

# Long Run Impacts of Interest Rate Liberalization on Stock Market Development

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## Abstract

The paper investigates the long run impacts of interest rate liberalization on stock market development in the seven selected sub-Saharan African countries using panel dataset that spans 1990 to 2013. Interest rates deregulation is measured by liberalization index considering the different periods that the respective SSA countries liberalized their interest rates. The index of stock market development is proxy by market capitalization. The study employs dynamic heterogeneous panel method using the technique of Pooled Mean Group (PMG). The results reveal that on the average liberalizing the interest rates has a negative long run impact on the development of the stock markets in the seven selected SSA economies. The policy recommendation as a result of this finding is that liberalization of interest rates in the SSA region should be a guided one.

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*Keywords* Interest rate, liberalization, pooled mean group, stock market development.

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## 1. Introduction

Owing to the underdevelopment nature of the economies of the SSA, these countries were advised to restructure their economies under the framework of World Bank and International Monetary Fund supported structural adjustment programme. Financial liberalization was thus recommended as one of the strategies of growing their economies. This concept consists of interest rate; banking sector, stock market; the exchange rate and the capital account liberalization. According to McKinnon (1973) and Shaw (1973), the financial repression feature of the developing countries was responsible for the retardation of growth of the less developed economies, hence the recommendation for liberalization of their economies. In this respect it was recommended that the government should hands off all involvement in the business and economic activities and thus allows the economies to be market driven.

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Extensive researches have been conducted on the effects of different forms of liberalization in the developing countries and some of them focus on the Sub-Saharan African (SSA) countries. However, little has been done on the aftermath of interest rate liberalization on the development of stock market in the SSA countries. Analysts have mainly focused on the impact of liberalized interest rate on growth separately from the stock market development. It is against this backdrop that the present study examines the effects of interest rate liberalization on stock market development in the SSA region.

Apart from South Africa, stock market growths in the SSA region have been really low compared to the level of the other developing countries. This is manifested in the statistics on the indices of measuring stock market development computed for some selected SSA countries in comparison with Philippines and Malaysia. These indices are stock market capitalization scaled by GDP, stock value traded as a percentage of GDP and the turnover ratio. They are the average values of the stock indices calculated from 2001 to 2012.

Table 1. Average Values from (2001-2012) of Stock Market indices in Selected SSA Countries, Malaysia and Philippines

Selected Countries	Market Capitalization Scaled by GDP	Stock Value Traded as a % of GDP	Turnover Ratio in %
Botswana	32.2	0.93	3.1
Ghana	13.3	0.39	3.1
Kenya	32.2	2.70	8.1
Mauritius	48.9	2.90	6.4
Nigeria	18.6	2.90	14.0
Total average of selected SSA without South Africa	145.2	9.82	34.7
South Africa	194.9	95.80	50.9
Malaysia	138.6	40.90	31.2
Philippines	55.2	9.4	18.5

Source: *World Development Indicators 2014*

Part of the literature on liberalization believe that liberalizing the financial market have positive impact on the growth of the stock market (Bekaert, Harvey & Lundblad, 2003; Henry, 2000). Another aspect holds the contrary view that the empirical findings of positive effect of liberalization have not been documented (Ahmed, 2013; Prasad, Rogoff, Wei, & Kose, 2003).

As a follow up to these arguments, the present paper examines the impact of interest rate liberalization on stock market development in the seven selected SSA countries including Botswana, Cote d'Ivoire, Ghana, Kenya, Mauritius, Nigeria and South Africa for the period 1990 to 2013. This is based on data availability and the fact that these countries have embarked on interest liberalization ahead of others in the SSA region. The remainder of the paper is structured as follows: Section 2 discusses the stock market development and financial liberalization. Section 3 consists of overview of interest rate liberalization in selected SSA countries. Section 4 reviews the literature. Section 5 details on theoretical framework, data and methodology. Section 6 presents estimation results and interpretation. Section 7 concludes the paper.

## 2. Stock Market Development and Financial Liberalization

Stock market development is a multidimensional concept that can be evaluated from the indices of measuring the stock markets such as market size, liquidity, volatility institutional factors (Demirguc-Kunt & Levine, 1996; El-Wassal, 2013). Market size is measured as market capitalization scaled by the GDP. Capitalization entails the number of listed securities in the exchange. Liquidity of the market indicates the extent to which shares can be traded with

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