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A tale of two cities: Economic development, corporate governance and firm value in Vietnam



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ABSTRACT

This study examines the moderating effect of financial and economic development on the relation between corporate governance and firm value in Vietnam, which has two exchanges, one located in the business center in the South, and the other located in the center of government in the North. This unique setting allows an investigation of corporate governance dynamics controlling for legal jurisdiction. The results show a positive relation between corporate governance and firm value in Ho Chi Minh City but not in Hanoi. The finding suggests that financial and economic development play critical roles in enhancing the benefits of corporate governance in emerging markets.

1. Introduction

The aftermath of the 1997 Asian Financial Crisis brought forth the realization that poor corporate governance was the root cause of the crisis. Consequently, policy makers and regulators in Asian economies have made a concerted effort to push for corporate governance reform in the region.¹ As a result of their efforts, the corporate governance landscape in Asia has improved drastically (Jurdant, 2011).² In nation after nation, many rules and regulations have been introduced with the purpose of improving the quality of corporate governance practices among publicly listed companies in Asia. However, at the center of the reform effort is a debate over the role of government, along with legal and financial institutions, in corporate governance dynamics. Many experts question if more regulation pushes managers in Asia toward a “box-ticking” mentality of purely mechanical compliance with the regulations. As scholars continued to scrutinize the governance failures exposed during the Asian Financial Crisis, it became clear that the absence of regulations was not the root cause. The trail of failure led back to a lack of enforcement of the existing regulations. Gradually, regulators in Asian economies shifted the focus of their priorities. The regulators shifted out of the mode of issuing flurries of new

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¹ In 1999, the Organization for Economic Co-operation and Development (OECD) established the Asian Corporate Governance Roundtable to bring together influential policy makers and experts in the region to work on pushing a reform agenda and promoting awareness of corporate governance in Asia. Every year, high-ranking officers from the ministries of finance, the stock exchanges, and the securities exchange commissions from all nations in the region meet to set priorities and develop action plans to address pressing corporate governance issues.

² For example, before the onset of the Asian Financial Crisis, only three East Asian economies had regulations designed to promulgate the use of independent directors and regulations containing clear definitions of director independence. By 2003, nearly all Asian economies had developed definitions of director independence and introduced regulations requiring independent directors to sit on boards.

regulations and directives to a mode of effective enforcement of the existing laws and regulations pertaining to corporate governance. Overlooked in the process of improving governance practices at firms are the influences that financial and economic development can play in the drive to improve the quality of corporate governance practices. It is possible that the levels of financial and economic development can complement the force of regulations when it comes to corporate governance. A key research question remains open: do the levels of financial and economic development play a role in corporate governance dynamics? If the empirical evidence shows that the levels of financial and economic development are relevant, the government can shift their focus to improving the financial and economic conditions rather than increasing regulation.

Underlying the debate among regulators in East Asia are the fundamentally opposing viewpoints of the market perspective versus the regulatory perspective. Proponents of free markets regularly cite Adam Smith (1776) who contended that markets are naturally efficient and, therefore, need no intervention from the government (i.e., regulation). Proponents of the market perspective assert competition for external funds and access to capital naturally force firms to adopt good corporate governance practices in order to attract investors. On the other hand, proponents of regulation contend that the assumptions underlying the free market tenet are so restrictive that they are rarely observed in current economic conditions (Stiglitz, 2009). Greenwald and Stiglitz (1986) for example show that government intervention induces efficiency when information is not complete and the market is not perfect. However, several economists (Peltzman, 1976; Posner, 1974; Stigler, 1964, 1971) provide an argument against the use of regulation because the political process that creates and monitors the resulting regulations is dictated by bureaucrats with their own self-interests.³ Based on high-profile accounting scandals in the US, Ball (2009) posits that regulation creates rules-based accounting standards whereas market forces favor a principles-based approach to the standards. Another important aspect of regulation is that it is countercyclical with the economy. Governments tend to push new regulations during recessions or in the aftermath of crises and take little action during economic booms (Rajan and Zingales, 2003a). Stiglitz (2009) concludes that there is a real need for regulation, as it can address market failures, but the extent of regulation needs to be optimal. The key issue faced by regulators in East Asian economies is to understand the extent to which financial and economic development can advance the corporate governance reform agenda.

