE granger cause IIP where as a bidirectional causal relationship exhibited between M2 and KSE as both the KSE and M2 granger cause each other.