International Review of Economics and Finance 32 (2014) 132–142

Contents lists available at ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

The effect of corporate governance on stock liquidity: The case of Thailand☆

Panu Prommin[a], Seksak Jumreornvong[b], Pornsit Jiraporn[c,d,e,f,g,*]

[a] Bank of Thailand, Bangkok, Thailand
[b] Thammasat University, Bangkok, Thailand
[c] Great Valley School of Graduate Professional Studies, Pennsylvania State University, United States
[d] Thammasat University, Thailand
[e] Mahidol University, Thailand
[f] National Institute of Development Administration (NIDA), Thailand
[g] Chiangmai University, Thailand

ARTICLE INFO

Available online 27 January 2014

JEL classification:
G34
G12

Keywords:
Corporate governance
Liquidity
Thailand
Emerging markets

ABSTRACT

Grounded in agency theory, this study explores the effect of corporate governance on equity liquidity in Thailand. Theory suggests that effective governance enhances financial and operational transparency, which in turn, reduces adverse selection. Facing less adverse selection problems, traders provide more liquidity to stocks of well-governed firms. Based on a sample of largest firms in Thailand from 2006 to 2009, our results show a significant relationship between governance and liquidity within firms over time. In particular, within firms, when governance quality increases, liquidity significantly improves. For instance, a rise in governance quality by one standard deviation improves the liquidity ratio by 26.19%. We also show that our results are unlikely confounded by endogeneity.

1. Introduction

Corporate governance constitutes an important area in the literature, particularly given the recent governance reforms introduced by a number of legislations in the U.S. Although a large number of studies examine the impact of corporate governance on various firm outcomes, the effect of governance on stock liquidity has received little attention. The only exception is Chung, Elder, and Kim (2010), who explore the association between governance quality and liquidity, using a sample of U.S. companies. They report that firms with more effective governance have more liquid equity. Their results, however, cannot be readily extended to other countries, particularly to emerging markets where stock markets are significantly less developed and equity is substantially less liquid. We fill this void in the literature by examining the impact of corporate governance on stock liquidity in an emerging market. Thailand possesses several characteristics that make it an interesting setting for studying this issue, such as the prevalence of bank loans and the less prominent role of capital market financing, the younger and less sophisticated stock market, and the presence of large conglomerates with commercial banks that provide financing for their own member firms. These distinctive features make it impossible to readily extend the findings in Chung et al. (2010) to Thailand.

In theory, corporate governance influences stock market liquidity because effective governance imposes more monitoring on managers, thereby preventing inefficient or opportunistic managers from concealing information. Thus, strong governance is expected to improve transparency, which reduces information asymmetry (Chung et al., 2010). When information asymmetry is

☆ Part of this article was written while the third author was serving as Visiting Associate Professor of Finance at Thammasat University, Mahidol University, Chiangmai University, and The National Institute of Development Administration (NIDA) in Thailand.

* Corresponding author at: Pennsylvania State University, School of Graduate Professional Studies, 30 E.Swedesford Road, Malvern, PA 19355, United States. Tel.: +1 484 753 3655.
E-mail address: pjiraporn@psu.edu (P. Jiraporn).

1059-0560/$ – see front matter © 2014 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.iref.2014.01.011

less severe, liquidity providers face less adverse selection problems (Glosten & Milgrom, 1985). As a result, firms with stronger governance are expected to exhibit more equity liquidity.[1]

We measure the quality of corporate governance by constructing a governance index based on nine governance factors related to boards of directors, audit, executive compensation, and director nominations. This method is used in Sawicki (2009), who documents that governance quality in five Asian countries, Thailand included, has a significant impact on dividend policy.[2] We employ three alternative measures of stock liquidity, i.e. Amihud's illiquidity, turnover, and liquidity ratio. We find evidence that corporate governance influences stock liquidity. In particular, although we find insignificant evidence of a cross-sectional association between governance and liquidity, our results demonstrate that, when firms improve their governance quality, their stocks experience higher liquidity.

