

**Governance in Emerging Markets:**  
*Evidence and Implications for Growth and  
Market Prospects*

**Daniel Kaufmann**

**The World Bank Institute**

**[www.worldbank.org/wbi/governance](http://www.worldbank.org/wbi/governance)**

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# Challenging Convention about Emerging Markets

## 7 'popular' tenets

1. **Good Governance = Anti-Corruption?**
2. **Governance Measurement Skepticism:**
  - **It is Unmeasurable; *or*, Measurable, but so imprecise  
——→ Useless; *or*, Cannot Assess Trends; *or*,  
Irrelevant for assessing emerging markets prospects**
3. **Evidence: *Governance improved globally?***
4. **Good Governance: outcome of development and growth? – & *emerging economies are corrupt...?***
5. **The trouble with Public Sector & officials in LDCs?**
6. **Corporates as passive 'Investment Climate Taker'**
7. **Country Governance & Financial Markets: *Unlinked?***

**Tenet # 8: Challenging the previous 7 ‘popular notions’ – *Evidence-based Approach, through empirics***

- 1. Data Matters--*on Governance & Institutions: data can be gathered, analyzed, and used judiciously***
- 2. Expanding Beyond the Washington Consensus: Institutions, Governance and Corruption Matters**
- 3. Broadening country analysis: *Governance***
- 4. On average stagnation on Governance – yet high variance --*some countries improve in short term***
- 5. The behavior of the Firm and Investor also Matters**
- 6. Governance matters for a country’s: growth, competitiveness and financial market prospects**

# **The ‘Power of Data’: Technical progress in measurement -- gradual increase in use**

- 1. The ‘Macro’/Aggregate Level of Measurement:**  
*Worldwide Aggregate Governance Indicators: 200 countries, 6 components, periodic.*
- 2. ‘Mezzo’: *Cross-Country Surveys of Enterprises***
- 3. ‘Micro’: Specialized, in-depth, in-country Governance and Institutional Capacity Diagnostics: Includes surveys of: i) user of public services (citizens); ii) firms, and, iii) public officials**

*On ‘Aggregate/Macro’ Level first... 4*

# **Six Dimensions of Governance**

*Governance as the set of traditions and institutions by which authority in a country is exercised -- specifically:*

- **The process by which those in authority are selected and replaced**
  - **VOICE AND ACCOUNTABILITY**
  - **POLITICAL STABILITY & ABSENCE OF VIOLENCE/TERRORISM**
- **The capacity of government to formulate and implement policies**
  - **GOVERNMENT EFFECTIVENESS**
  - **REGULATORY QUALITY**
- **The respect of citizens and state for institutions that govern interactions among them**
  - **RULE OF LAW**
  - **CONTROL OF CORRUPTION**

# Governance Data

- **Data on governance from 37 different sources constructed by 31 different organizations**
- **Data sources include cross-country surveys of firms, commercial risk-rating agencies, think-tanks, government agencies, international organizations, etc.**
- **352 proxies for various dimensions of governance**
- **Organize these measures into six clusters corresponding to definition of governance, for five periods: 1996, 1998, 2000, 2002, 2004**

## **Sources of Governance Data**

- **Cross-Country Surveys of Firms: Global Competitiveness Survey, World Business Environment Survey, World Competitiveness Yearbook, BEEPS**
- **Cross-Country Surveys of Individuals: Gallup International Voice of the People, Latinobarometro, Afrobarometer, *Vanderbilt University/USAID***

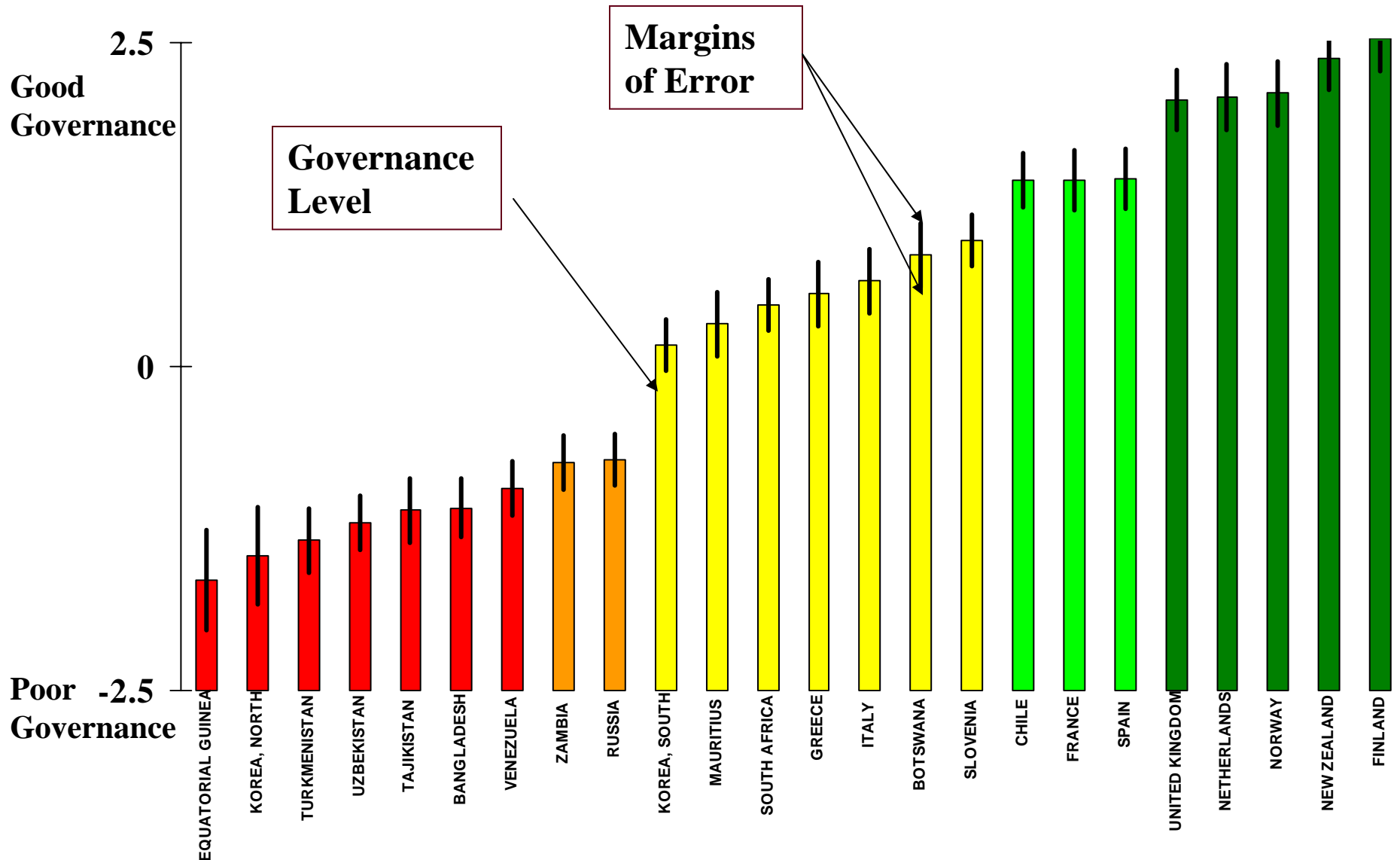
# Sources of Governance Data, Cont'd

- **Expert Assessments from Commercial Risk Rating Agencies:** DRI, PRS, EIU, World Markets Online, *Merchant International Group, IJET Travel Consultancy, PERC*
- **Expert Assessments from NGOs, Think Tanks:** Reporters Without Borders, Heritage Foundation, Freedom House, Amnesty International, *Bertelsmann Foundation, Fundar, International Research and Exchanges Board, Brown University, Columbia University, Binghamton University*
- **Expert Assessments from Governments, Multilaterals:** World Bank CPIA, EBRD, *AFDB, ADB, UNECA, State Dept. Human Rights Report*



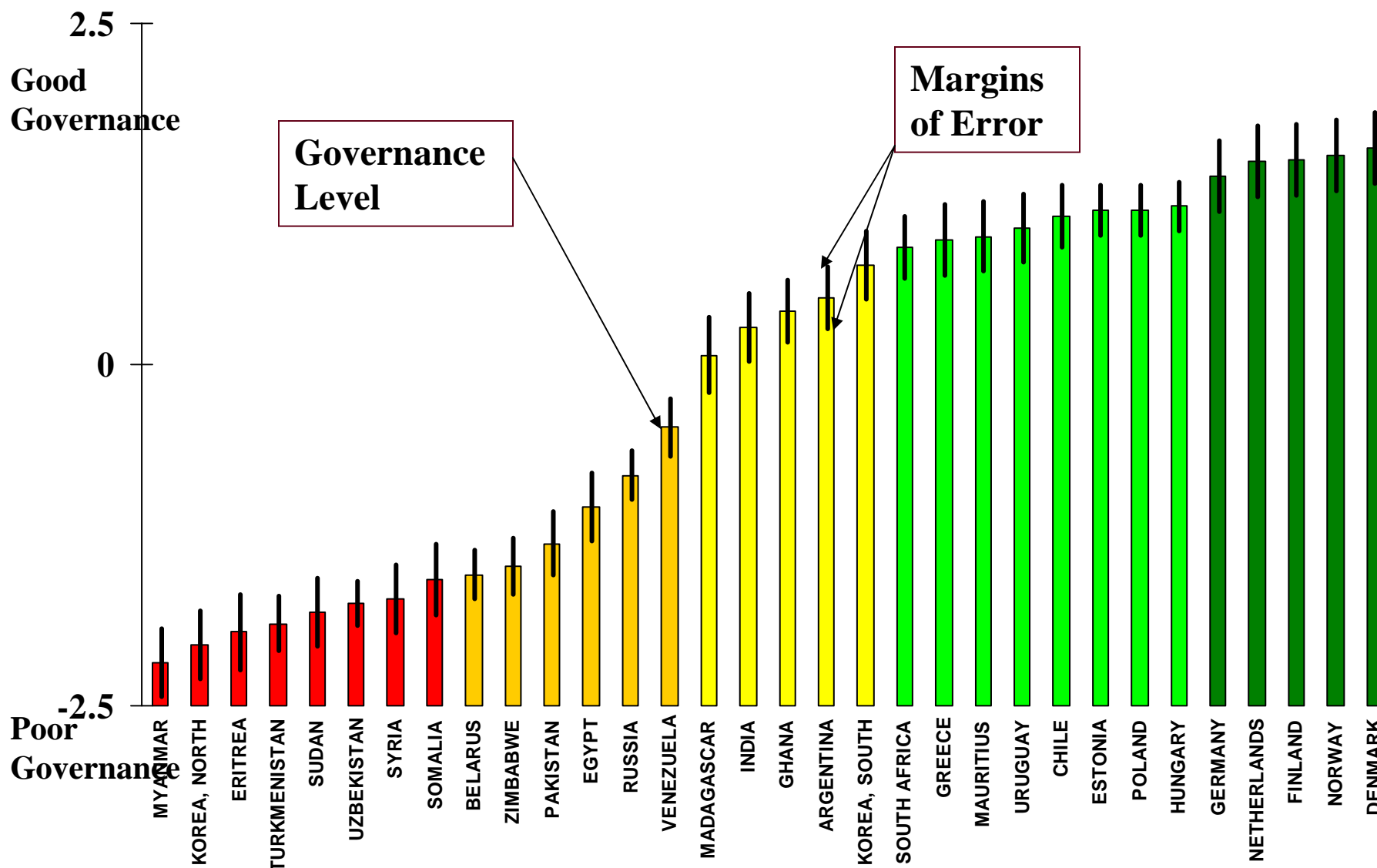
# Control of Corruption: one Aggregate Indicator

(selected countries from 204 worldwide, for illustration, based on 2004 research data)



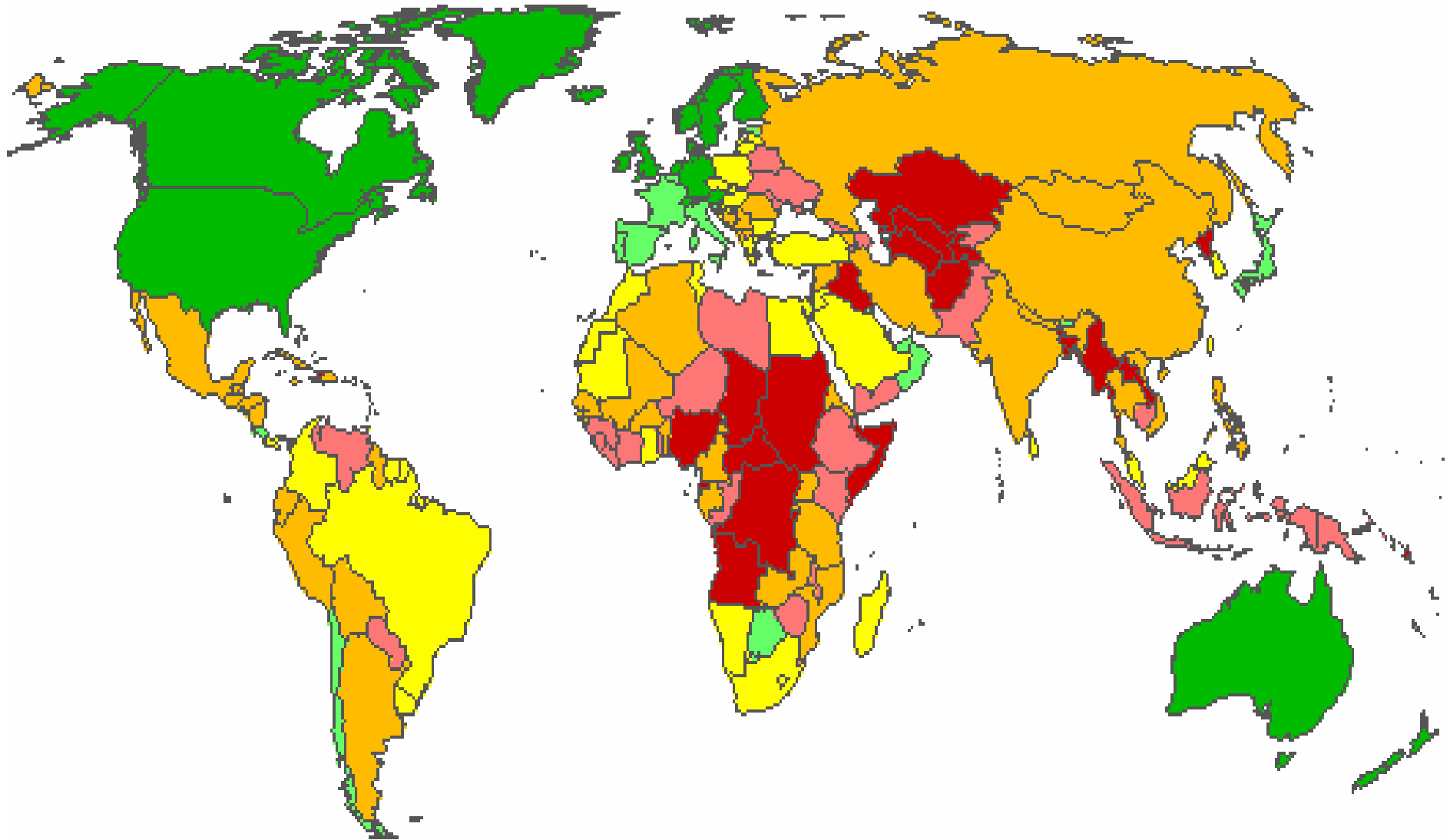
Source for data: : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi, (<http://www.worldbank.org/wbi/governance/govdata/>); Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red between 10<sup>th</sup> and 25<sup>th</sup>; Orange, between 25<sup>th</sup> and 50<sup>th</sup>; Yellow, between 50<sup>th</sup> and 75<sup>th</sup>; Light Green between 75<sup>th</sup> and 90<sup>th</sup>; Dark Green above 90<sup>th</sup>.

