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National competitiveness: a cross country analysis of quality of governance and financial sophistication of Asian emerging markets

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ABSTRACT

This paper proposes a research framework involving two indicators of national competitiveness namely quality of governance and financial sophistication. Specifically, it proposes to examine the role of governance in influencing the level of financial sophistication among emerging economies in Asia. Good governance is needed to increase the wealth of people in a country as this will create positive influences at the regional and international scopes. On the other hand, a sophisticated financial markets is required to ensure the availability of capital especially from banking and capital market. The proposed framework is an important area of research as it will highlight the significance of governance practices as a major element in determining the level of financial sophistication in which suitable policies are implemented through good governance are expected to ensure a better access to financing that could improve the country's economic growth.

Introduction

The goal of citizen's welfare and wealth of people in a country is consistent with the perspective of competitiveness which has direct relationship to a nation's standard of living (Porter, 2002). According to The Global Competitiveness Report (2008), a nation's level of competitiveness reflects the extent to which it is able to provide rising prosperity to its citizens.

National competitiveness has been a serious concerns by policy makers. The most worry is for the governments of a rich countries that concern on retaining technological lead and entering new activities where high wages are not a competitive handicap. On the other hand, New Industrial Economies (NIEs) worry about staying ahead of lower wage entrants and challenging mature industrial countries in sophisticated activities. Meanwhile, the least developed countries worry about reviving their economies and diversifying into new export activites (Lall, 2001). In overall, serious concerns on national competitiveness requires a set of policy through good governance for the purpose of welfare and wealth of the citizens.

Isssues of governance has been an area of concern especially during the Asian financial crisis in 1997. It has been reflected in many forms which has been documented in vast literature but exclusively at the firm level. Of particular, this is existed in study that mostly link governance and performance. Meanwhile, earlier studies on governance at the country level focused on the link between law and finance that began with the findings that the laws that protect investors differ significantly across countries which was partly due to differences in legal origins (La Porta et al, 1998).

The financial crisis highlighted the importance of efficient financial markets in allocating financial resources to the most productive uses. Therefore, a sophisticated financial markets is required to ensure the availability of capital especially from the banking and capital market. It is also promoting entrepreneurial development as funds can be chanelled to those innovators to finance their commercially viable products and services (The Global Competitiveness Report,2013).

The recent interest between financial and real sector has been usually on banking sector and stock markets. However, it was also found that the 1997 financial crisis highlighted the problem of bond market underdevelopment. Such situation complicated the efforts to finance large infrastructure projects while financing package through loan syndication arranged by banking institutions which could securitize the loan was costly (Eichengreen and Luengnaruemitchai, 2004). This indicates that having a sound bond market in a well-diversified financial system is very much importance and has becoming a priority of policy makers. In pursuing this objective, effective governance system is recommended as part of policy reforms to foster bond markets as a way of opening up additional channels for debt financing (Eichengreen, Borenztein and Panizza, 2006). Hence, this study is actually incorporated an another component of capital market which is debt or bond market.

Asia is chosen in this study due to the fact that during the post-crisis, it was the key requirements for the region to strengthen the financial sectors and to reduce vulnerabilities to future financial crises (Fadella and Madhur, 2003). Therefore, it is interesting to identify the effectiveness of governance in strengthening the banking sector and capital markets after more than a decade from the financial crisis.

Literature Review

Agency Theory

Agency Theory is employed to address the problem of asymmetric information between the agent who was delegated and the principal who delegated its authority. According to Jensen and Meckling (1976), agency theory involved with a contract under one or more persons, called 'principal' engage to another person, called 'agent' to perform some actions, that includes the delegation of authority from the principal to the agent. Agency theory is always applied at the firm level especially on the issues of corporate governance where it relates

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shareholder as principal and managers as their agent knowing as Type 1 Agency Theory and between controlling shareholder and other shareholder known as Type II Agency Theory.

