The Influence of Governance Quality Factors on Stock Market Performance in ASEAN

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ABSTRACT

Whilst regional participation across ASEAN induces the liberalization of trade and investment, as well as other forms of economic cooperation, the quality of governance plays a crucial role as it is a key component of sustainability. This study aimed to examine how governance quality factors influenced stock market performance. This study applied the Panel Least Square (PLS) and Panel Cointegration Full-Modified Ordinary Least Squares (FMOLS) estimations to gauge how quality governance factors impact an integrated ASEAN stock market in the long run. This study utilized data from the ASEAN Exchanges covering the period 2002 to 2020. The findings demonstrated the significant positive influence of voice and accountability, as well as political stability and the lack of violence; meanwhile, rule of law negatively affects the stock market performance. The study also identified a long-term relationship between governance quality and stock market performance. This implies that higher-quality governance improves the stock market performance in an integrated market.

Keywords: governance quality, stock market performance, ASEAN exchanges

INTRODUCTION

The stock market index is one type of economic indicator that reflects the state of a country's economic activities and financial infrastructure. Stock market index movements indicate current changes in the economy and provide investors with meaningful market information. In addition, stock market performance is a metric used to determine a stock's capacity to raise or reduce its owners' wealth. In the Southeast Asian region, the establishment of ASEAN Exchanges in 2011 aimed to promote the growth of the ASEAN capital market by bringing ASEAN investment opportunities to a wider market. Six countries collaborated to create the ASEAN Exchanges, which includes Bursa Malaysia (KLCI), Indonesia Stock Exchange (IDX), Singapore Exchange (SGX), the Stock Exchange of Thailand (SET), Ho Chi Minh Stock Exchange (HOSE) and the Philippines Stock Exchange (PSE).

According to the Census and Economic Information Center (CEIC) in 2022, the regional markets had a market capitalisation totalling USD 2.4 trillion, with approximately 3,855 businesses listed (Figure 1). The market has grown by 26.08 per cent year-to-year, with Singapore and Indonesia leading in terms of market size. The price-earnings ratio (Figure 2) demonstrated that ASEAN markets are more affordable than the established markets in other Asian nations.
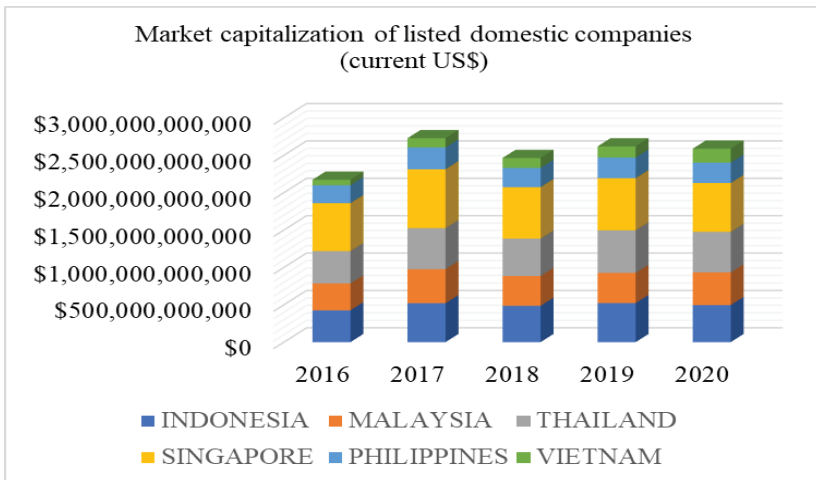
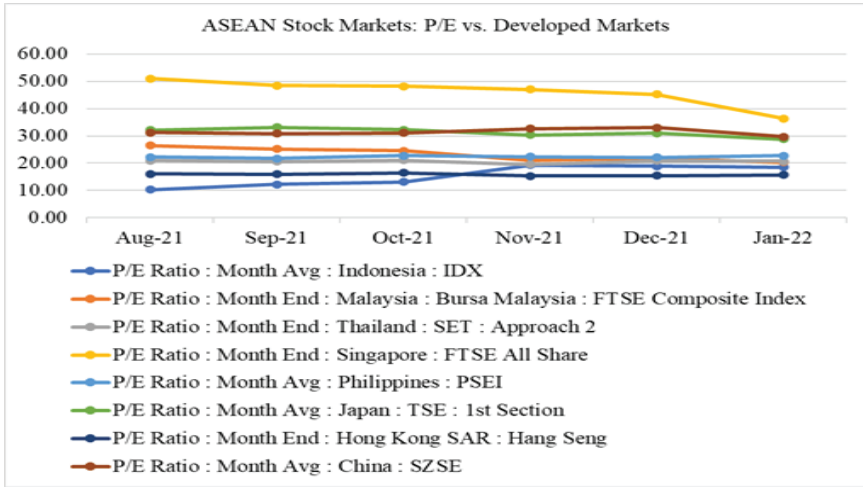**Figure 1: Market Capitalisation of Listed Domestic Companies (Current US$)**