# Voice & Accountability, 2004 (Selected Countries)



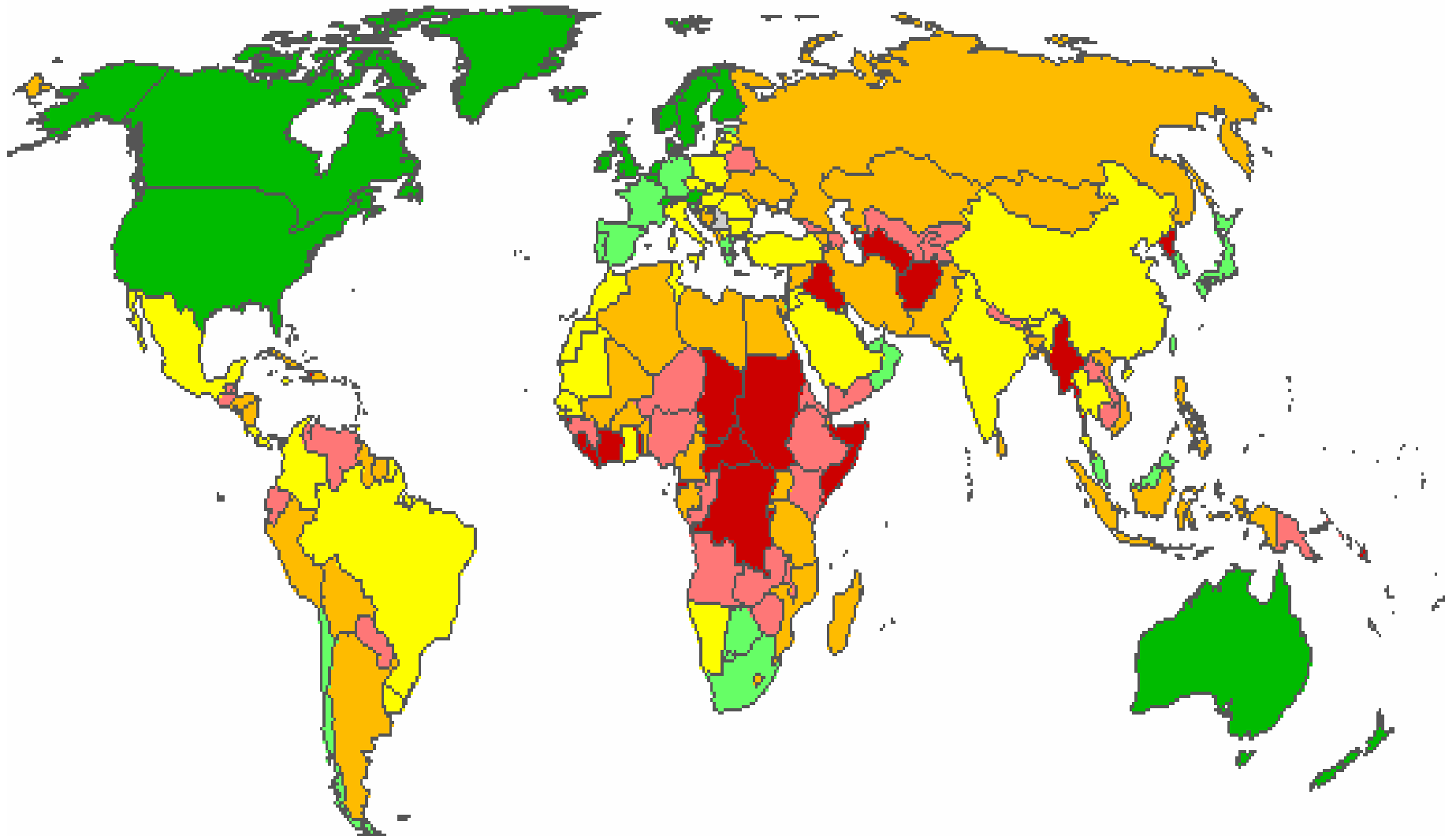
Source for data : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi, (<http://www.worldbank.org/wbi/governance/govdata/>); Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red between 10<sup>th</sup> and 25<sup>th</sup>; Orange, between 25<sup>th</sup> and 50<sup>th</sup>; Yellow, between 50<sup>th</sup> and 75<sup>th</sup>; Light Green between 75<sup>th</sup> and 90<sup>th</sup>; Dark Green above 90<sup>th</sup>.

# Control of Corruption, 2004: World Map



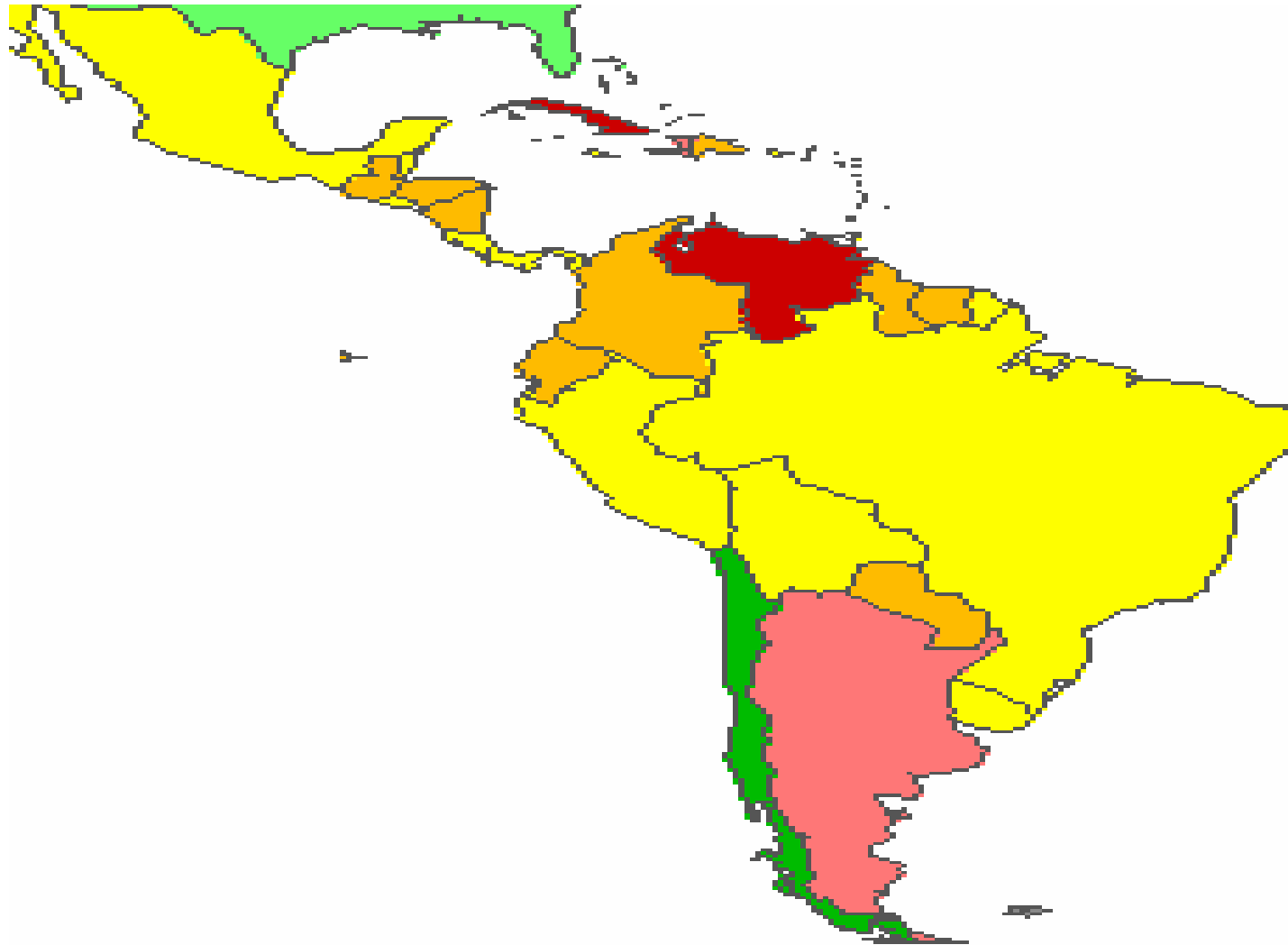
Source for data: : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi, (<http://www.worldbank.org/wbi/governance/govdata/>); Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red between 10<sup>th</sup> and 25<sup>th</sup> ; Orange, between 25<sup>th</sup> and 50<sup>th</sup> ; Yellow, between 50<sup>th</sup> and 75<sup>th</sup> ; Light Green between 75<sup>th</sup> and 90<sup>th</sup> ; Dark Green above 90<sup>th</sup>.

# Government Effectiveness, 2004: World Map



Source for data: : '**Governance Matters IV: Governance Indicators for 1996-2004**', D. Kaufmann, A. Kraay and M. Mastruzzi, (<http://www.worldbank.org/wbi/governance/govdata/>); Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red between 10<sup>th</sup> and 25<sup>th</sup> ; Orange, between 25<sup>th</sup> and 50<sup>th</sup> ; Yellow, between 50<sup>th</sup> and 75<sup>th</sup> ; Light Green between 75<sup>th</sup> and 90<sup>th</sup> ; Dark Green above 90<sup>th</sup>.

# Regulatory Quality, 2004: Latin America & Caribbean

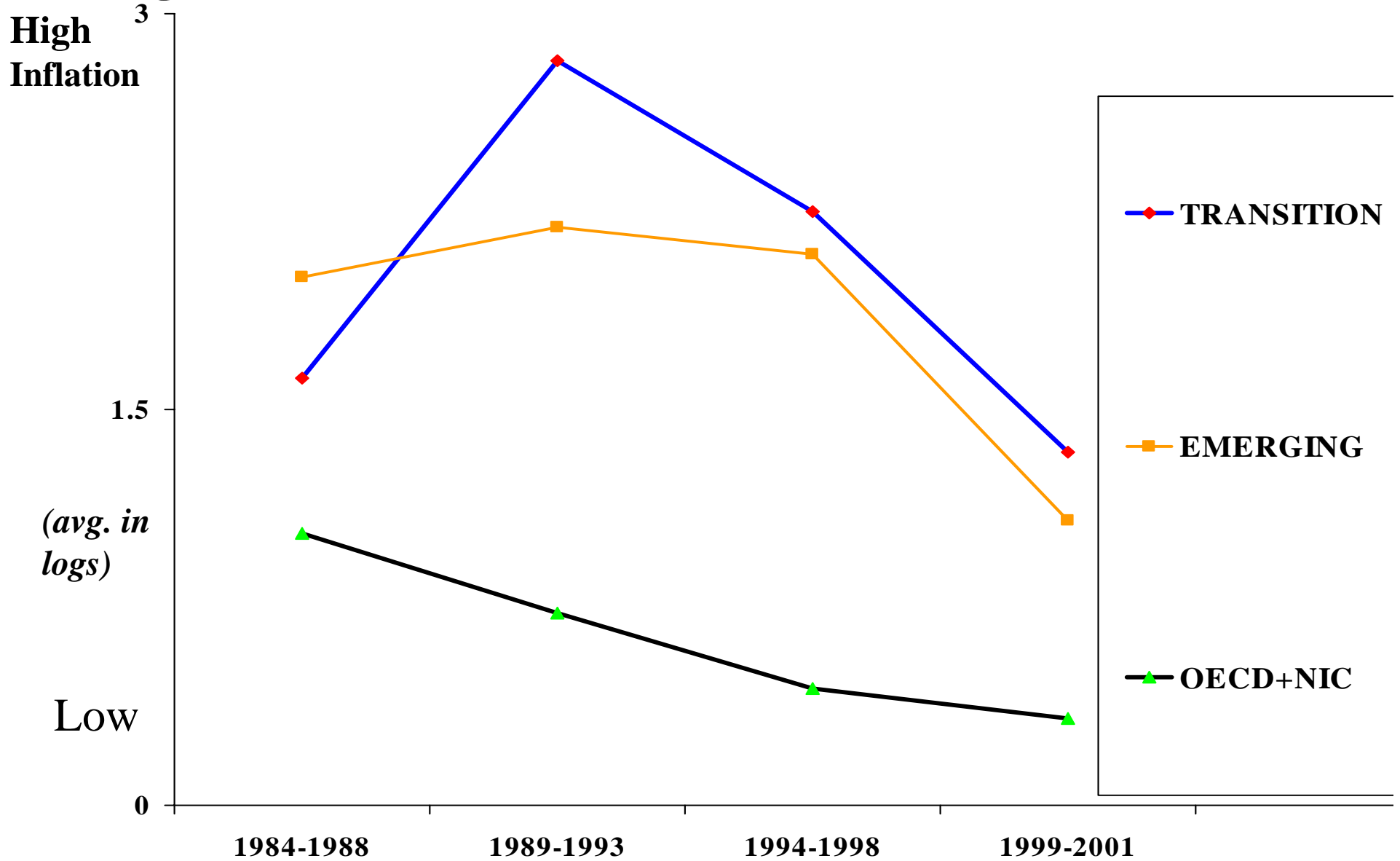


Source for data: : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi, (<http://www.worldbank.org/wbi/governance/govdata>); Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red between 10<sup>th</sup> and 25<sup>th</sup> ; Orange, between 25<sup>th</sup> and 50<sup>th</sup> ; Yellow, between 50<sup>th</sup> and 75<sup>th</sup> ; Light Green between 75<sup>th</sup> and 90<sup>th</sup> ; Dark Green above 90<sup>th</sup>.