The effect of governance quality on liquidity is not only statistically significant, but also economically meaningful. For instance, our fixed-effects analysis reveals that an increase in governance quality by one standard deviation improves Amihud's measure of liquidity by as much as 67%. The effect survives even after controlling for a number of firm specific characteristics that have been found to influence liquidity. In particular, we control for firm size, leverage, return volatility, asset tangibility, share price and firm age. In addition, we also investigate changes in the variables. Regressions based on levels of variables are more vulnerable to endogeneity, whereas regressions based on changes help control for unobservable firm characteristics and therefore tend to be less vulnerable to endogeneity. Our results based on changes in the variables show that a rise in governance quality is associated with a significant improvement in stock liquidity, confirming our results based on variable levels. The results based on changes are also remarkably consistent across all liquidity measures and thus appear to be robust. To alleviate concern for possible endogeneity, we execute a two-stage least squares (2SLS) analysis. The 2SLS results, based on two alternative instrumental variables, confirm that stronger governance leads to higher liquidity. Moreover, we examine specific governance categories and find that liquidity is related to three out of four governance categories that make up the overall governance index. The relationship is not driven by a narrow group of governance standards. Rather, it seems to be broadly based on overall governance quality.

Combining two crucial areas of the finance literature, i.e. corporate finance and market microstructure, our study makes several contributions to the literature. First, we contribute to the fierce and on-going debate on the impact of corporate governance on various critical corporate outcomes such as firm value, capital structure, costs of debt financing, corporate diversification, cash holding, debt maturity structure, CEO compensation and institutional ownership.[3] We show that corporate governance is a significant determinant of stock liquidity in Thailand. Second, the literature in market microstructure documents a number of factors that influence liquidity such as firm size, return volatility, trading volume, etc. We contribute to this area of the literature by identifying corporate governance quality as another influential determinant of liquidity. Finally, our results contribute to the literature in emerging markets. A number of prior studies examine how corporate policies and outcomes in emerging markets are different from those in developed countries. We offer empirical evidence on the role of corporate governance on liquidity in an emerging market, i.e. Thailand.

The remainder of this paper is organized as follows. Section 2 reviews prior literature and develops the hypothesis. Section 3 describes the sample as well as explains the data. Section 4 discusses the results on corporate governance and liquidity and presents the results on liquidity and firm value. Section 5 offers the concluding remarks.

2. Prior literature and hypothesis development

2.1. Literature review

A number of prior studies concentrate on variation across countries and examine the role of corporate governance on liquidity. For instance, Bacidore and Sofianos (2002) examine stocks listed on the New York Stock Exchange (NYSE) and report that those based in the U.S. exhibit higher stock market liquidity than those outside the U.S. In particular, non-U.S. stocks have wider spreads, less depth, and greater transitory volatility than U.S. stocks. Brockman and Chung (2003) document similar evidence between firms listed in Hong Kong and those listed in mainland China. Other studies that offer cross-country evidence include Chung (2006) and Eleswarapu and Venkataraman (2006).

By contrast, several studies argue that internal corporate governance is related to liquidity as well. For instance, Coffee (1991) contends that large investors promote measures that improve internal corporate governance because such measures also increase stock market liquidity, which makes their exit less costly. Bhide (1993) and Maug (2002) argue that high stock market liquidity deters internal monitoring by large shareholders.

In spite of the above arguments, empirical evidence of the effect of internal corporate governance on liquidity is scarce. Only recently do Chung et al. (2010) document that firms with better governance experience better liquidity. In particular, they find that stronger governance is associated with narrower spreads, higher market quality index, smaller price impact of trades, and lower probability of informed trading (PIN). Chung et al. (2010) measure governance quality by using the governance factors reported by the Institutional Shareholder Services (ISS). Because this governance data are available only for U.S. firms, their conclusion is strictly

[1] The effects of corporate governance on corporate outcomes have been examined in recent studies. For instance, corporate governance has been related to the adverse selection component of the bid–ask spread (Charoenwong, Ding, & Siraprapasiri, 2011), to capital structure (Jiraporn, Kim, Kim, & Kitsabunnarat, 2012), to stock price increases upon the liberalization of the equity market etc.

[2] Prommin et al. (2012) also use the same method to explore the interactions between ownership structure and corporate governance in Thailand.

[3] See Brown and Caylor (2006), Gompers, Ishii, and Metrick (2003), Ciceksever, Kale, and Ryan (2006), Cremers, Nair, and Wei (2007), Jiraporn, Kim, Davidson, and Singh (2006), Dittmar and Mahrt-Smith (2007), Harford, Li, and Zhao (2007), Fahlenbrach (2008), and Chung, Elder, and Kim (2010).