



The Relationship between Financial Freedom, Financial Depth and Mutual Funds: Panel Bounds Testing Approach

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Extensive Summary

Introduction

It is widely believed that high levels of financial freedom and financial depth are important factors to assure financial market stability and diversity of financial devices, due to the fact that one of the most important duties of financial market is to carry out the market deepening is thought. Therefore, there seems to be a close connection between financial freedom and financial depth, such that development in financial globalization induces globalization of markets for goods and services and *vice versa*. The process of financial globalization and financial freedom increase both capital inflows such as foreign direct investment, portfolio investment, international trade credits and rise the financial transactions of individual investors. With the help of the financial freedom, financial resources are permitted to flow from capital-abundant countries, where expected returns were low, to capital-scarce countries, where expected returns were high. The flow of resources into the liberalizing countries reduce their cost of capital, increase investment, deepen the financial markets and raise output. This dynamic structure beginning with the financial liberalization and triggered by the financial freedom continues in financial depth and contributes to sustainable economic growth.

In conjunction with the financial freedom, mutual funds have become an invaluable tool for a wide range of investors, from individuals seeking to save for retirement to sophisticated socialites focused on preserving their assets and businessmen determined to create wealth. A mutual fund is a company that pools money from a group of people with common investment goals to buy securities such as stocks, bonds, money market instruments, a combination of these investments or even other funds. the collected holdings of these securities is known as its portfolio. Each share or unit represents an investor's proportionate holding of the portfolio and their proportionate entitlement to the income generated by those holdings. there have been a number of reasons for holding mutual funds: Advanced customer services, low transaction costs, diversification and professional management are some of them. Mutual funds help

ensure financial depth by providing structure, clarity and transparency. Increase in financial freedom and depth and reduction in transaction costs would attract small potential investors to invest their surplus income in the mutual fund industry. Such investment over time shall increase the purchasing power of those investors. Increase in purchasing power would necessarily stimulate the aggregate demand for goods and services thereby augmenting employment, output and income. Hence, the role of mutual funds is not just to provide people with a vehicle to invest but a vehicle to invest wisely.

Method

In this study, in order to examine the relationship between financial freedom, financial depth and mutual fund assets in 54 countries in the period 2000 – 2011 the panel bounds testing analysis (ARDL) is applied. Because the ARDL cointegration approach has numerous advantages in comparison with other cointegration methods such as Engle and Granger (1987), Johansen (1988), and Johansen and Juselius (1990) procedures, it is appropriate to use the ARDL model. Thanks to bounds test approach which is based on the Wald or F-statistic and developed by Pesaran et al. (2001), it is possible to test whether there is the cointegration relationship between the variables regardless the integration level of series.

The ARDL bounds testing approach is based on the estimation of Ordinary Least Squares (OLS) estimator and unrestricted error correction model. The cointegration relationship among the variables in the main model is determined by applying bounds test to the unrestricted error correction model. Therefore, it can be said that the bounds testing procedure is based on the joint *F-statistic* or *Wald statistic* that is tested the null of no cointegration. The value of the calculated *F-statistic* is compared with two sets of critical values, the lower and the upper. If the calculated *F-statistics* lies above the upper level of the band, the null is rejected, implying cointegration. If the calculated *F-statistics* is below the lower critical value, we cannot reject the null hypothesis of no cointegration. Finally, if it lies between the bounds, a clear comment on the cointegration cannot be made. The lower and the upper critical values can be obtained from Pesaran et al. (2001).

If a cointegration relationship is found among the variables, both long and short-term models can also be estimated with the help of appropriate equations. The long term coefficients are obtained as follows: The sum of the lagged values of the coefficients of the independent variables which are multiplied by the negative mark is divided to the value that is obtained by subtracting 1 from the sum of the coefficient of the dependent variable. The coefficients of the current period lags of the independent variables represent the short term coefficients. In this context, the short term relationship among the variables is investigated with the help of the error correction model based on the ARDL approach. Hence, the error correction term called as *EC* which is obtained from long-term dynamic is included into the short term dynamic equation to obtain the robust results. The error correction term shows how quickly variables converge to equilibrium and it is expected to have a statistically significant coefficient with a negative sign.

Conclusion

This paper investigates the nexus between financial freedom, financial depth and mutual fund assets for 54 countries from 2000 to 2011. To examine this linkage, we use the two-step procedure from panel ARDL bounds testing model introduced by Pesaran et al. (2001): In first step, we explore the long-run relationship among the variables by

using panel ARDL bounds testing approach of cointegration. Secondly, we employ a dynamic error correction model to explore the short-term relationship between the variables.

All results suggest that there is a positive and statistically significant evidence between financial freedom, financial depth and mutual fund assets in both long and short-term. Besides, long-term empirical results refer that current period financial freedom and financial depth are the important factors for determining the mutual fund assets. Therefore, it can be said that liberalising the financial markets and financial depth would enhance the mutual fund assets. In addition, the results of the short-term dynamics are parallel with the long-term estimation results. In order to estimate the current period mutual fund assets; the value of the previous mutual fund assets, the value of current financial freedom and financial depth need to be taken into account. Therefore, it can be said that the financial depth enlarges in conjunction with the process of the financial liberalisation and this process contributes to increase in the value of mutual fund assets. Furthermore, because the error correction term is found negative and statistically significant, it can be said that the variables converge to equilibrium quickly, and short-term imbalances will be wholly overcome in the long-term. In general, these results suggest that both financial freedom and financial depth associated with globalisation process increase the value of mutual fund assets as a percent of Gross Domestic Product. Therefore, the findings here refer that it is possible for 54 countries to achieve better mutual fund assets without setting a monetary rule by insulating financial freedom from political control and liberalising their financial markets.