# **Are Countries Stagnating in Governance?**

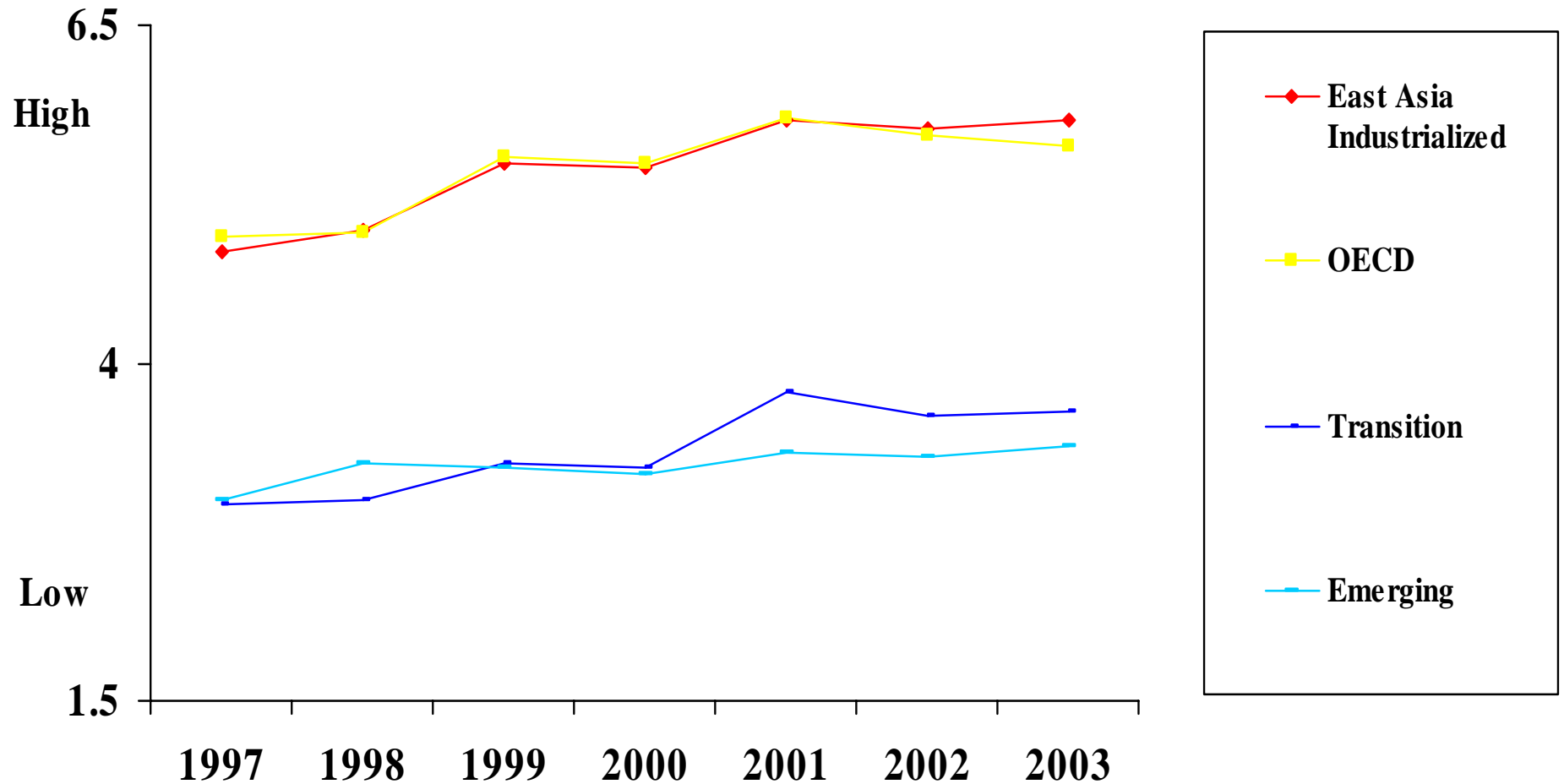
- **The world on average has not improved**
- **But large or small variation across countries?**
- **New method: for each country, we can identify whether there are significant changes over time**
- **It is found that changes can take place in the short-term: in 6-to-8 years, some deteriorations as well as some significant improvements as well**

# Significant Decline in Inflation Rates Worldwide



Source: 'Rethinking Governance', based on calculations from WDI. Y-axis measures the log value of the average inflation for each region across each period

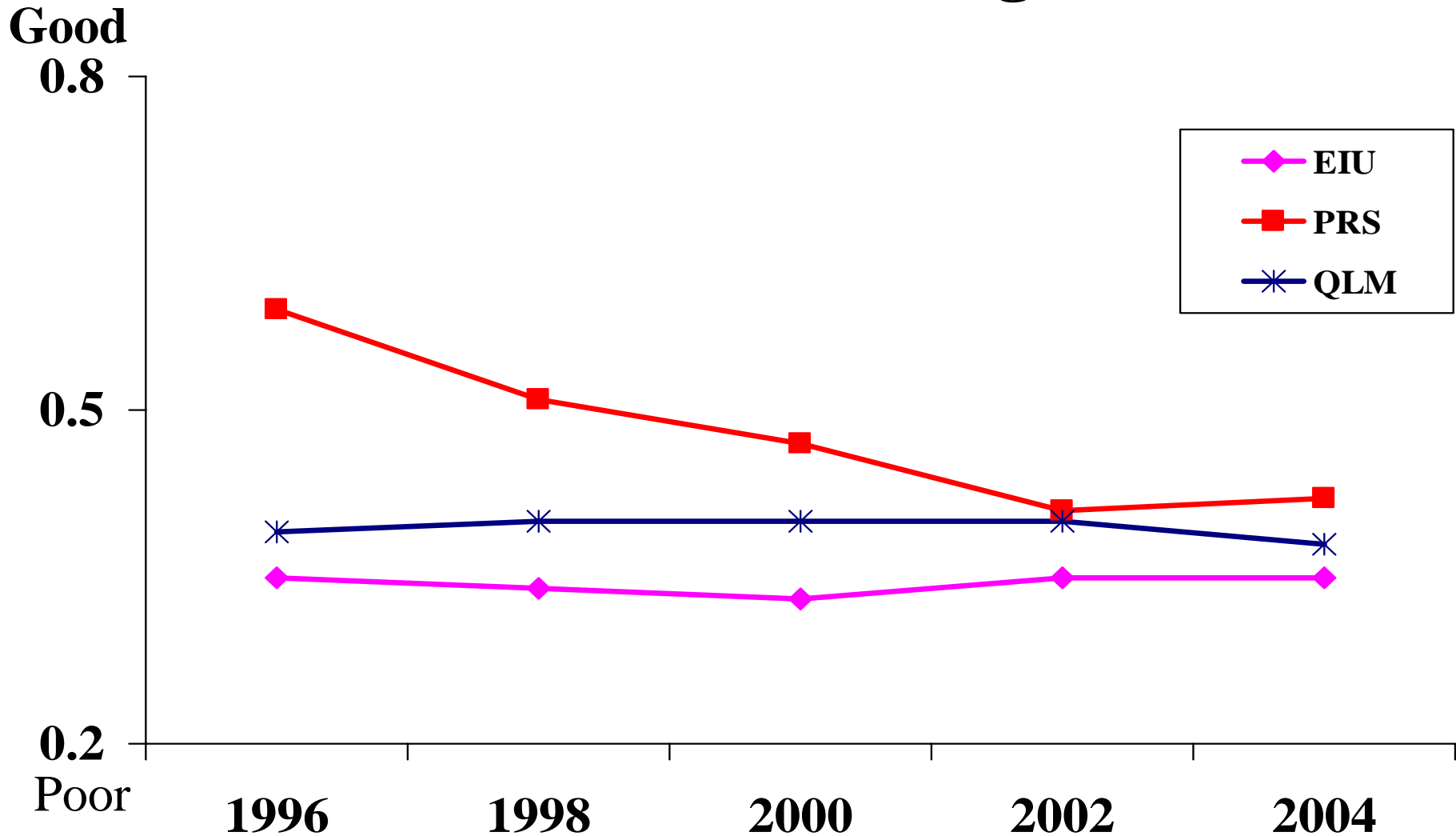
# Quality of Infrastructure



Source: EOS 1997-2003 (Quasi-balanced panel). Question 6.01: General infrastructure in your country is among the best in the world?



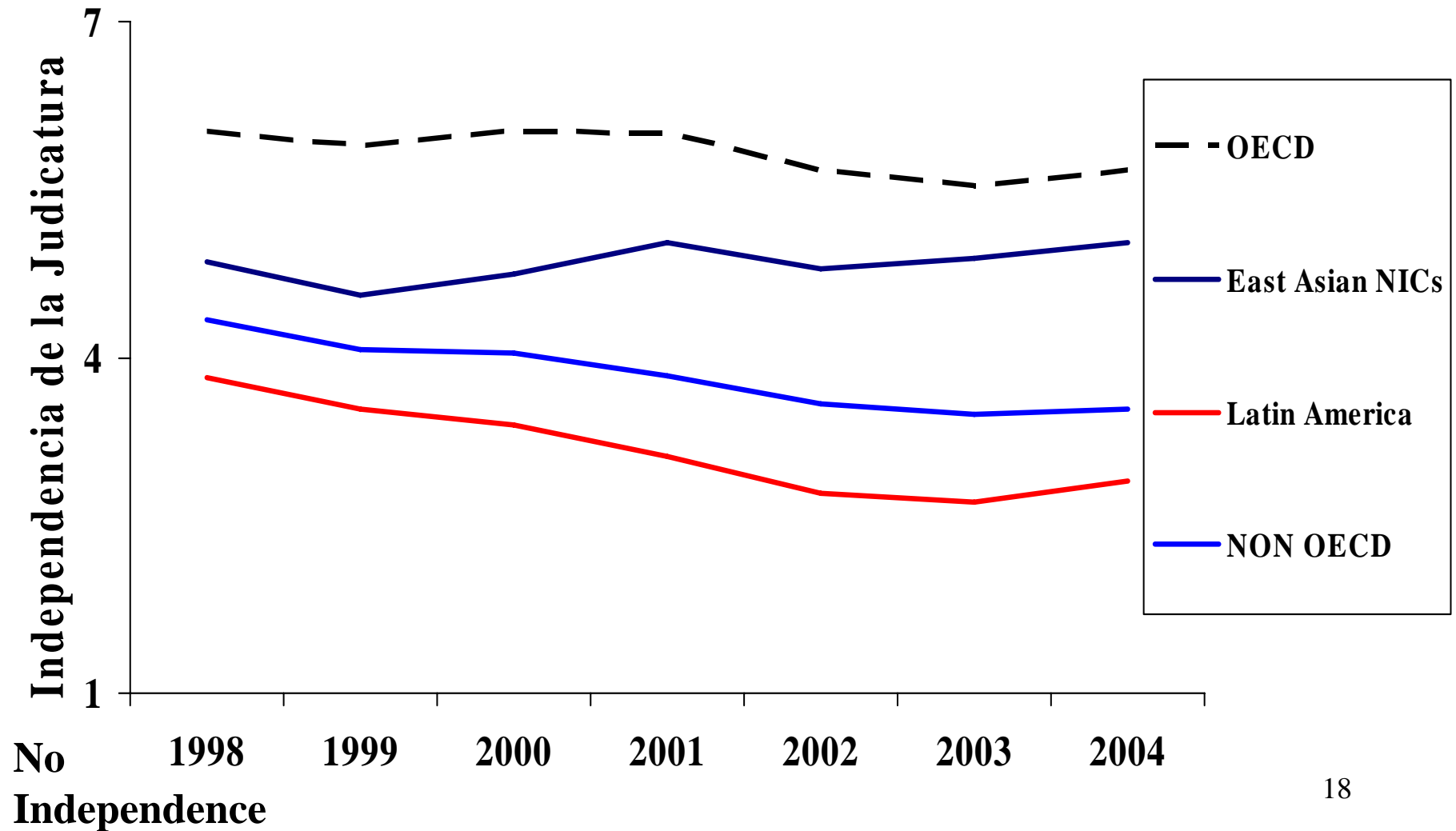
# No Significant Trend in Control of Corruption Worldwide Averages



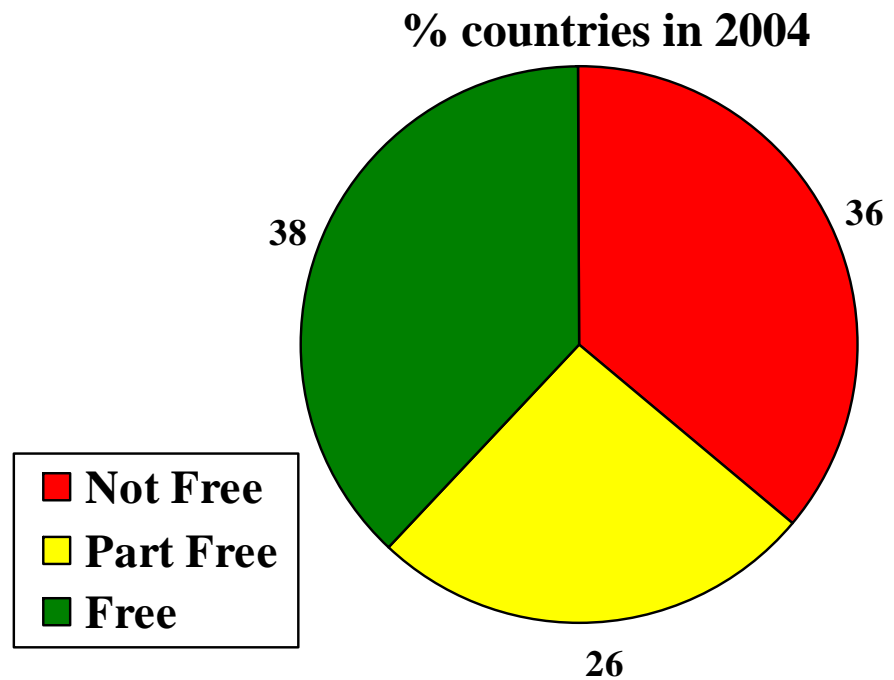
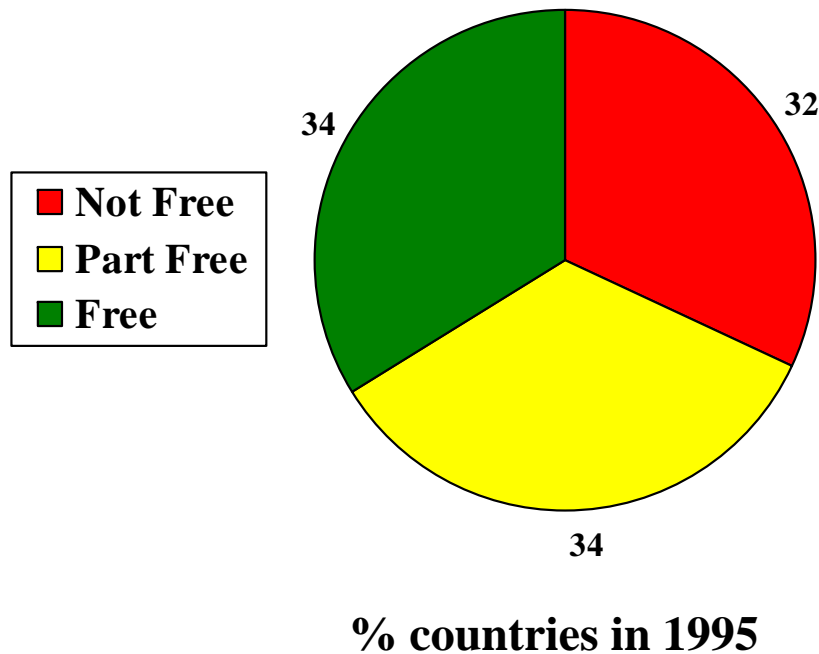
PRS country coverage in 1996: 129, all other periods 140; QLM and EIU country coverage: 115 for all periods. 17