Figure 2: ASEAN Stock Markets: P/E vs. Developed Markets

In 2021, ASEAN Exchanges focused on shared sustainability investments using the key criteria of environmental, social and governance (ESG). ESG considerations have grown in importance as a component of global investment choices. ESG investing spans a broad range of metrics and is gaining greater attention and acknowledgement amongst policymakers, investors and the public for its role in encouraging sustainable business practices and operations. Investors have come to recognise the value of ESG elements in terms of their efficiency, productivity, long-term risk management and operational development. ESG investing is a strategy that enables businesses to engage effectively and provide value to their investors beyond profit, thus benefiting society and wider stakeholders. Whilst regional participation across ASEAN induces the liberalisation of trade and investment, as well as other forms of economic cooperation, the quality of governance (QoG) plays a crucial role as it is a key component of sustainability (Darusalam et al., 2021) and impacts significantly on the success of the stock market (Ahmed et al., 2021).

In the previous literature, Kraay and Tawara (2013) and Busse and Gröning (2009) argued that the quality of governance is an important element of a country's economic and social development. Furthermore, the QoG influences investors' trust in the efficiency of the market. Consequently, this has a major impact on the stock market's performance. Generally,

for investors seeking to obtain capital, the liquidity of the stock market is critical, and the quality of corporate governance has a significant impact on the success of the stock market. As Yartey (2008) argued in his landmark work, another issue to consider when foreign investors make investment choices is political risk. Several researchers have examined the relationship between governance quality and stock market performance. Hooper et al. (2009) studied the association between governance quality and stock market performance using a sample of 50 established and emerging economies. Utilising stock index returns and volatility as proxies for stock market performance, their research showed that governance quality was favourably connected to the stock index returns and negatively related to stock market risk. Additionally, their findings indicated that governance quality has a significant impact on market risk and returns. Conversely, Low et al. (2011) discovered a negative relationship between governance quality and stock index performance.

Besides, the institutional theory also identifies the importance of governance in terms of how institutional factors and regulatory frameworks affect the performance of the stock market. In addition, the COVID-19 outbreak has caused economic trends and a precipitous reversal. This has affected investors' expectations and uncertainty sentiments, which has subsequently influenced the returns on assets, including stock market indexes. This has resulted from the actions investors took because of the deteriorating stock market conditions. Given this background, this study aimed to examine the influence of governance quality factors on stock market performance. This study utilised ASEAN Exchange datasets covering 19 years. To the same end, the study sought to gauge how quality governance factors impact an integrated ASEAN stock market in the long run. The study offers empirical evidence of how such factors impact the stock market performance in an integrated stock market in the long run. The remainder of the paper is organised as follows: the existing literature is discussed in Section 2, while Section 3 describes the research methodology. The discussion of the results is presented in Section 4, and Section 5 concludes the study.