This study contributes to the literature and an on-going debate among regulators in Asia by examining the marginal effect that financial and economic development have on the relation between the quality of corporate governance practices and firm value.⁴ In general, it is very difficult to isolate the effect of financial and economic development while controlling for the effects of a nation's underlying legal and regulatory frameworks.⁵ Therefore, Vietnam provides an ideal setting for our investigation because of its unique history and institutional structure. Specifically, there are two major cities and two stock exchanges in Vietnam.⁶ One stock exchange (HOSE) is located in Ho Chi Minh City (formerly Saigon), the largest city Vietnam, thriving with economic activity but situated in the South. The second exchange (HNX) is located in Hanoi, the capital city in the North and the home to all government offices and regulatory agencies. In addition to a geographic separation, the two cities differ in other significant ways, including the level and pace of financial and economic development.⁷ As noted in a literature review by Claessens and Yurtoglu (2013), previous studies treat each market as homogeneous but that is not the case in Vietnam. In the case of the two principal cities in Vietnam, the levels of financial and economic development were historically much more advanced in Ho Chi Minh City than in Hanoi for a significant period of time. Consequently, the setting of this study controls for the effect of legal institution because both cities and exchanges operate under the same laws and regulations established by the Vietnamese government. The findings from this study provide empirical evidence on the impact of economic development on corporate governance dynamics and also yield additional insights on the law and finance debate.

The main research question is whether the degree of financial and economic development in the two cities, under the same set of

³ Political forces can affect the desired outcomes of the legal and regulatory frameworks (Rajan and Zingales, 2003a). Empirical evidence shows that firms benefit from political connections (Claessens et al., 2008; Faccio, 2006; Fisman, 2001). However, previous research also shows that political forces can distort the roles played by the legal setting and financial institutions with respect to corporate governance.

⁴ There is extant literature on the relation between financial development and economic growth (e.g., Ang and McKibbin, 2007; Beck and Levine, 2002; Beck et al., 2000; Castaneda, 2006; Dornbusch and Reynoso, 1989; Greenwood et al., 2010; King and Levine, 1993; Levine and Zervos, 1998; Levine et al., 2000; Rajan and Zingales, 1998; Rioja and Valev, 2004). This study accepts the notion and goes beyond the issue by examining how both financial and economic development contribute to corporate governance dynamics in an emerging economy.

⁵ The existing finance and economic literature suggests that a nation's legal institutions can play a critical role in facilitating financial development. In addition, economists have noted that legal institutions, such as courts and regulatory agencies, influence the development of a nation's capital markets (Beck and Levine, 2008; Coffee, 2002). La Porta et al. (1997, 1998, 1999, 2000) posit that enforcement of private property rights, support of contractual arrangements, and protection of the legal rights of investors are three pillars of financial market development. The main reason why a nation's courts and regulatory agencies shape its financial development is because corporate governance systems can effectively mitigate agency problems and other governance conflicts specific to a particular economy (Gompers et al., 2003; John and Senbet, 1998; Leuz and Wysocki, 2016; Shleifer and Vishny, 1997). There is empirical evidence in support of the notion that strong legal institutions and securities regulations benefit firms financially (Hail and Leuz, 2006; La Porta et al., 2006; Wurgler, 2000). There is an active debate concerning the effect that the origin of a nation's legal system can have on investor protection and financial development (Rajan and Zingales, 2003b; Roe, 1994). Despite some disagreement among scholars, there is a consensus that law and finance are interrelated.

⁶ As of 2014, the total market capitalization of the two exchanges in Vietnam was approximately \$52 billion. According to the most recent statistics available from the World Bank, in 2012 the market capitalization of Vietnam was equal to US\$33 billion or approximately 21 percent of the nation's GDP. By comparison, in 2012, the market capitalization of the stock market in Singapore was US\$414 billion (144 percent of GDP), in Thailand was US\$383 (105 percent of GDP), and in the Philippines US\$264.1 billion (106 percent of GDP).

⁷ Although there are many nations with a common legal framework and more than one stock exchange, the setting of Vietnam is unique because the two cities differ in the pace of financial and economic development. For example, China also has two major stock markets, one in Shanghai and one in Shenzhen. Although the two cities and markets in China differ in terms of size and location, both cities and both markets have very similar business-friendly environments and both cities are known for fast-paced economic development. Before 2013 in Japan, there were two major stock exchanges, the Tokyo Stock Exchange and the Osaka Stock Exchange. Nevertheless, the degree of financial and economic development in the two cities is qualitatively similar.

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