# Judiciary Independence (*EOS survey results 1998-2004*)

High  
Independence

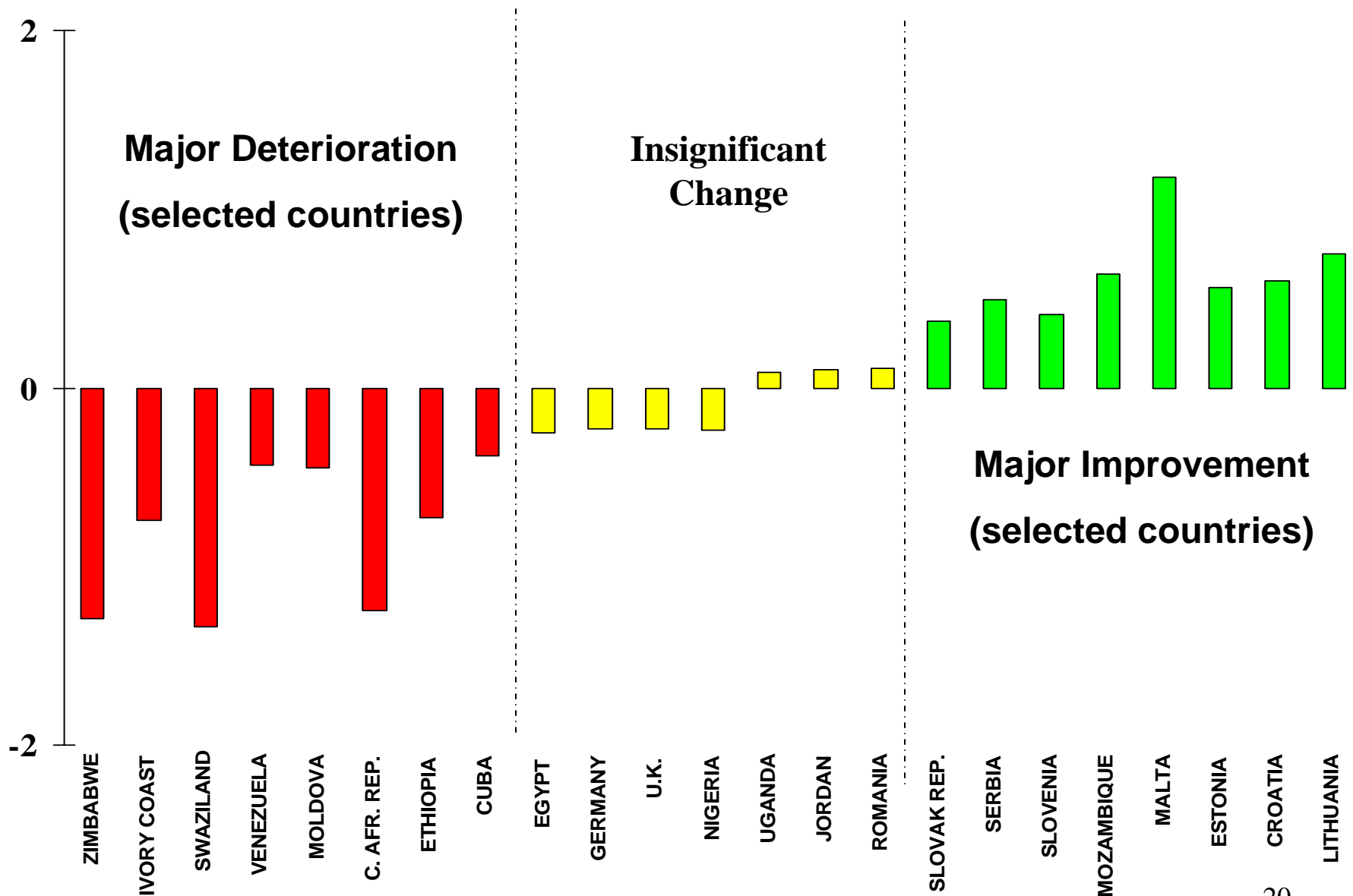


# Press Freedom in the World, 1995 vs. 2004: *Stagnant?*



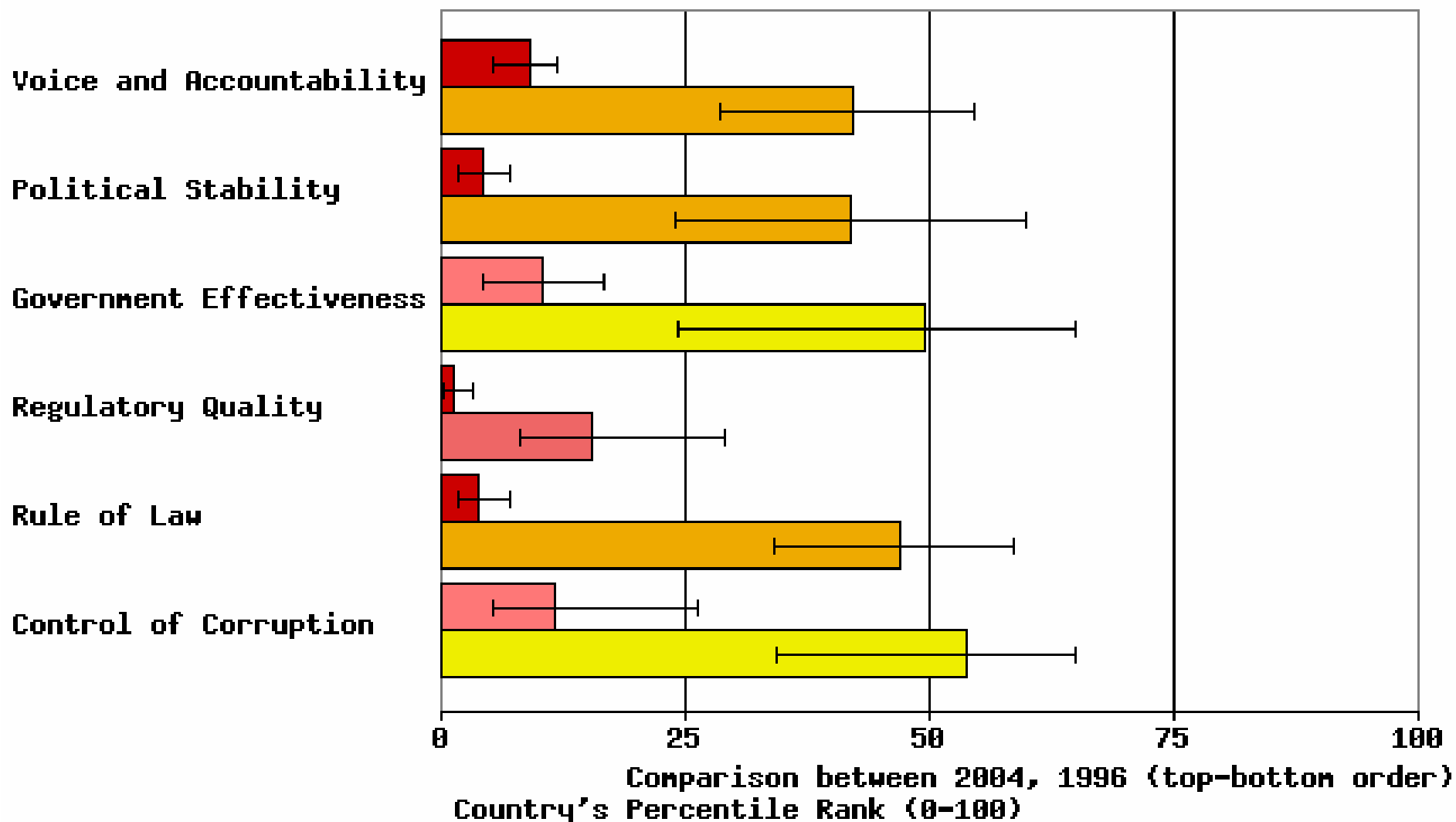
Source: Freedom House. Y axis measures percentage of countries in the region with free press (rating of 30 or below), partly free (ratings between 30 and 60) and not free (rating above 60).

# Changes in Rule of Law, 1996-2004



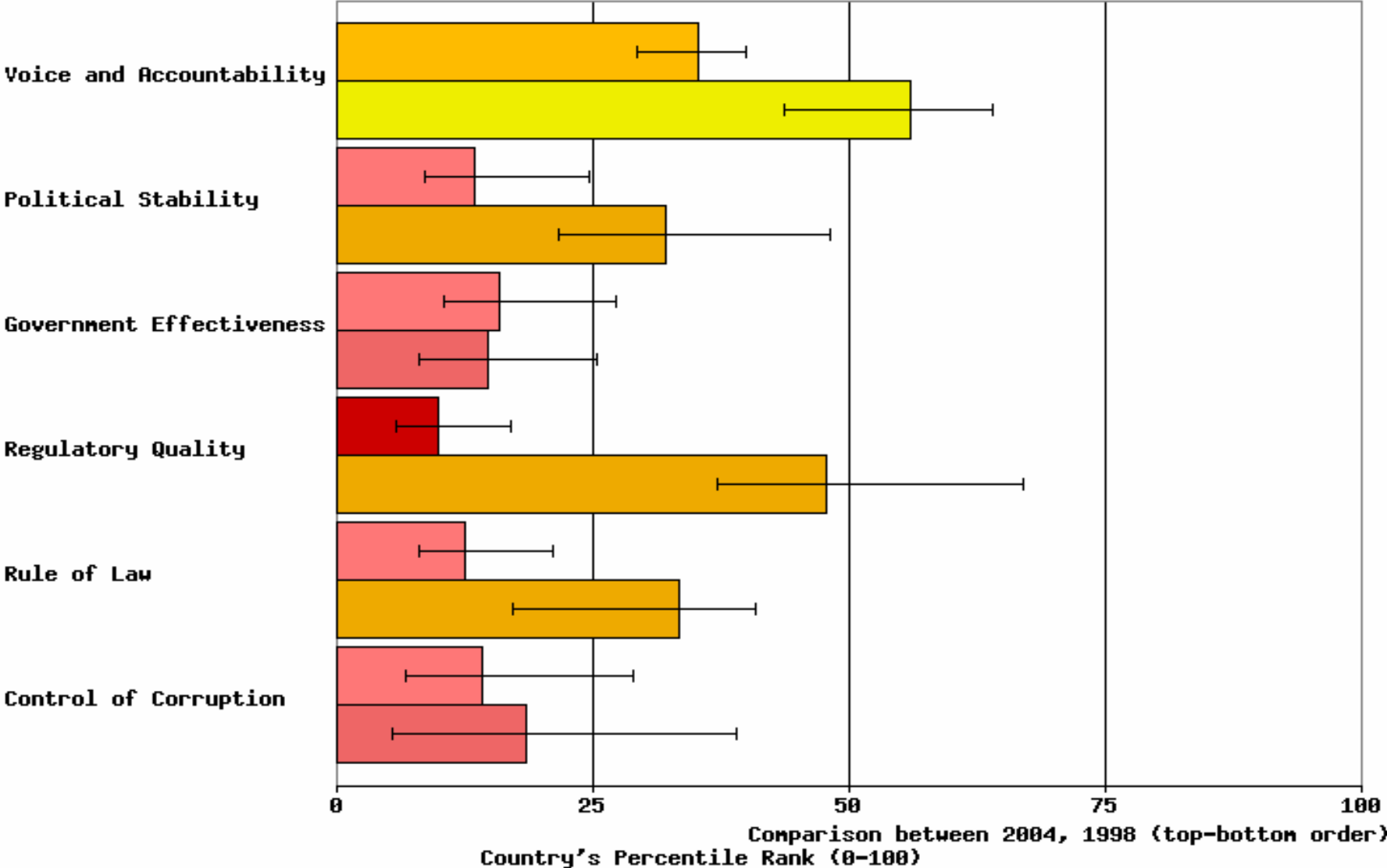
Changes were calculated on the basis of the differences in country estimates from 1996 and 2004. Classification for major deteriorations and improvements were based on 75% confidence interval. Source for data: <http://www.worldbank.org/wbi/governance/govdata/>.

# Governance Indicators: Zimbabwe, 2004 vs. 1996



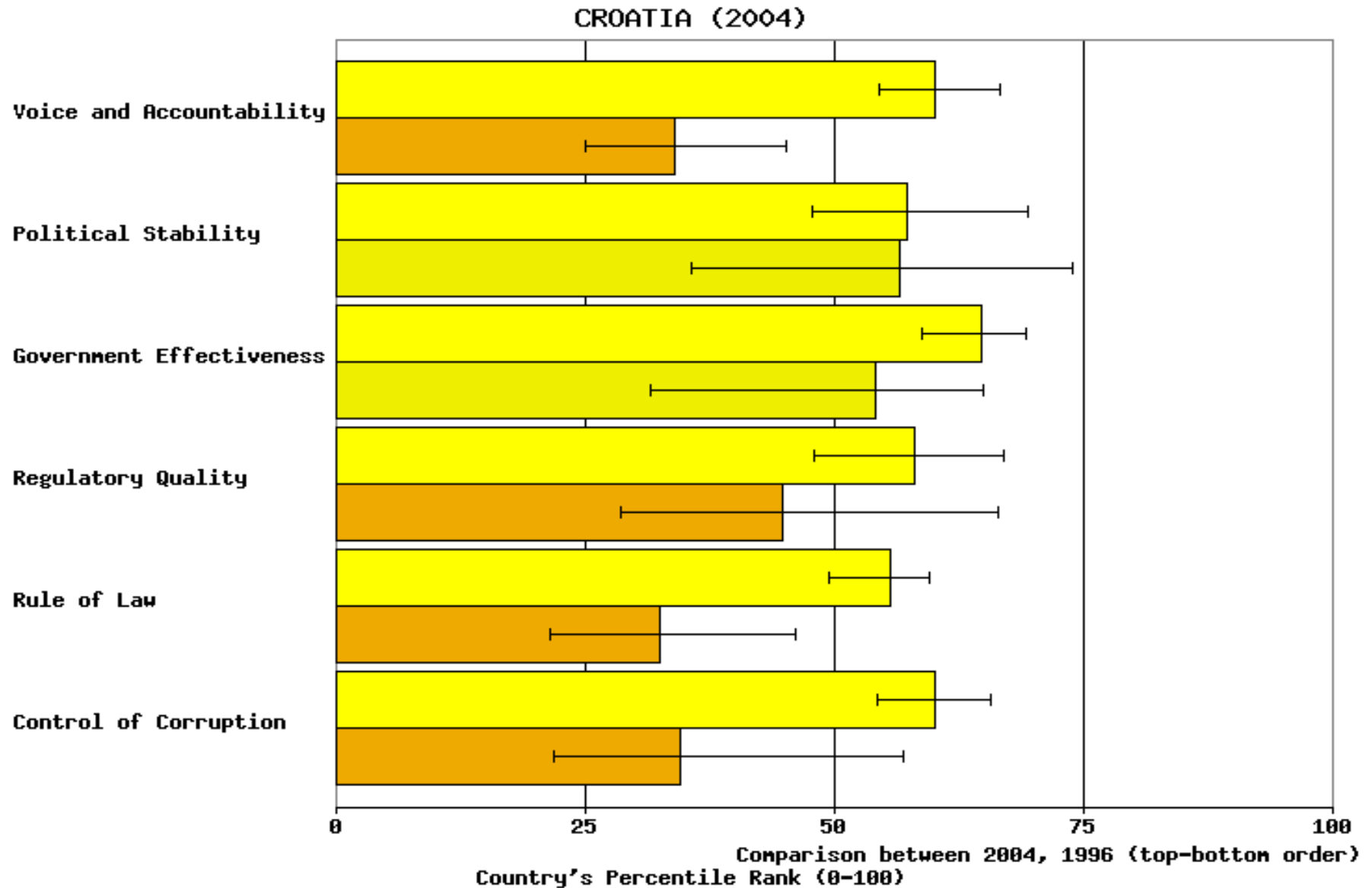
Source for data: <http://www.worldbank.org/wbi/governance/govdata2002> ; Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red, between 10<sup>th</sup> and 25<sup>th</sup>; Orange, between 25<sup>th</sup> and 50<sup>th</sup>; Yellow, between 50<sup>th</sup> and 75<sup>th</sup>; Light Green, between 75<sup>th</sup> and 90<sup>th</sup>; Dark Green above 90<sup>th</sup>.