LITERATURE REVIEW

Theoretical Considerations

Efficient market hypothesis and institutional theory

The term "efficient market" was first used by Fama (1965). The paper suggested that in an efficient market, competition would lead to fresh information being rapid reflected in the real stock prices, all other factors being equal. Investors and analysts devote significant amounts of energy to identifying assets with the potential for future value appreciation. There are three types of Efficient Market Hypothesis (EMH): mild, semi-strong and powerful. In its weakest version, the EMH asserts that the present price integrates all the information contained in prior prices and that, as a result, no one can discover mispriced stocks or beat the market by investigating historical prices. With the semi-strong form of the EMH, it is reasonable to assume that the current price comprises all publicly accessible information. Historical pricing, as well as other financial and non-financial disclosures made in corporation annual reports, are all examples of this type of information. Equities with a low current value but a projected growth in future prices might beat the market using applicable forecasting, along with valuation algorithms and procedures. Using the findings of such studies, investors who have greater knowledge and predicting capacity may make significant gains. Unfortunately, according to the EMH, no analysis or approach is worth the time and money they entail. Given that all market players have access to the same information, no one can acquire an unfair edge over another since the rewards do not outweigh the research and transaction expenses. The information in this type of EMH is available to the public, confirming the impossibility of benefiting from aberrant future pricing in the short term. This is the strongest version of EMH, which states that the current market price of stocks considers all the information available, from both public and private sources.

Meanwhile, the normative social theory is a socio-political concept that encompasses the manner in how rules, norms, culture, laws and regulations are formed and administered by a higher authority in order to serve as authoritative guides for social conduct within an ecosystem According to Scott et al. (2004), institutions are highly resilient social structures comprised of cultural-cognitive, normative and regulative

components which, in conjunction with related activities and resources, give social life stability and purpose. The institutional theory, a branch of political science that studies institutions and their interactions (Clemens & Cook, 1999), proposes that a stock market would not exist without an institutional and regulatory environment. The theory proves that governance arrangements can influence investors' trust in an efficient market, which subsequently affects their degree of involvement in the stock market and the consequences of this.

Governance Quality and Stock Market Performance

Under the auspicious of the World Bank, Kaufmann et al. (2011) defined QoG as "the tradition and institutions by which authority in a country is exercised". More specifically, the concept includes "the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies and the respect of citizens and the state of the institutions that govern economic and social interactions among them" (p.3). A study by Ernest et al. (2016) demonstrated that institutional quality components benefit developing economies and stock market performance. Theoretically, reducing corruption would increase government effectiveness and promote political stability. Hence, good governance frameworks create higher value for shareholders. For example, an event in Thailand was connected to the issues of governance quality and stock market performance. A youth protest demanded that the government dissolve parliament and draft a new democratic constitution. The demonstrators also demanded major reforms to the monarchy, which had never occurred in the contemporary history of the country, which is prone to political volatility. However, none of these demands were satisfied by the government. Instead, the authorities began a broad crackdown on dissent, including a slew of charges under Thailand's infamous lese-majesty statute, Article 112. Unfortunately, the event significantly impacted Thailand's stock market performance. It was also reported that foreign direct investment (FDI) inflows had declined. This appeared to be an initial shock to the stock market and a signal of investors' confidence in the economy (Abbott, 2021). In another event, the Malaysian stock market also experienced a similar market reaction due to a change of government, with the previous administration falling to the Pakatan Harapan-led coalition. Political instability resurfaced, resulting in

heightened market volatility and negative risks barely seven months after the new Prime Minister had been appointed. The event evidenced how political risk influences the confidence of local and foreign investors to invest in Malaysia's capital market (Khuen, 2020).

Moreover, Boadi and Amegbe (2017) used panel data models to examine the relationship between governance quality and stock market performance in 23 economies worldwide from 1996 to 2014. The study found that governance substantially affects stock market success. The study used six components to measure the quality of governance, namely; voice and accountability, political stability and the absence of violence, government effectiveness, regulatory quality, rule of law, and corruption control. Meanwhile, Ahmed et al. (2021) employed three variables to measure the quality of governance, namely control of corruption, voice and accountability, and rule of law. They found that the quality of governance has a positive and statistically significant impact on stock market growth. However, Modugu and Dempere (2020) claimed that of the six quality of governance characteristics, only rule of law, political stability, and the absence of violence have a significant influence on stock market returns. It has been proposed that good quality governance is associated with higher returns on stock, which contrasts with the findings of Imran et al. (2020). In addition, Knack and Keefer (1995) stated that the quality of governance is a crucial variable in explaining the rate of investment, while Olson et al. (2000) argued that the strategy of encouraging the capital market and investment climate could enhance economic growth.

