Asset Pricing Implications of Good Governance

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ABSTRACT

In this paper, I aim to explore the effect of good governance on equity returns, and empirically investigate if good governance at the country level has asset pricing implications and contributes to the idiosyncrasy of price jumps. Relying on an equilibrium asset-pricing model in an economy under jump diffusion, I decompose the moments of the returns of international stock markets into a diffusive (systematic) risk and a (idiosyncratic) jump risk part. For a balanced panel of 52 countries, my results suggest that governance is an important determinant of (idiosyncratic) jump risk. Stock markets in poorly governed countries are characterized by higher volatility and more negative return asymmetry, primarily driven by the higher jump risk. Regulatory quality, the government effectiveness and the control of corruption appear to be most important. Results are robust to the inclusion of various controls for other country- or market-specific characteristics. My results have important policy implications.

Keywords: Governance, Price Jumps, Stock Markets, Asset-Pricing.
JEL-Classification: G12, G15.

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