# Governance Indicators for Venezuela, 1996 & 2004



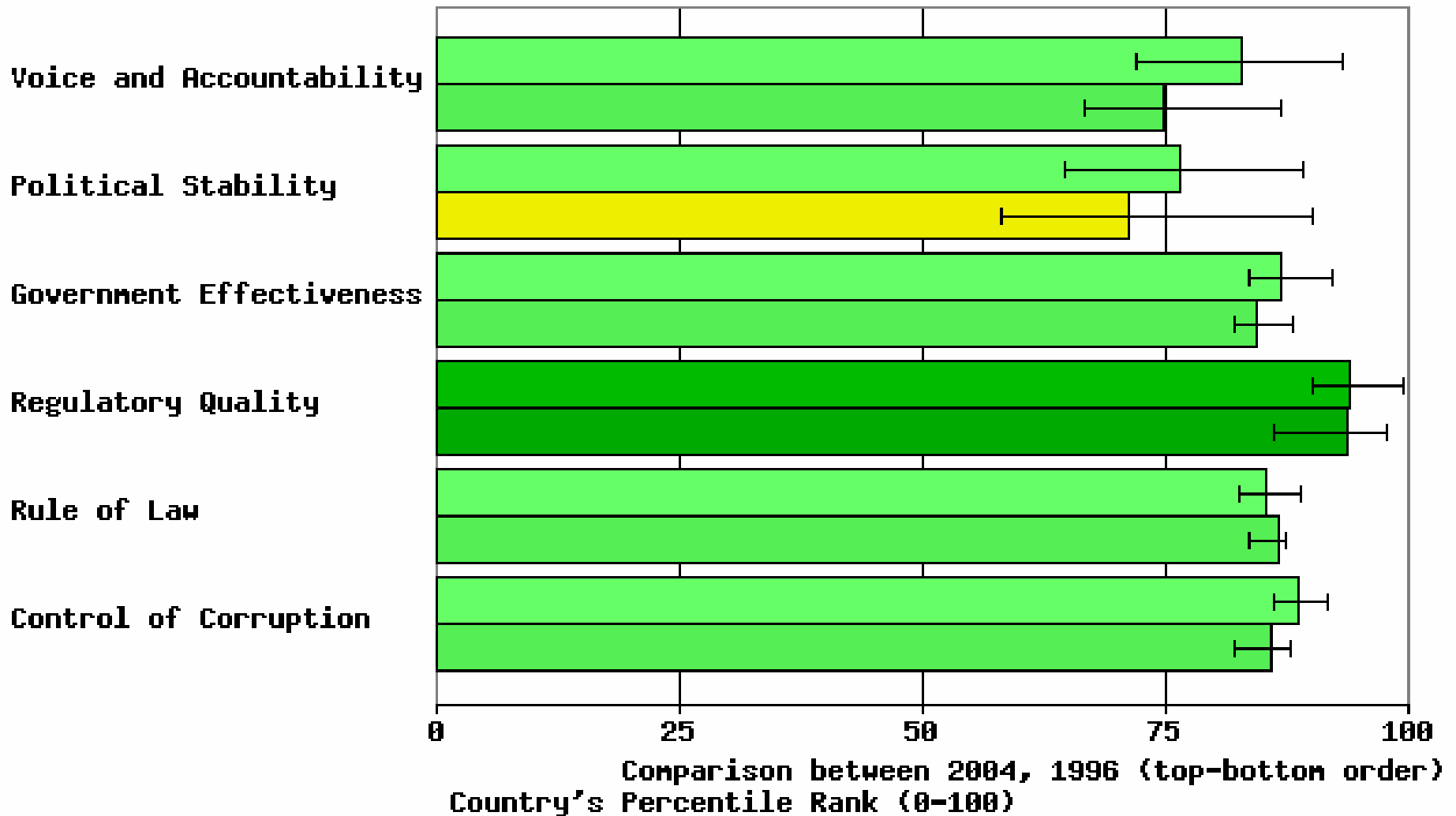
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# Croatia 2004 vs.1996



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004  
(<http://www.worldbank.org/ubi/governance/pubs/govmatters4.html>)

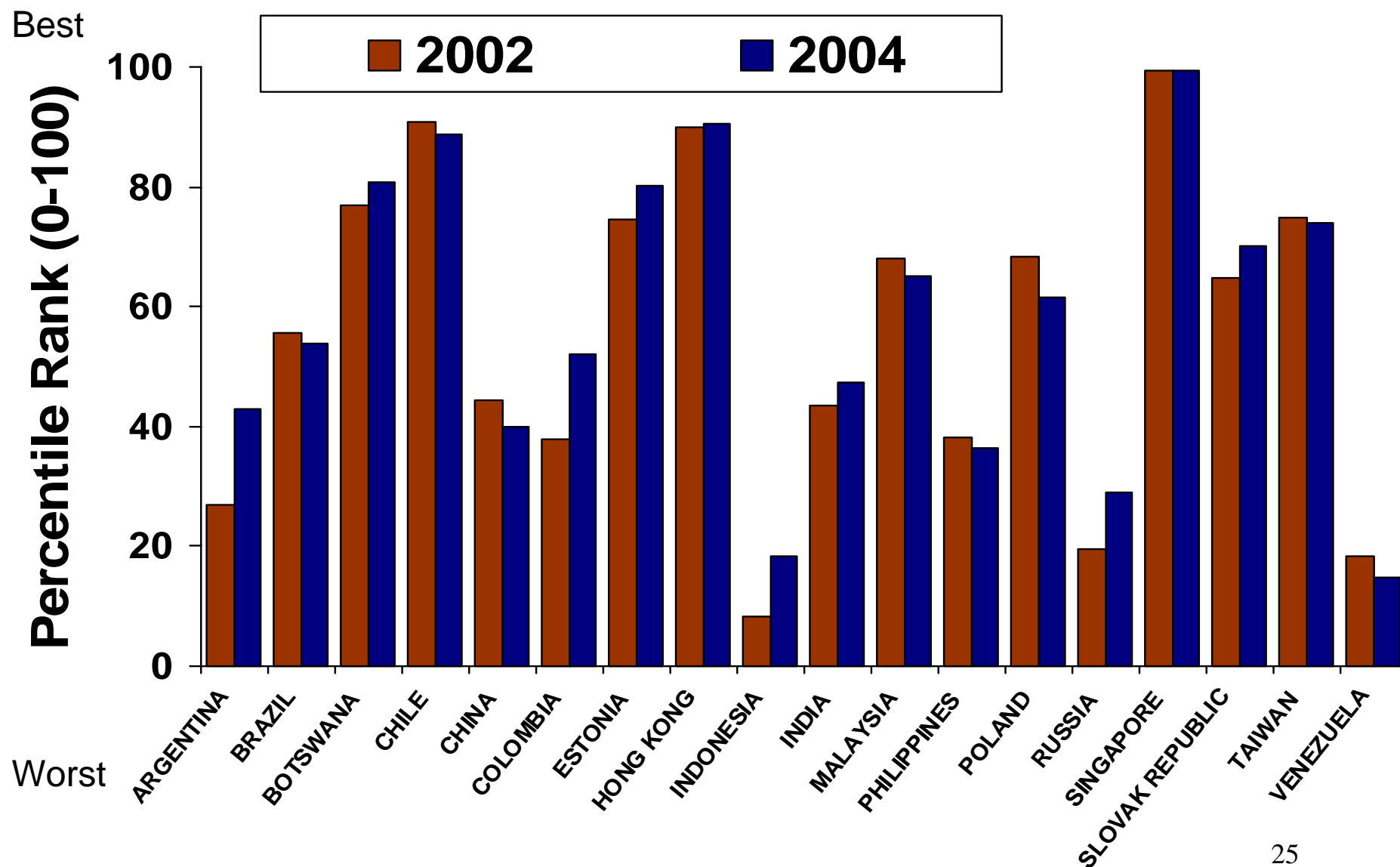
# Governance Indicators: Chile, 2004 vs. 1996



Source for data: <http://www.worldbank.org/wbi/governance/govdata2002> ; Colors are assigned according to the following criteria: Dark Red, bottom 10<sup>th</sup> percentile rank; Light Red between 10<sup>th</sup> and 25<sup>th</sup>; Orange, between 25<sup>th</sup> and 50<sup>th</sup>; Yellow, between 50<sup>th</sup> and 75<sup>th</sup>; Light Green between 75<sup>th</sup> and 90<sup>th</sup>; Dark Green above 90<sup>th</sup>.



# Control of Corruption Indicator, 2002 and 2004: *Selected Emerging Markets*

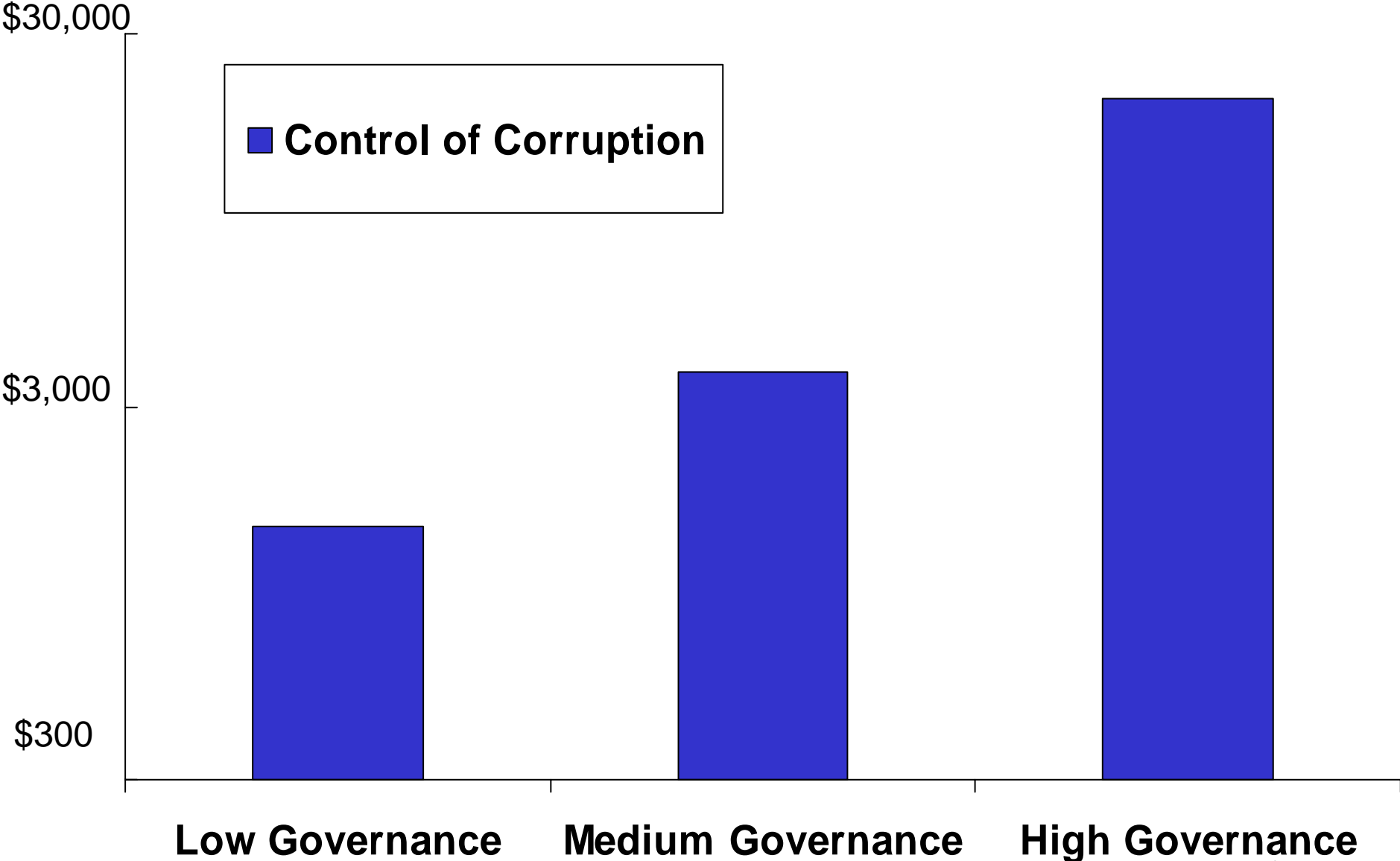


Source for data: : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi,  
(<http://www.worldbank.org/wbi/governance/govdata/>).