In brief, the influence of governance quality on stock market performance remains equivocal. Some studies have presented a favourable relationship between the quality of governance and the success of the stock market. Hence, this study aimed to determine how governance quality factors affect stock market performance. The study also intended to investigate the long-run relationship concerning the link between governance quality and stock market performance using FMOLS analysis to gauge the importance of governance quality in relation to stock market performance, especially in ASEAN Exchanges.

METHODOLOGY

This study collected data from the six ASEAN countries that collaborated to form ASEAN Exchanges: Malaysia, Indonesia, Singapore, Thailand, the Philippines and Vietnam. This study aimed to understand the relationship between governance quality factors and stock market performance. This study used panel datasets from two primary sources, the World Bank Data and the World Governance Indicator, covering the period from 2002 to 2020. This study involved panel data analysis using Panel Least Square (PLS) and Panel Cointegration Full-Modified OLS (FMOLS) to investigate the long-run equilibrium relationship between governance quality factors and the equity index across time. The elements of governance quality employed here included voice and accountability, political stability and the absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

Measurements of Variables

This study used the equity index as the dependent variable, while the six dimensions of governance quality formed the independent variables; these were voice and accountability, regulatory quality, rule of law, political stability and the absence of violence, government effectiveness, and control of corruption. Meanwhile, the inflation rate and gross domestic product (GDP) were included as control variables, as shown in Table 1.

Table 1: Measurements of Variables

Variables	Indicators	Scale of Measurement
Equity index	Indicates stock market performance	Index
Voice and accountability	Persons who administer government institutions are chosen, as well as the stability of positions within such institutions. It is also assessed by democracy.	Index
Regulatory quality	The government's capacity to establish and execute effective policies and regulations for fostering private sector growth that will be evaluated.	Index
Rule of law	The efficacy and predictability of the court, as well as the enforcement of contracts and property rights, among other things.	Index

Political stability and absence of violence	Government stability and internal conflict.	Index
Government effectiveness	Judged by the bureaucratic quality of public services. It determines the government's capacity to develop and deliver public goods by putting in place sound policy measures.	Index
Control of corruption	Corruption includes various forms of uncontrolled power exercise in the public sector, such as kickbacks and kickback schemes.	Index
Inflation Rate	Inflation is the rate that is related to the value of currency and prices of goods and services.	%
Gross Domestic Product	The market value of all final products and services produced domestically each year. It shows the economic condition and growth rate of the country.	%

Model Estimation

The following model was used to examine the effect of the governance quality factors on stock market performance.

$$EQIND_{it} = \alpha X_{it} + \beta Z_t + \mu_{it} \tag{1}$$

In equation (1) above, Equity index (EQIND) represents the performance of the stock market; X_{it} is a matrix of the quality of governance components, which include six variables: Voice and accountability (*VACC*), Regulatory quality (*RQUA*), Rule of law (*ROL*), Political stability and the absence of violence (*PSAV*), Government effectiveness (*GEFF*), and Control of corruption (*COC*). Zt is a matrix of the control variables, Inflation rate (*IFR*) and gross domestic product (*GDP*). α and β coefficients, μit is the error term. The equity indices as a proxy for stock market performance were collected from the Thomson Reuters Eikon Database, while the governance quality indicators were collected from the World Governance Indicators (WGI).

This study focused on ASEAN Exchanges, a collaboration of six stock exchanges: Bursa Malaysia (KLCI), Indonesia Stock Exchange (IDX), Singapore Exchange (SGX), the Stock Exchange of Thailand (SET), Ho Chi Minh Stock Exchange (HOSE) and the Philippines Stock Exchange (PSE). The collaboration was intended to boost the ASEAN capital market by making ASEAN investment possibilities more accessible to a wider

range of individuals, as well as offering cross-border harmonisation and developing ASEAN-centric goods.

