Journal of Corporate Finance 16 (2010) 609–621

Contents lists available at ScienceDirect

Journal of Corporate Finance

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

# Equity market liberalization and corporate governance

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A R T I C L E   I N F O

*Article history:*
Received 27 May 2010
Received in revised form 29 August 2010
Accepted 30 August 2010
Available online 7 September 2010

*JEL classification:*
D23
G21
G32
K42

*Keywords:*
Equity market liberalization
Risk-sharing
Cost of capital
Corporate governance

A B S T R A C T

Equity market liberalizations open up domestic stock markets to foreign investors. A puzzle in the literature is why developing countries exhibit relatively small financial impacts associated with liberalizations. We use cross-firm variation in corporate governance at the time of the official liberalization of the equity market in Korea to test whether governance can explain the extent to which firms benefit when countries liberalize. The results show that better-governed firms experience significantly greater stock price increases upon equity market liberalization. Following the liberalization in Korea, foreign ownership in firms with strong corporate governance was significantly higher than that in firms with weak governance. Better-governed firms also exhibit higher rates of physical capital accumulation after liberalization.

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## 1. Introduction

Stock market liberalization is a decision by a country's government to allow foreign investors to purchase shares in companies listed on the domestic stock exchange. Theory predicts that when a country liberalizes, foreign capital will pour into that country since the rates of return to capital are much higher in developing economies than they are in the rest of the world. The impact of liberalization works through a reduction in the cost of capital — real interest rates decline and systematic risk falls as the relevant benchmark for pricing risk changes from the local market index to a world market index. Consequently, firms in liberalizing countries should experience increases in stock prices and their rate of capital accumulation should rise until their marginal product of capital is driven down to the new lower cost of capital.

While existing studies provide some support for both of these predictions,[1] an as yet unsolved puzzle in the literature is why the financial impact of liberalization as experienced by developing economies is not as large as that predicted by theory. Lucas (1990) shows that neoclassical models of trade and growth predict much larger capital flows into developing countries than what is observed in reality. A prominent explanation for this paradox is that foreign investors are at an informational disadvantage relative to local investors and incur higher monitoring costs when they make investments in firms with questionable corporate

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[1] See Bekaert and Harvey (2000), Henry (2000a), Kim and Singal (2000), and Chari and Henry (2004) for evidence of stock price revaluations at the time of liberalization. The evidence on aggregate investment and economic growth around the time of equity market liberalization is reported in Henry (2000b), Bekaert et al. (2001, 2005), Gupta and Yuan (2009), and Quinn and Toyoda (2008).

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doi:10.1016/j.jcorpfin.2010.08.008

governance (Henry and Lorentzen, 2003; Stulz, 2005). The greater risk of expropriation for foreign investors leads to low equity flows into these countries.

The question is to what extent poor corporate governance explains the relatively small impact of equity market liberalization.[2] We examine this question using disaggregated data from Korea. The Korean stock market is ideal for this experiment since Korea is perhaps the only emerging market economy where it is possible to obtain ownership and governance data from as far back as the late 1980s and early 1990s, a period during which many emerging markets liberalized their stock markets (Korea officially liberalized its equity market in January 1992). This ability to exploit within-country variation in corporate governance provides more powerful tests of the impact of governance on stock price revaluations and investment growth than is possible from country-level studies.

We construct three measures of corporate governance. Our first measure is the ownership by the largest shareholder. Governance problems are expected to be less severe in firms in which the largest shareholder has greater ownership of cash flow rights. Second, we use affiliations with business groups known as *chaebols*. The business and ownership structures in *chaebols* provide controlling shareholders with the ability to expropriate outside investors and the incentives to do so. Third, we use an indicator for dividend-paying firms since we expect these firms to be better-governed than non-dividend-paying firms.

The paper presents three key findings. First, the abnormal returns in the month of liberalization are significantly higher for firms that have strong governance. All else equal, non-*chaebol* firms experience abnormal returns that are 10% higher than those for *chaebols*. Dividend-paying firms experience 9% higher abnormal returns upon liberalization. Similarly, we find that abnormal returns are positively related to ownership by the largest shareholder.

Second, firms in Korea with better corporate governance attracted significantly larger foreign ownership in the aftermath of liberalization than firms with relatively poor governance. We find that, after controlling for firm characteristics, foreign ownership is significantly higher for non-*chaebols*, for firms with more concentrated ownership, and for firms that pay dividends.

Third, we find that the investment growth rate is higher for firms for which foreign ownership increases and for independent firms that are not affiliated with business groups. These findings suggest that better-governed firms with greater foreign ownership tend to have higher rates of physical capital accumulation after the liberalization.

Overall, our evidence underscores the importance of governance in explaining the within-country cross-firm variation in the benefits of stock market liberalization. Better-governed firms experienced significantly higher stock price revaluations at the time of liberalization, attracted greater foreign ownership, and exhibited higher rates of physical capital accumulation following the liberalization.

The results of this study have significant policy implications. If public firms with weak governance structures do not benefit from liberalization, perhaps owing to entrenched controlling shareholders, then more attention should be paid to improving governance structures before countries decide to liberalize their markets. In this examination of the impact of governance structures on the benefits of liberalization within a country, we find that governance matters.

This paper is organized as follows. We discuss testable predictions and describe corporate governance measures in Section 2. Section 3 describes the data and variables. This section also presents descriptive statistics and correlations among variables. Section 4 examines the effect of corporate governance on liberalization returns. In Section 5, we examine foreign ownership after liberalization and how it responds to firm level governance measures. Section 6 examines the effect of governance on changes in investment rates following liberalization. Section 7 concludes the paper.

## 2. Measures of corporate governance

### 2.1. Chaebol affiliation

As noted above, our first measure of corporate governance is a firm's affiliation with a business group, known in Korea as a *chaebol*. These business groups have governance structures that are highly conducive to the expropriation of outside investors as the control in a *chaebol* is heavily concentrated in one family which makes most of the major decisions for all the member firms of the group.[3] Their boards have few outside directors. The professional managers in these firms own little equity.

The family's ability to control member firms without purchasing a significant direct stake in individual firms is facilitated through extensive interlocking institutional ownership and complex pyramidal ownership structures. The divergence between cash flow and control rights, together with weak incentives for individual and institutional shareholders to monitor controlling shareholders, gives them both the ability to expropriate and the incentives to do so.

[2] There is increasing evidence that foreign investors avoid investing in firms that exhibit weak corporate governance. Giannetti and Simonov (2006) find that foreign portfolio investors are less likely to invest in Swedish firms with weak governance. Leuz et al. (2009) find that foreign investors invest significantly less in firms that have ownership structures that are conducive to outside investor expropriation. There is also evidence that stock price movements in firms and/or countries that have better governance or institutions reflect more firm-specific information, resulting in more efficient investment of resources (Morck et al., 2000; Durnev et al., 2004). Further, firm-specific information contained in stock prices tends to increase as countries adopt greater capital market openness (Li et al., 2004; Bae et al., 2006). Thus, the benefits from improvements in informational efficiency will accrue more to firms with better governance.

[3] A different view of business groups is provided by Khanna and Palepu (2000), who argue that business groups have advantages over independent firms in emerging markets because of savings through intra-group trading and internal capital markets. However, much of the evidence on business groups in emerging markets suggests that these advantages must be relatively small compared with their costs, since firms affiliated with business groups often trade at lower valuations than otherwise similar independent firms (La Porta et al., 2002; Claessens et al., 2002).

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