# Governance Matters: The 300% 'Dividend'

1. Large Development Dividend of Good Governance: *a one-standard-deviation improvement in governance raise incomes per capita in a country by about 300% in long-run*
2. But is such a decline in corruption unrealistically large?: **NO -- One S.D. is the difference from: Eq. Guinea → Iran or Uganda → Mauritius → Portugal → Finland or New Zealand**
3. The impact is from governance to incomes, and not viceversa -- *higher incomes alone will not do*
4. Urgency of interventions to improve governance

# Development Dividend From Good Governance

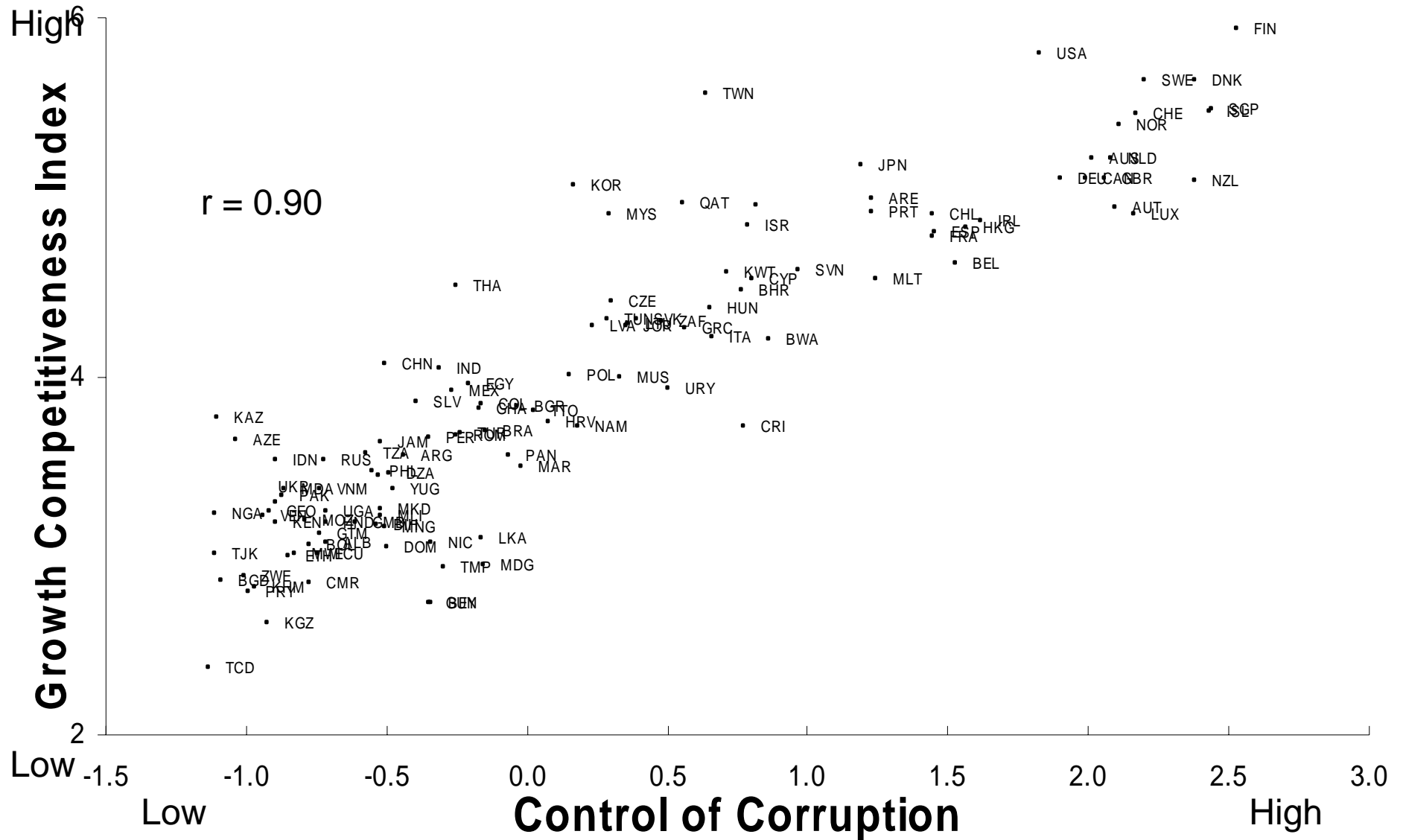


Data Source for calculations: KK 2004. Y-axis measures predicted GDP per capita on the basis of Instrumental Variable (IV) results for each of the 3 categories. Estimations based on various authors' studies, including Kaufmann and Kraay.

# **The perspective of the Firm -- Worldwide**

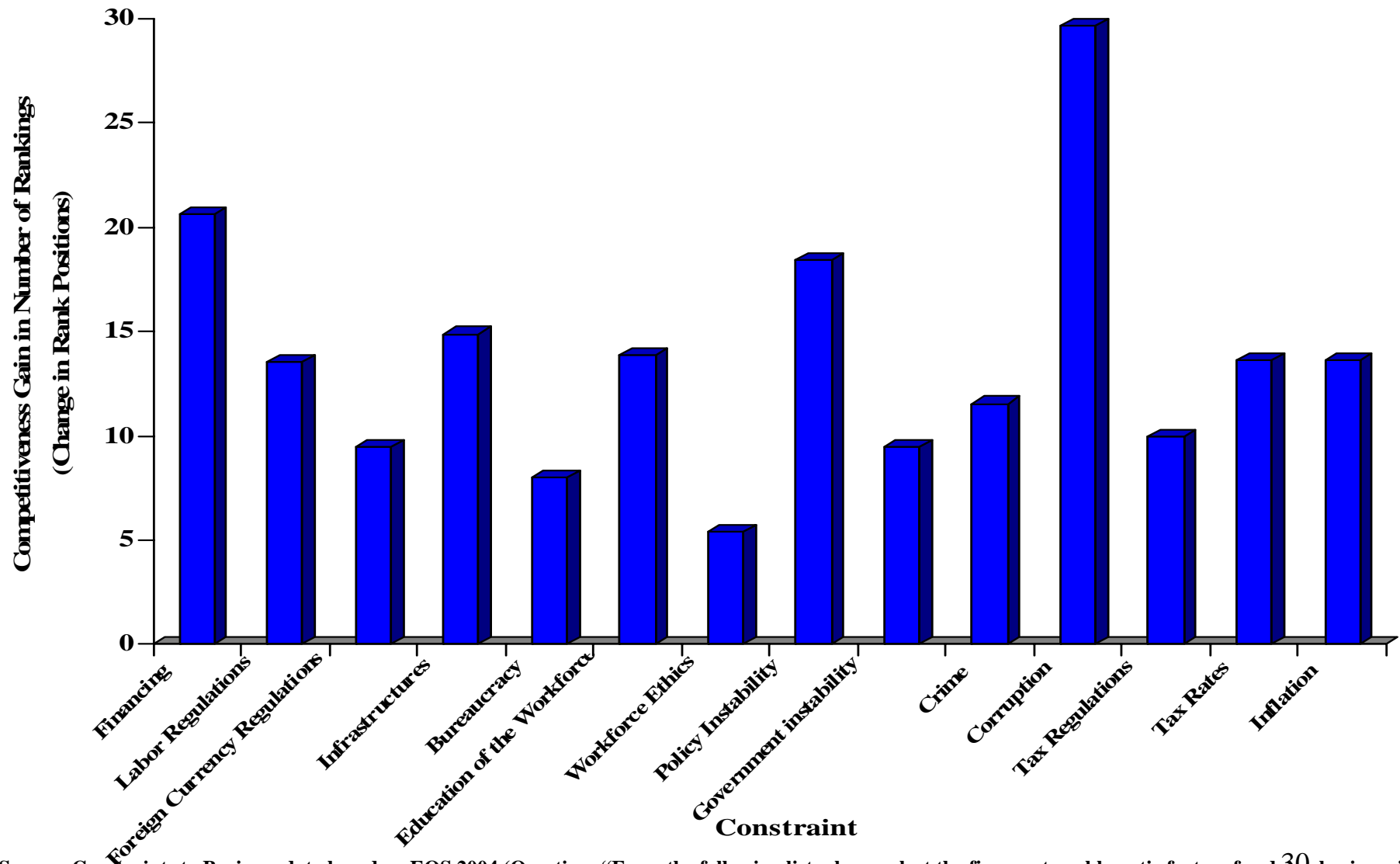
- **Good governance in a country is inextricably linked to its competitiveness**
- **Quality of governance in emerging markets vary enormously**
- **Within a country, different aspects of governance perform differently, and it changes over time**
- **Importance to ‘unbundle’ governance & corruption**
- **Corporate Governance and Ethics Matters as well: the link between corporate and public sector governance**

# Good Governance associated Country's Competitiveness



Sources: GCI drawn from EOS firm survey, WEF 2005 – 117 countries; Control of Corruption from Kaufmann, Kraay and Mastruzzi, 'Governance Matters IV: Governance Indicators for 1996-2004'.

# Impact on Global Competitiveness Index (GCI) Rank of Improvement in Constraint to the Firm

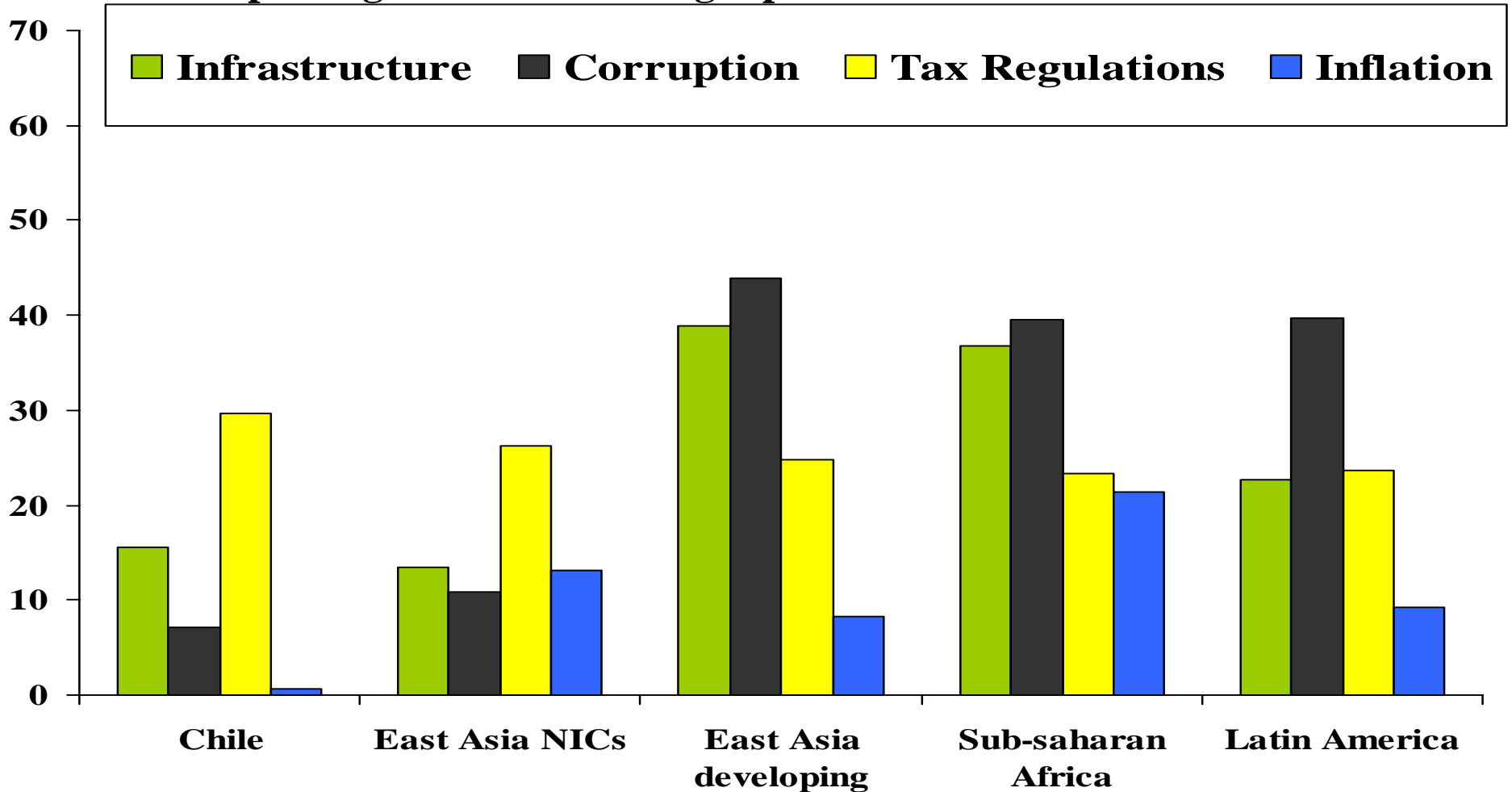


Source: Constraints to Business data based on EOS 2004 (Question: "From the following list, please select the five most problematic factors for doing business in your country, and rank them from 1 to 5."); GCI based on GCR team calculations for 2004/2005 Report; GDP per capita from World Bank. Calculations based on regression estimates of the impact on the GCI of an improvement in the constraint by one standard deviation.

# Constraints to Business vary across regions & countries

*(responses from the Firm in EOS 2005)*

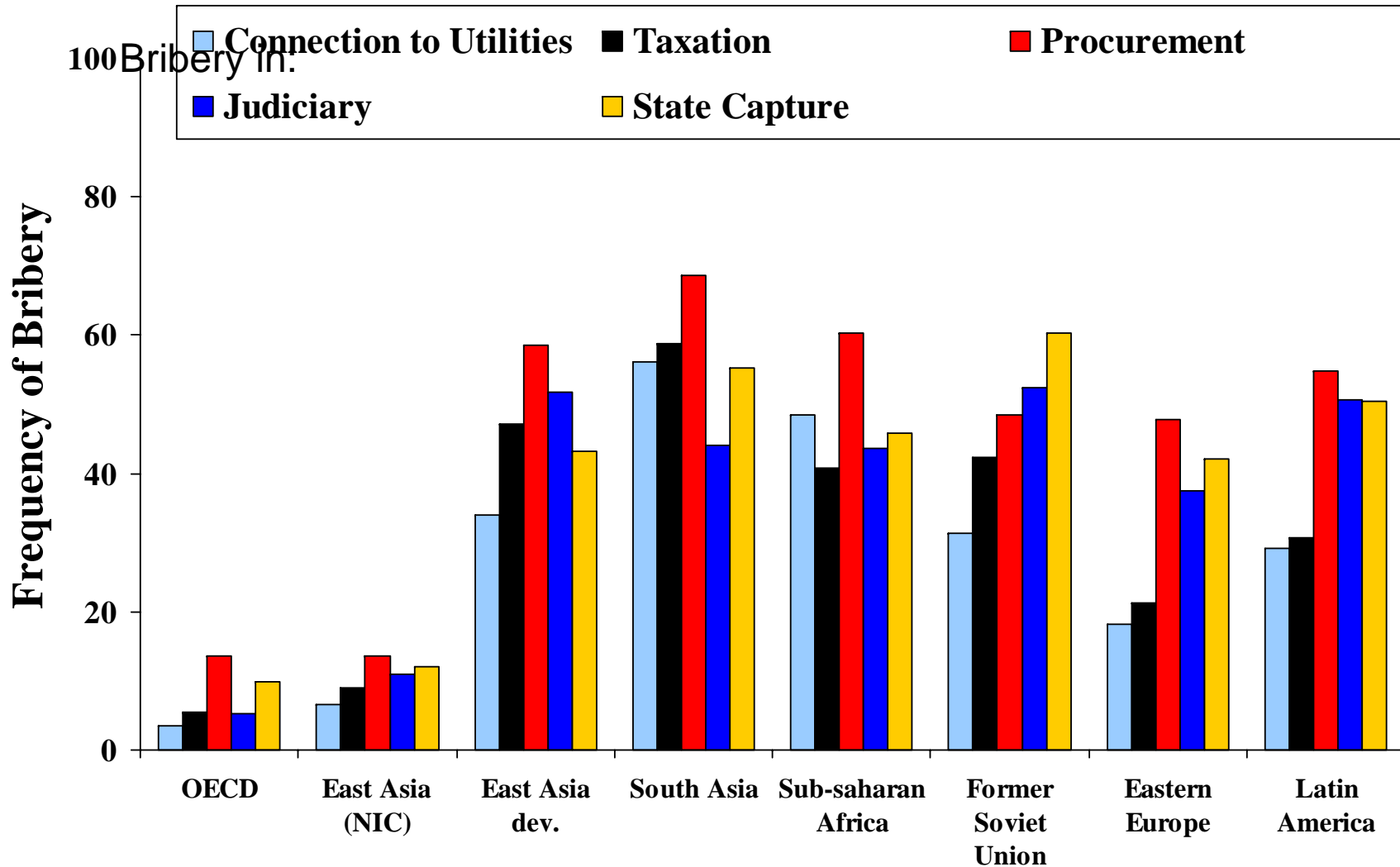
% firms reporting constraint among top 3:



Source: EOS 2005. The question posed to the firm was: Select among the above 14 constraints the five most problematic factors for doing business in your country. Note that the overall EOS sample covers 120 [CHECK] countries, and in some regions –particularly in the Middle East, Africa and the FSU, many countries are not surveyed. Thus, regional averages need to be interpreted with caution, since typically countries not surveyed tend to rate lower in governance than those surveyed.