RESULTS AND DISCUSSION

Descriptive Statistics

Table 2 presents the descriptive statistics taken from the datasets that reflect the variables included in the model. The findings showed that none of the variables were normally distributed, except that of political stability and the absence of violence (PSAV).

Table 2: Descriptive Statistics

	EQIND	VACC	RQUA	ROL	PSAV	GEF	COC	IFR	GDP
Mean	2292.976	-4.041	0.2951	0.1210	-2.4333	0.5218	0.0326	3.8911	5.3188
Median	1624.270	-0.2216	0.0610	-0.1713	-0.0324	0.1902	-0.4035	3.0868	5.4285
Maximum	8558.418	0.3215	2.2605	1.8789	1.6157	2.4370	2.3256	23.1155	14.5256
Minimum	165.570	-1.5385	-0.7959	-0.9140	-2.0946	-0.4831	-1.1440	-0.9004	-1.5135
Std. Dev	1959.250	0.5439	0.8445	0.8051	0.9602	0.8657	1.0145	3.6594	2.1176
Skewness	1.3398	-0.9493	1.0263	1.0267	0.1440	0.9515	1.4318	2.2529	-0.0539
Kurtosis	4.0667	2.5852	2.9835	2.8089	2.0313	2.5968	3.5285	10.9020	6.6748
Jarque-Bera	37.433	16.996	18.961	19.137	4.5959	17.026	38.158	372.34	60.820
Probability	0.0000	0.0002	0.0000	0.0000	0.1004	0.0002	0.0000	0.0000	0.0000
Observation	108	108	108	108	108	108	108	108	108

Unit Root Test

It is essential to examine the order of integration of the variables for an estimation model. This study employed the Augmented Dickey-Fuller (ADF) unit root test on individual stochastic structures to conclude whether the variables were stationary and integrated in the same order. As shown in Table 3 all the variables were stationary at the first difference at a 1% level of significance, except for the variables control of corruption (COC) and Gross domestic product (GDP), which were at 5% and 10% levels of significance, respectively.

Table 3: Unit Root Test Result

	Variables	Level		1st Differences	
		Tau	Pr < Tau	Tau	Pr < Tau
Without Drift	EQIND	0.9998	1.5715	75.5508***	0.0000
	VACC	23.9428**	0.0207	65.2519***	0.0000
	RQUA	19.6499*	0.0740	60.7774***	0.0000
	ROL	20.4143*	0.0597	60.4746***	0.0000
	PSAV	29.9771***	0.0028	86.0786***	0.0000
	GEF	15.6210	0.2092	61.4040***	0.0000
	COC	13.7744	0.3153	58.5130***	0.0000
	IFR	16.4338	0.1722	106.381***	0.0000
	GDP	18.3830	0.1045	56.2214***	0.0000
With Drift	EQIND	10.4513	0.5764	60.6887***	0.0000
	VACC	20.8017*	0.0534	37.4116***	0.0002
	RQUA	6.3421	0.8979	38.2474***	0.0001
	ROL	6.4376	0.8924	36.4631***	0.0003
	PSAV	20.1111*	0.0650	57.1175***	0.0000
	GEF	10.4521	0.5764	40.6391***	0.0001
	COC	10.9389	0.5342	33.9020***	0.0007
	IFR	12.6130	0.3978	68.6661***	0.0000
	GDP	9.2478	0.6816	31.2096***	0.0018
With Trends and Drift	EQIND	12.7463	0.3877	48.5759***	0.0000
	VACC	10.7410	0.5512	29.5433***	0.0033
	RQUA	19.8434*	0.0701	28.0663***	0.0054
	ROL	5.8089	0.9254	30.7726***	0.0021
	PSAV	28.5511***	0.0046	54.9636***	0.0000
	GEF	9.7523	0.6377	28.2735***	0.0050
	COC	14.9496	0.2442	23.0420**	0.0274
	IFR	19.2924*	0.0817	55.0897***	0.0000
	GDP	13.0336	0.3666	20.8491*	0.0526

