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Governance and stock market performance

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This study uses international asset pricing models to investigate the link between the quality of government institutions and the performance of global stock markets. The results demonstrate a significant positive association between stock market performance measures and the quality of the institutional environment. Performance measures examined for the cross-section of countries were the average monthly stock index excess returns and the Sharpe ratio. All measures of performance were adjusted for global and local risk factors known to explain their international variation. The quality of governance is also found to be negatively associated with stock market total risk and idiosyncratic risk, consistent with the notion that stable institutions are linked to reduced variations in equity returns. These findings suggest countries with better-developed governance systems have stock markets with higher returns on equity and lower levels of risk. The results lend support for the view that a precondition for financial market development is the improvement of the institutions which govern the process of exchange.

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1. Introduction

This study investigates how the quality of governance affects the performance and risks of stock markets. Governance describes the institutional arrangements that regulate financial markets. These institutions compose legal, political and supervisory bodies that provide order and cohesion to business activities. The equitable functioning of the legal process, the degree of political stability, the level of systemic corruption and accountability are factors that define the quality of these institutions and their ability to oversee financial markets. The quality of governance has important

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implications on the interactions between firms and institutions and the costs associated with such dealings.

The ability of the judiciary to enforce contractual rights of shareholders impinges on the likelihood of managerial expropriation and ultimately the profitability of firms. In this regard, La Porta et al. (1997) argue that improving corporate governance rules, their enforcement and the quality of accounting standards results in greater reliance on equity financing by companies. In addition, judicial factors directly limit the amount of corporate resources diverted by managers and allow shareholders to monitor managers at lower costs. Legal systems supportive of investor protections tend to increase the amount of funds risk-averse investors are willing to channel towards firms. Aggarwal et al. (2002) find that fund managers invest less in countries with poor legal environments and low corporate governance standards.

The payoffs from judicial improvements include not only larger stock markets, but also greater integration with world capital markets via the influx of capital. La Porta et al. (2000) discuss the experience of transitional economies and the central role that legal institutions play in the functioning of markets. The Russian experience has demonstrated that foreign investors are willing to provide funds and much needed managing expertise to newly privatized firms only if the legal and political infrastructure is adequate in curbing corruption among government officials and limiting the risks of expropriation. Rosenberg and Birdzell (1986) believe that the emergence of London as a world financial centre was made possible by the reputation for fairness that the English courts and the common law had acquired by the 20th century.

Apart from the interaction between firms and institutions arising from agency costs, another well known source of interaction appears under neoclassical economic theory. Transaction costs have been the neglect of many market-centred views of economic structure. Coase (1960) stated that under zero-transaction costs, market participants would organise their transactions in ways that achieved the most efficient outcomes. Advocates of his theorem argued against large regulatory involvement in the market. In his Nobel lecture, Coase (1992) emphasized that in the presence of transaction costs, the legal system affects the ability of an economy to achieve its full production potential by the distribution of legal rights among economic agents. Transaction costs cannot be ignored and the initial allocation of property rights mattered in the presence of side effects or externalities. North (1994) argued that tightly defined property rights and their cost-effective enforcement are important requirements for low-cost transacting which are essential to productive economies. While the debate on the validity of the Coase theorem is ongoing, there exists mounting research on the importance of institutions in harmonizing financial arrangements.

Better governance environments can increase returns to shareholders by reducing both transaction costs and agency costs. However, superior investor protection environments will command an equity premium across internationally competitive financial markets, resulting in lower returns on equity. These two competing hypotheses are tested through the empirical analysis using a number of international asset pricing models and performance measures, after controlling for factors known to explain the international variation of equity returns. A number of international asset pricing models and performance measures are adopted in this study to verify the consistency of the results. Lintner regressions are used to control for relevant risk factors in examining the cross-sectional variation in average excess market returns, Sharpe ratios, total stock market risk and idiosyncratic risk. Instrumental variables are used to control for measurement errors resulting from the time-series parameter estimates of the first-stage Lintner regressions and seemingly unrelated regressions techniques are used to control for cross-market correlation in the disturbances of these estimations.

This study contributes to the literature by confirming the evidence on the relationship between the quality of the judicial environment and returns to shareholders, and extending the examination to include the effects of other dimensions of governance such as the efficiency of the government, the political climate, the level of corruption and the regulatory authority. It is argued that the institutional agents that govern a country have a direct impact on the profitability of firms through transaction costs associated to business dealings and the regulation and enforcement of corporate governance mechanisms.

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