# Unbundling Corruption: Different types of Bribery (responses by firms 2005)

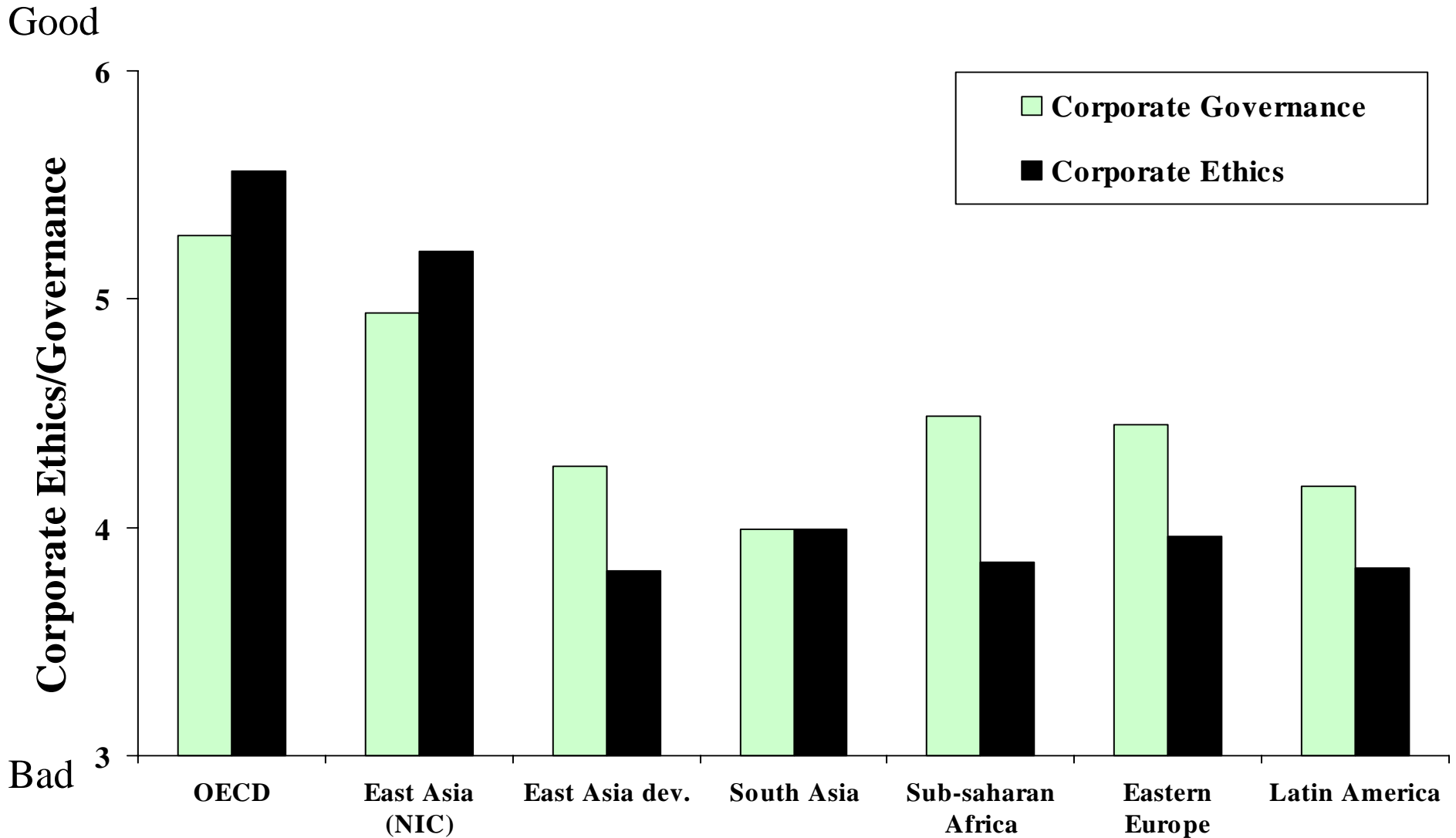
% Firm Report High Bribery (1-3)



Source: EOS firm survey, WEF2005 – 117 countries. Question: In your industry, how commonly firms make undocumented extra payments or bribes connected with permits / utilities / taxation / awarding of public contracts / judiciary? (common...never occurs).



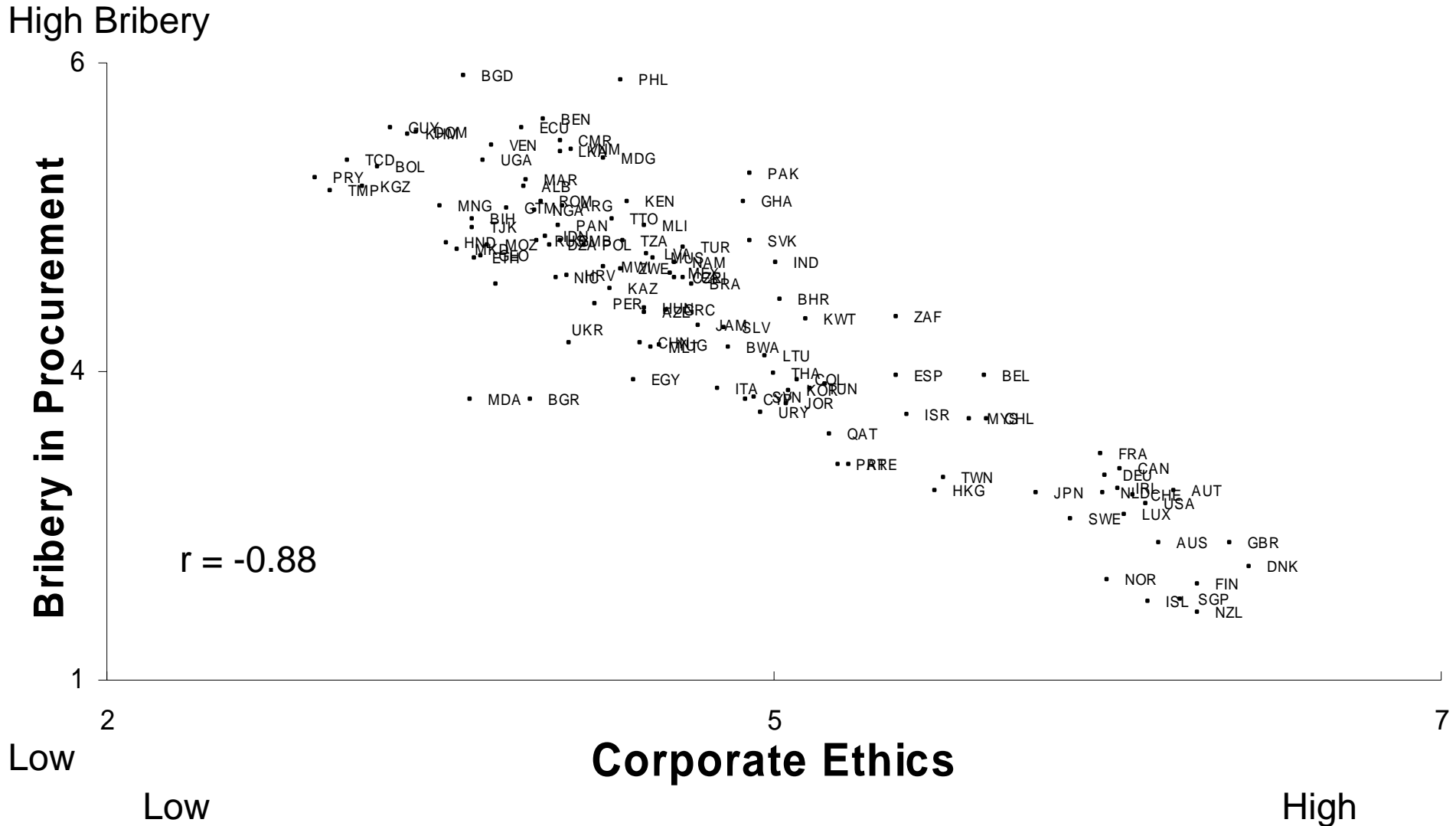
# Corporate Governance and Ethics, EOS 2005



Source: EOS firm survey, WEF2005 – 117 countries. Question: Corporate Governance by investors and boards of directors in your country is characterized by strong supervision of management decisions); The corporate ethics of your country's firms in your industry are among the best in the world.



# Bribery in Public Procurement & Corporate Ethics



Source: EOS firm survey, WEF2005 – 117 countries. Questions: In your industry, how commonly firms make undocumented payment connected with awarding of public contracts?; The corporate ethics of your country's firms in your industry are among the best in the world.

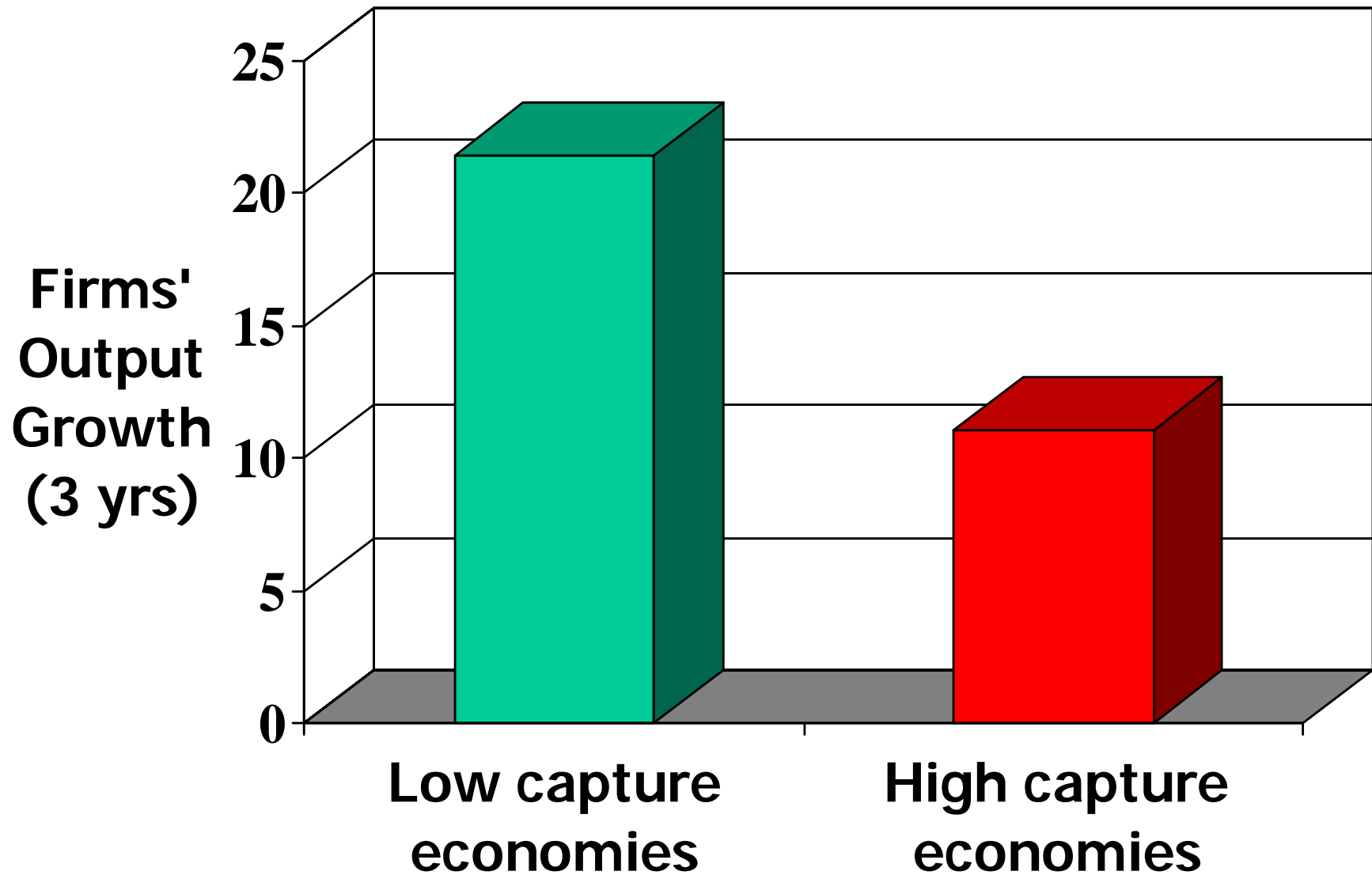
# State Capture

**Some Powerful firms shape the legal, policy and regulatory environment through *illicit* provision of private gains to public officials**

- **Examples include:**

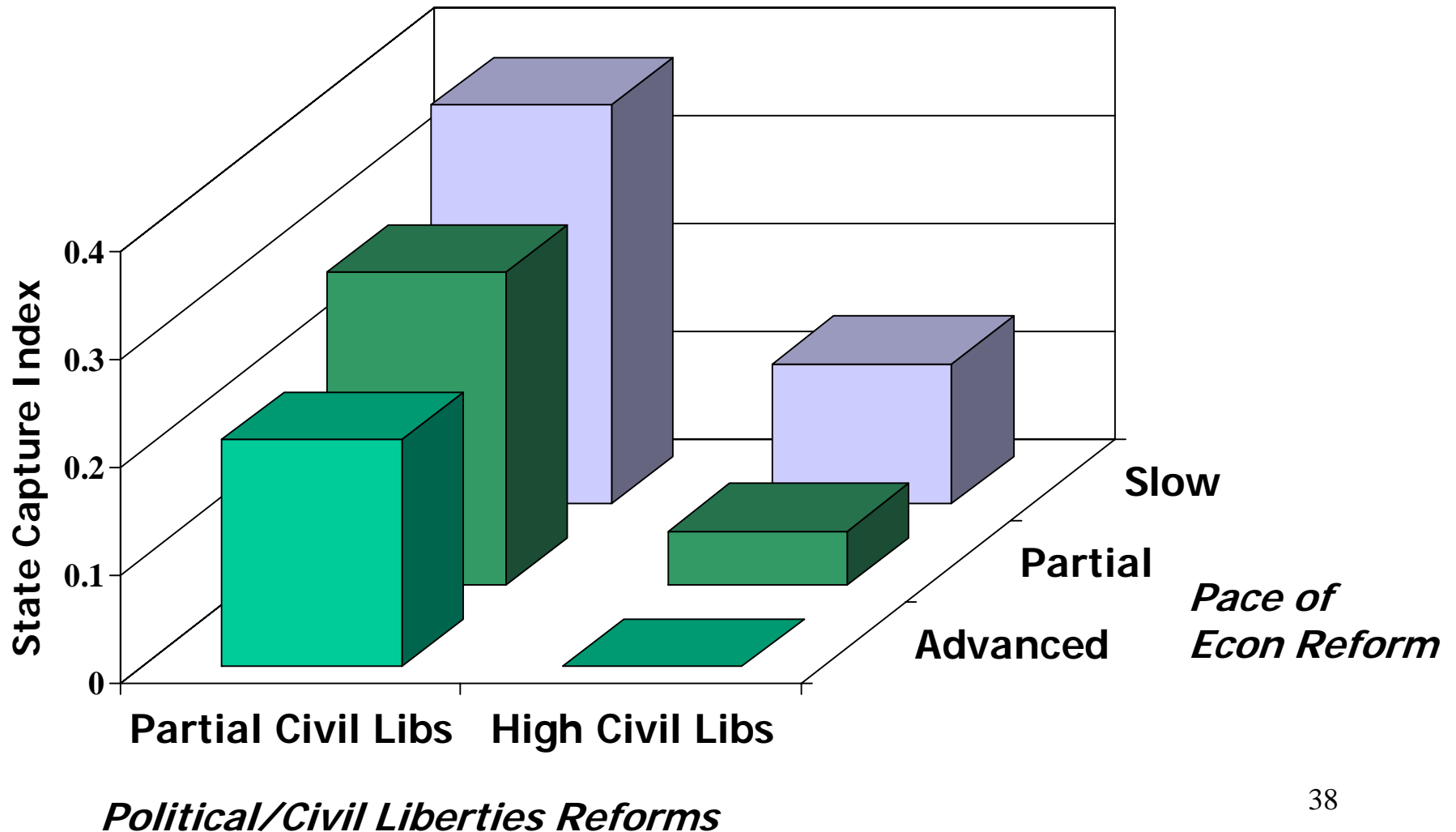
- *private purchase of legislative votes*
- *private purchase of executive decrees*
- *private purchase of court decisions*
- *illicit political party financing*