Panel Least Square Estimation

To analyse the influence of governance quality factors on stock market performance, the Panel Least Square (PLS) estimation was applied. Table 4 presents the regression results for the model. The R-squared statistic indicated that the model is well explained, with 46.31%. The results showed that voice and accountability (VACC), political stability and the absence of violence or terrorism (PSAV), and gross domestic product (GDP) each have a positive and significant effect on stock market performance. Meanwhile, rule of law (ROL) and the inflation rate (IFR) have a negative

and significant impact on stock market performance. The findings suggest that certain factors of governance quality - namely voice and accountability, political stability and the absence of violence, and rule of law - are important influences on stock market performance. These outcomes support the works of Dima et al. (2018), Asaad and Marane (2020), and Masrorkhah and Lehnert (2017), who revealed similar findings, whereby voice and accountability, political stability and the absence of violence and rule of law were found to significantly affect stock market performance. However, rule of law had a negative statistically significant relationship with stock market performance.

Table 4: Panel Least Square (PLS)

Variable	Coefficient	t-Statistic	Prob.
C	2661.776 (733.14)	3.6306	0.0004
VACC	1948.496*** (1948.49)	5.0057	0.0000
RQUA	2012.686 (1248.03)	1.6127	0.1100
ROL	-5330.093*** (1427.54)	-3.7337	0.0003
PSAV	913.5735** (393.23)	2.3232	0.0222
GEF	785.1401 (978.15)	0.8027	0.4241
COC	834.3942 (713.45)	1.1695	0.2450
IFR	-116.7894** (49.38)	-2.3650	0.0200
GDP	133.3515* (74.92)	1.7799	0.0782
R-squared	0.4631	DW-stat	0.3054
Adjusted R^2	0.4197		
F-statistic	10.6749		
Prob(F-statistic)	0.0000		

Symbols of ***p<.01, **p<.05, *p<.10. and P-values are in parentheses.

Long Run Analysis Using Panel Fully Modified OLS (FMOLS)

Next, the study applied the Panel Cointegration Full-Modified Ordinary Least Squares (FMOLS) estimation to investigate the long-run equilibrium between the governance quality factors and stock market performance across time. FMOLS is based on a single equation and an optimum panel data method for heterogeneous and serial correlation (Rehman, 2021). The FMOLS estimator is a group mean or between-group estimator that accommodates a significant degree of heterogeneity in the dataset.

Table 5: FMOLS Results

Variable	Coefficient	t-Statistic	Prob
VACC	-1333.646*** (195.27)	-6.8296	0.0000
RQUA	2281.225*** (362.7506)	6.2887	0.0000
ROL	-1325.330*** (428.35)	-3.0941	0.0026
PSAV	1825.123*** (191.14)	9.5484	0.0000
GEF	980.8041*** (454.71)	2.1570	0.0335
COC	3187.721*** (454.71)	6.3997	0.0000
R-squared	0.8133		
Adj. R-squared	0.7919		
S.E. of regression		916.1381	
Long-run variance		495149.2	
Symbols of ***p<.01, **p<.05, *p<.10. and P-values are in parentheses.			

According to Pedroni (1999), FMOLS can deal with cointegrated heterogeneous coefficients. The panel FMOLS offers numerous advantages since it can tolerate serial correlation, the existence of endogeneity and cross-sectional heterogeneity (Erdal & Erdal, 2020). Prior to the FMOLS estimation, a Panel Pedroni cointegration test was conducted on the governance quality factors and the equity index to test the cointegration among the variables. The results, as presented in Table 6, showed that the probability for the Panel ADF Statistic is 0.0022, which is less than 1; thus, the null hypothesis was rejected. This indicates that all the variables were cointegrated and therefore enabled the study to estimate the long-run model using FMOLS (Rehman, 2021).