Even though agency theory is strongly applied in economic research, it has widely applied in theoretical and empirical framework for many different disciplines and approaches (Kivisto, 2008). Agency theory is also applicable at country level as it can be applied in the relationship between government and the people. This is in accordance with Kiser (1999) who argued that agency theory is not only used in economy, but also used in policy implementation, especially in political science. A perspective on the application of agency theory to a public administration can be observed based on the fact that politicians who govern the public administration called as government are elected by the people to serve the nation. They become the 'agent' who are entrusted to act on the best interest of the people in ways that they will be able to foster the growth of the nation Therefore, agency theory is also recommended at the country level where the principals are people in that country, called as citizens and the agent are the government that consists of politicians elected by the citizens.

Quality of Governance

Government in a country plays an important role in achieving economic growth. Every economic activity is proposed to create citizens' welfare by fulfilling their necessity. In implementing citizens' welfare, the government will carry out some actions through suitable policies that support a good economic condition. Good governance is needed to increase the wealth of people in a country, and furthermore, this will create positive influences in regional and international scopes. The influences will be achieved by implementing suitable policies in supporting economics and investment environment within the country. The suitable policies then is expected to create good business and investment climate that could improve the country's economic position.

Hunter and Shah (1998) stated that country governance can be understood as a multi-faceted concept performing all aspects of its authority through formal and informal institutions in managing a state. In achieving the effectiveness of governance, the government accountability has to be established to match the service and the citizens' needs. This process is measured by the quality of policies enjoyed by the citizens.

There are also studies that used institutional quality to reflect the quailty of governance. North (2001) cited from Billmeir and Massa (2007) intreptreted institutions as the set of rules and norms that shapes the social, political and economic interactions among the members of a society, or as organizational institutions such as political, economic, social and educational bodies. One of the most popular measure of institutional quality is provided by International Country Risk Guide (ICRG). Eichengreen and Luengnaruemitchai (2004) and Bae (2012) used five dimensions of institutional quality.There are investment profile that involved with the assessment of factors affecting the risk to investment; country's legal system that explain the degree of investor protection; corruption index as an assessment of corruption within the political system and bureaucratic quality that measures the institutional strength and quality of the bureaucracy; and accounting standards that measures the quality of a country's accounting standard. Yartey (2008) uses four dimensions of instutional quality including law and order, bureaucratic quality, corruption and democratic accountability. The last indicator measures how responsive the government is to the people, on the basis that the less responsive it is, the more likely it is that the government will fall.

According to Kaufmann, Kraay and Mastruzzi (2010), governance is defined as as *"the traditions and institutions by which authority in a country is exercised."* This includes three areas with their measurement explain as follow

(a) the process by which governments are selected, monitored and replaced;

i. Voice and Accountability (VA) – capturing perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

ii. Political Stability and Absence of Violence/Terrorism (PV) – capturing perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

(b) The capacity of the government to effectively formulate and implement sound policies:

iii. Government Effectiveness (GE) – capturing perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

iv. Regulatory Quality (RQ) – capturing perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

(c) *The respect of citizens and the state for the institutions that govern economic and social interactions among them:*

v. Rule of Law (RL) – capturing perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

vi. Control of Corruption (CC) – capturing perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Financial Sophistication

The Global Competitiveness Report (2013) indicated that financial sophistication as one of its twelve pillars that has to do with the central role of a sound and well-functioning financial sector for economic activities. Bopkin (2008) indicated that financial market development in 34 emerging economies can be observed from banks, stock market and bond market. Earlier studies use stock market and banking sector indicators such as market capitalization of stock market and private sector credit expressed as a percentage of GDP (Yartey, 2008; Low and Azman-Saini, 2012;), which does not capture the functions of financial markets in an economy.

Financial sophistication is different from financial market development as it stressed on the aspects of efficiency where it requires among others the availability and affordability of financial services, financing through local equity market, ease of access to loans and venture capital availability. On the other hand, it is demanded that trustworthiness and confidence of financial markets and institutions to be upholded.

Quality of Governance and Financial Sophistication

As the role of financial markets is for the interaction of borrowers and lenders for the pupose of raising capital, it is important for the governments to continue their efforts to develop financial markets. According to Sundaresan (2009), this requires consideration on multiple dimensions which are observed to be consistent with the concept of quality of governance and institutional quality including a) regulatory policies, b)fiscal and exchange rate policies, c) bankruptcy code/laws, d) trade-patterns, e)infrastructure for trading and intermediation (financial and informational), f) access to the markets for global investors and issuers, and g) incentives for financial innovation.

