CHAPTER 3

CORPORATE GOVERNANCE, INVESTOR PROTECTION, AND FINANCIAL STABILITY IN EMERGING MARKETS

Summary

Emerging market economies have become more financially integrated with the rest of the world, allowing greater access to capital but also exposing them to financial shocks. With this increased integration, have institutional and legal frameworks improved accordingly, helping these economies to be more resilient in the face of a more volatile external environment?

This chapter focuses on the interrelatedness of corporate governance, investor protection, and financial stability across emerging market economies. Corporate governance and investor protection encompass rules and practices at both the country and firm level and deal with ways in which suppliers of financing to corporations ensure that they get a return on their investment. Past financial crises across major emerging market economies underscored how corporate governance deficiencies can contribute to financial instability.

The chapter finds that corporate governance and investor protection have generally improved in emerging market economies over the past two decades. The progress is apparent in both firm- and country-level indicators. Even so, there are important differences across emerging market economies, and there is room for further improvement.

The analysis supports the notion that stronger corporate governance and investor protection frameworks enhance the resilience of emerging market economies to global financial shocks. The chapter develops new firm-level indices of governance in emerging market economies and employs novel empirical approaches. The results show that corporate governance improvements foster deeper and more liquid capital markets, allowing them to absorb shocks better. Corporate governance improvements also enhance stock market efficiency, thereby making equity prices less sensitive to external shocks and less prone to crashes. For example, moving from the lower to the upper end of the country- and firm-level governance indices reduces the impact of global shocks by up to 50 percent for emerging market firms, on average. Emerging market economies with better corporate governance and investor protections generally have stronger corporate balance sheets. In particular, better-governed firms typically display lower short-term debt ratios and default probabilities and are able to borrow at longer maturities. This reduces their vulnerability to dry-ups in funding, enhancing financial stability.

The financial stability benefits associated with improved corporate governance strengthen the case for further reform. Although there is no single model, good corporate governance frameworks have some common characteristics. Accordingly, this chapter makes the following policy recommendations:

- All emerging market economies should continue to reform their legal, regulatory, and institutional frameworks to foster the effectiveness and enforceability of corporate governance regimes.
- Most emerging market economies should continue to bolster the rights of outside investors, in particular minority shareholders.
- Bringing disclosure requirements fully in line with international best practice is needed in many emerging market economies. Promoting greater board independence is also likely to yield benefits.