Table 6: Panel Pedroni Cointegration Test

	Probability
Panel ADF-Statistic	0.0022

H_0: p = 1 (no cointegration)
H_1: p < 1 (There is cointegration)

Table 5 presents the regression results for FMOLS, for which the R-squared value was 0.8133. The results showed that there is a long-run relationship between stock market performance on one hand and rule of law, government effectiveness, political stability and the absence of violence, control of corruption, and voice and accountability on the other. In addition, the findings showed that VACC, ROL and PSAV were significant at 1% and 5% levels of significance for both models, Panel Least Square and Panel Fully Modified Ordinary Least Square (FMOLS).

In brief, stock markets are critical to financial stability and economic progress (Ahmed et al., 2021). Thus, good governance leads to an efficient regulatory framework, which eventually improves and assists the financial markets of a nation. Moreover, as Evans and Rauch (1999) explained, certain strategies can be used to improve economic performance through excellent governance, such as ensuring a stable bureaucratic structure that encourages long-term private-sector investment. Rauch et al. (1995) stated that professionalising the bureaucracy encourages public and constructive investment while reducing corruption (Campos et al., 1999; Dahlström et al., 2012). A political influence framework might shape the economic system and policies (Liu et al., 2015). The finding of this study also suggested that the rule of law indicator has the most influence on stock market performance. This was supported by Gifford (2003), who claimed that rule of law prevents market subjects and governmental institutions from creating strain and encourages both parties to have a positive impact. This preserves ownership and intellectual property protection while encouraging investment and innovative ideas. A study by Khan and Siddiqui (2017) asserted that if a country practices good regulation, the stock market will rise, either directly or indirectly. This produces favourable economic growth and fosters foreign investors. Meanwhile, political stability and the absence of violence were also found to influence the performance of the stock market. Asaad and Marane (2020) and Permana (2016) produced the same outcomes, agreeing that excellent governance and political stability would draw capital to the state by boosting market share. This would allow a country to reach the desired degree of economic growth and create a favourable business climate.

Table 7: Results of Diagnostic Testing

	Breusch-Pagan Test	Normality Test (Jarque Bera)	Serial Correlation DW stats
PLS	123.741 (0.0000)	3.5166 (0.1723)	0.30537
P-values are in parentheses.			

The models passed the diagnostic tests of serial correlation, normality and heteroscedasticity, as indicated in Table 7. The probability value of the residual for normality was insignificant at the 5% level, while the residual value was normally distributed. The Breusch-Pagan test was conducted to examine whether the variance of the errors from a regression was dependent on the values of the independent variables. The results were significant, with the p-values of the chi-square being less than the significance level of 5%. Thus, heteroscedasticity was present in the model. The study employed the FMOLS, which can deal with cointegrated heterogeneous coefficients.

CONCLUSION

This study examined the influence of governance quality factors on stock market performance for ASEAN Exchanges. The study also intended to gauge how quality governance factors impact an integrated ASEAN stock market in the long run. This work focused on ASEAN Exchanges, a collaboration of six exchanges: Bursa Malaysia (KLCI), Indonesia Stock Exchange (IDX), Singapore Exchange (SGX), the Stock Exchange of Thailand (SET), Ho Chi Minh Stock Exchange (HOSE) and the Philippines Stock Exchange (PSE). The datasets were obtained from the Thomson Reuters Eikon Database and the World Governance Indicators (WGI). Using the PLS model, certain governance quality factors - voice and accountability, political stability and the absence of violence, rule of law and the inflation rate - were found to significantly influence the stock market performance in ASEAN Exchanges. The findings also indicate that there is a long-run relationship between governance quality factors and the performance of the stock market in ASEAN Exchanges. This is consistent with the EMH and Institutional theory, which emphasise the important effects that governance quality has on stock market performance because investors rely on market information. Thus, it is important to develop a comprehensive plan for ASEAN Exchanges to strengthen the integration of the capital market in

ASEAN. Moreover, the market liquidity may become more extensive in either the primary or secondary market by strengthening the fairness and efficiency of institutional investor engagement to foster market trust.

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