Effect of Institutional Excellence on Stock Market Development

T. U. I. Peiris

Department of Accountancy and Finance, Faculty of Management Studies
Sabaragamuwa University of Sri Lanka
tuipeiris@gmail.com

Institutional environments with good governance would lead to higher stock market returns by reducing both transaction and agency costs. Meanwhile, superior institutional environments ensure lower levels of uncertainty, resulting in lower returns on equity. Therefore, this study investigates the effect of institutional quality on the performance of global stock markets. Due to the persistence behavior of stock market development (SMD), a dynamic econometric model is developed in this regard. SMD is proxied by market capitalization to GDP ratio. A Proxy for institutional quality is obtained by the common component of governance indices that measure the effectiveness of government, regulatory quality, extent of corruption control, political stability, voice and accountability, and agents' confidence on the rules of the society. Several other empirically chosen variables are also included to the model to control the other potential effects. A panel data set of 43 countries over the period 2005 to 2013 is measured using Generalized Method of Moment (GMM) estimation techniques. Results depict a negatively significant relationship between SMD and the institutional quality. The relationship continued to remain negative when the model is robusted for developing and developed countries. Interestingly, the risk-return spectrum is supported when the model is further robusted for countries with strong and weak Institutional environments.

Keywords: Generalized method of moment; Institutional quality; Risk-return spectrum; Stock market development