Quality of governance or institutional quality indicates the level at which institutions protect investor rights while promoting transparency. This is is consistent with the argument by Billmeir and Massa(2007) that the most important forces for the development of capital markets are institutional together with macroeconomic factors. According to La Porta et al. (1998), countries with better institutions enable firms to make greater use of external finance and larger investments from external finance.

Even though, it is highlighted that having good institutions is beneficial in developing equity markets, evidence is scant in bond markets. Therefore, the study is proposing a framework to test the relationship betweeen quality of governance and financial sophistication that comprise the three main sources of financing that includes banking, equity and bond markets in Asia.

Significance of study

The proposed study is expected to yield several significant implications. It is expected to give additional insight on the relationship between the effectiveness of the government and the effectiveness of financial markets and institutions in extending capital for the economic development.

Uniqueness of Study

There are many researches that studied governance but primarily at the firm level. Most of those researches tried to find the relationship between corporate governance and performance. This study is unique as it proposes to analyze governance at the macro level in Asian emerging markets. Unlike earlier study that alligning institutional or governance quality and financial development into separated markets i.e stock and bond, this study uses a single measure of financial sophistication to capture the elements of efficiency and; trustworthiness and confidence of the financial markets and institutions. Interestingly, the availability and accessability of venture capital financing is also inorporated in this finacial sophistication variables. In overall, this study will help to provide a better understanding of the importance of effective government in improving access to and affordability of financing through financial markets.

Proposed Methodology

Based on the above discussion, a favorable degree of financial sophistication needs a good governance practices through the creation of suitable policies which are able to maintain a good environment for investment. Therefore, it is hypothesized that there is a positive relationship between quality of governance and financial sophistication in the Asian emerging markets.

Research Design

This study will involve with time serries data of the indicators of governance and level of financial sophistication at country level using a sample of countries in Asian emerging markets. Panel data analysis method is use to estimate the relationship between quality of governance and level of financial sophistication together with other determinants from macroeconomic indicators.

Sampling and Data Collection

It is very much interesting to note that emerging markets comprising Asia, Latin America and emerging Europe grew faster than developing markets in the previous years. These continents account for some 30% of the market capitalization in the world. According to Institute of International Finance (2014), emerging economies can be divided into four regions namely Africa and Middle East, Asia and Pacific, European and Latin America. The details of the countries are presented in Table 1.

Table 1. Emerging Markets Around the World

No.	Region	Countries
1.	Africa and Middle East	Egypt, Lebanon, Morocco, Nigeria, Saudi Arabia, South Africa, and United Arab Emirates.
2.	Asia and Pacific	China, India, Indonesia, Malaysia, Philippines, South Korea, and Thailand.
3.	European	Bulgaria, Czech Republic, Hungary, Poland, Romania, Russian Federation, Turkey, and Ukraine.
4.	Latin America	Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela

Source: Institute of International Finance, 2014

Investigation in this study focuses on the emerging market countries in Asia. Annual data for a period of 2000-2013 will be used to estimate the model covering seven countries involving China, India, Indonesia, Malaysia, Philippines, South Korea, and Thailand.

Variables

Quality of Governance

The quality of governance as an independent variable is explained by six dimensions namely rule of law, control of corruption, regulatory quality, government effectiveness, political stability and control of corruption. The data is obtained from Worldwide Governance Indicators (WGI) produced by World Bank Group.

Financial Sophistication

The financial sophistication is the dependent variable in this study. The data is obtained from The Global Competitiveness Report of World Economic Forum (WEF) published by Oxford University Press. The financial sophistication index is developed based on the elements of efficiency and; trustworthiness and confidence of the financial markets and institutions.

Macroeconomic Variable

Macroeconomic indicators notably inflation and GDP per capita are controlled in this study. Inflation is a measure of economic stability while GDP per capita is a measure of income that is included in this study as higher income is usually associated with better government or institution.

Conclusion

The objective of this paper is to establish a research framework linking quality of governance as the independent variable and financial sophistication as the dependent variable. The relationships between the two national competitiveness variables will be analyzed based on the agency theory, where, the investigation is conducted on the expectation that the government effectiveness influence the degree of accessibility to capital. The literature has provided evidence to support the proposed framework.

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