# Economic Cost of Capture for Growth



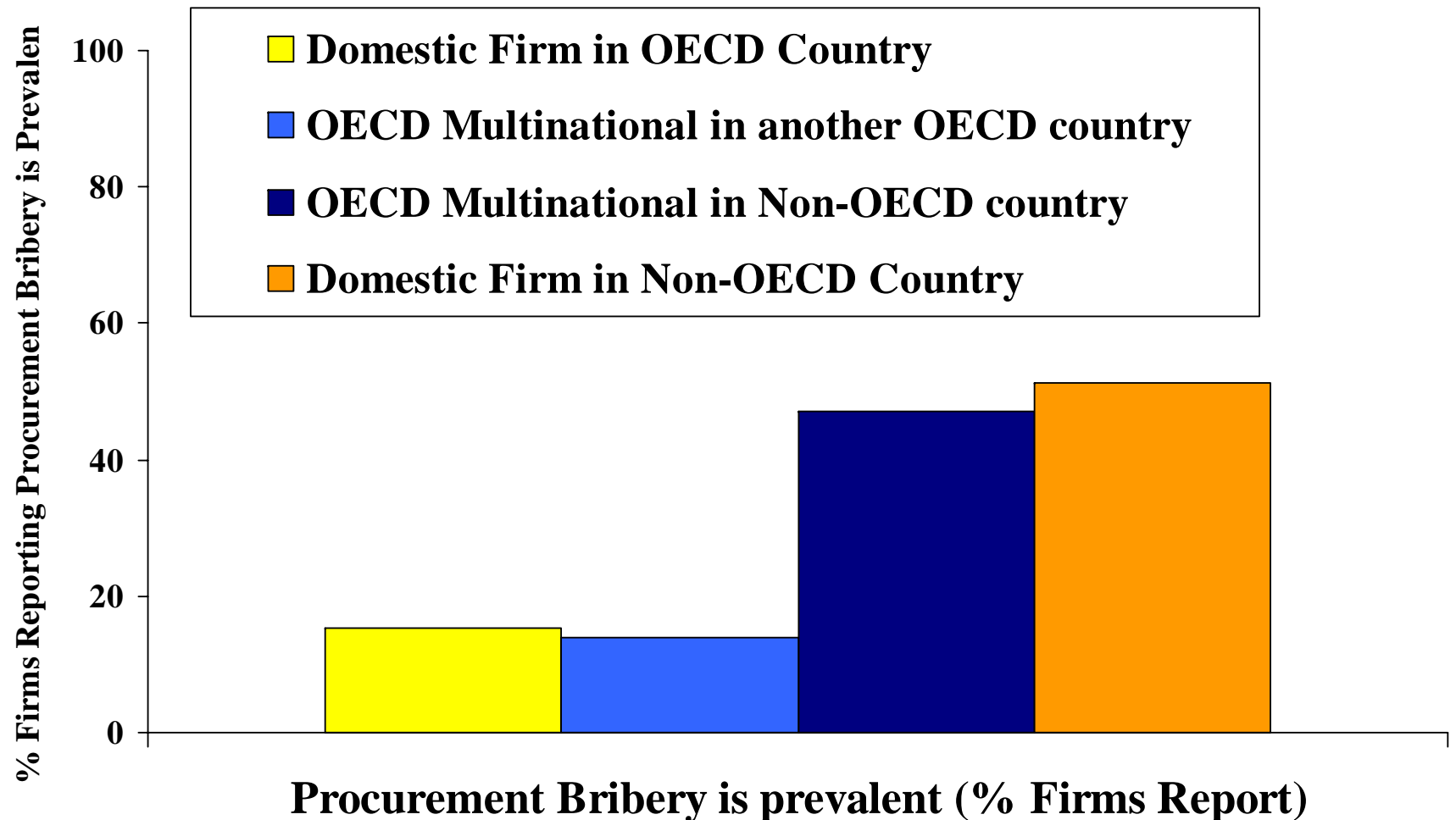
*Based on survey of transition economies, 2000*

# *Addressing Capture: Economic Reform, Political Competition & Voice/Civil Liberties Matter*



# Multinationals Bribe Abroad?

*% Firms Reporting Frequent Procurement Bribery, EOS 2005*



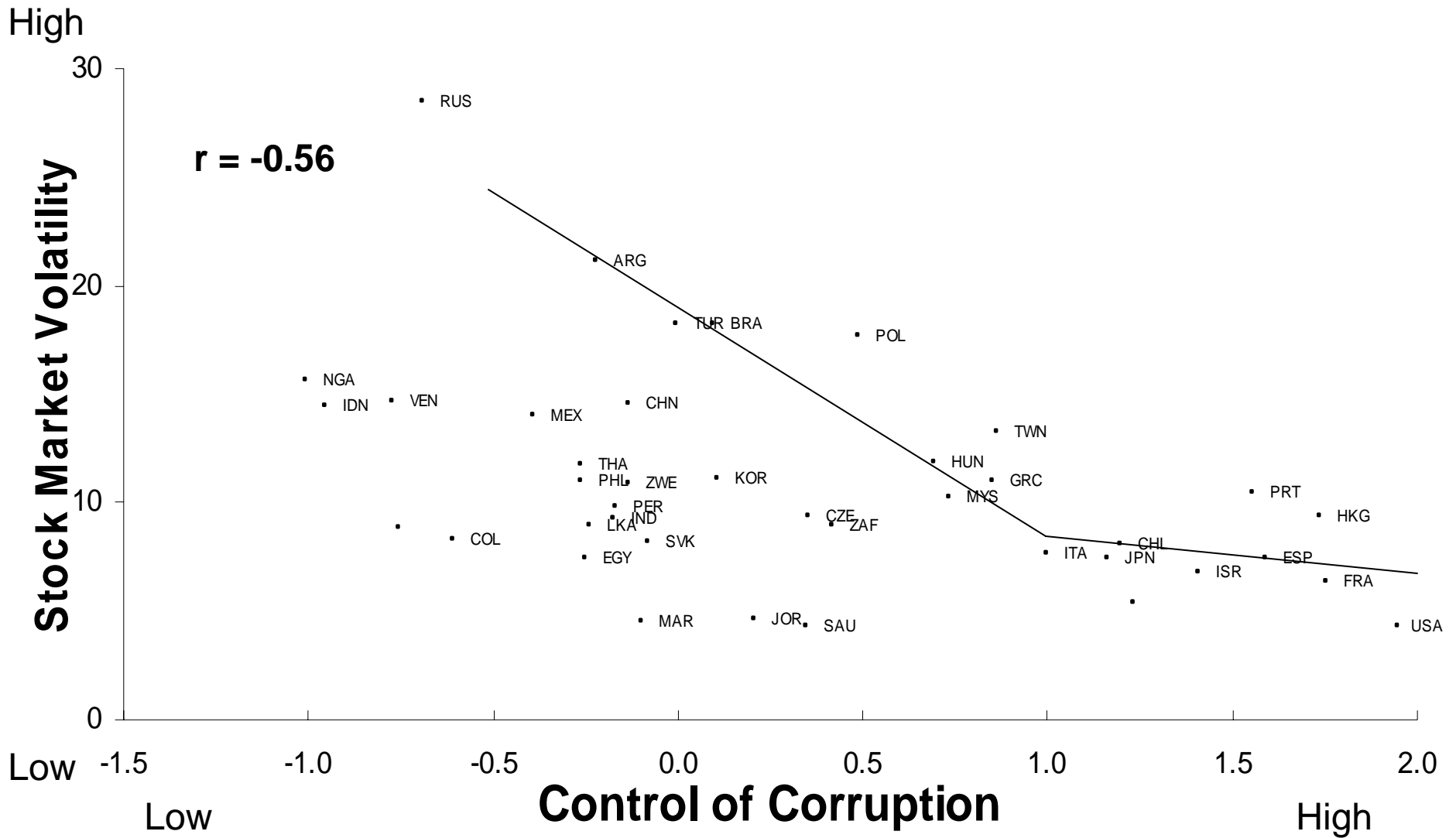
Source: EOS, preliminary. Question: In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with the following: permits, public utilities, tax payments, loan applications, awarding of public contracts, influencing of laws, policies, regulations and decrees to favor selected business interest, and judicial decisions. Any firms reporting answers 1 through 3 were considered to be reporting at least high frequency of bribery, while answers 4 through 7 were not.

# **Governance Matter for Assessing Emerging Financial Markets Prospects?**

## **Indicators Matter, and Some Empirical Lessons**



# Stock Market Volatility vs. Control of Corruption



Sources: KK 1998 and Morgan Stanley Capital International Dataset and Emerging Markets Database (1998). Stock volatility defined as the standard deviation of monthly returns over December 1984 to December 1998, multiplied by 100.



# Stock Market Volatility vs. Extent of Insider Trading



Sources: EOS firm survey, WEF (1998) and Morgan Stanley Capital International Dataset and Emerging Markets Database (1998). Question for insider trading: "Insider trading is not common in domestic stock markets", 1=strongly disagree, 7=strongly agree. Stock volatility defined as the standard deviation of monthly returns over December 1984 to December 1998, multiplied by 100. Based on Du and Wei (2004)

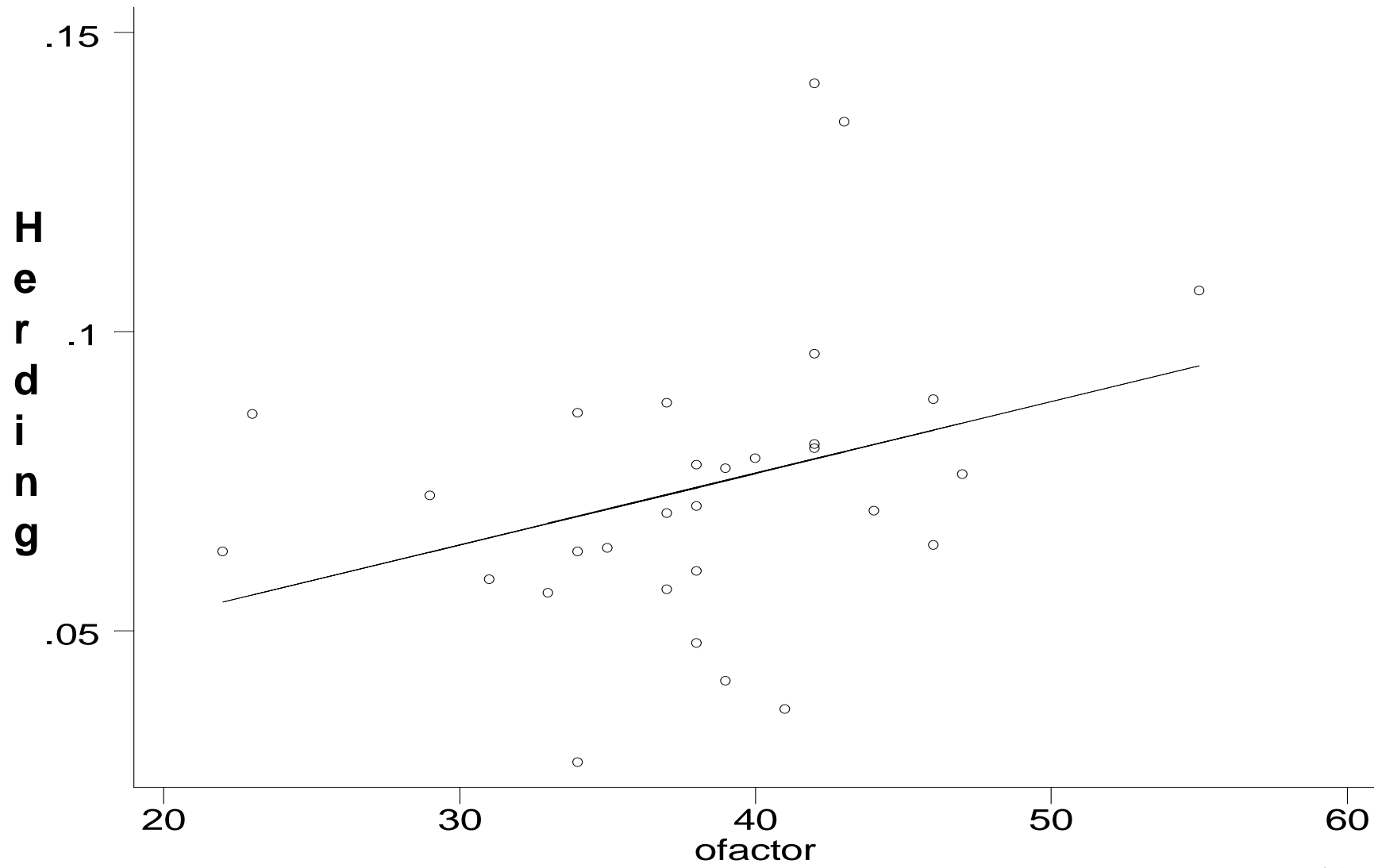
## Insider Trading Significantly Affects Stock Market Volatility: An Example from Du and Wei (2004)

|  | US<br>(1)    | China<br>(2) | Difference<br>(3)=(2)-(1) | Increase in<br>mkt Volatility |
|--|--------------|--------------|---------------------------|-------------------------------|
| Insider<br>Trading<br>Output<br>Volatility | 2.62<br>1.7% | 4.62<br>3.0% | 2.00<br>1.3%              | 245 bp<br>103 bp              |

More volatility effect  
from an ↑ in insider  
trading

> The volatility effect from an  
↑ in output volatility

# Opacity (or misgovernance) affects Herding (investors mimic each other's behavior)



Gelos and Wei, 2005

Opacity (Misgovernance)

# **Findings on Governance & Emerging Financial Markets**

*Du and Wei (2004)*: Insider trading → higher market volatility

*Gelos and Wei (2005)* find that in opaque countries:

↓ FDI, ↑ herding intensity, &, ↑ capital flight during a crisis

*Wei (2000)*: short term flows 'intensity' in corrupt countries

*Mehrez and Kaufmann (1999)*: financial crisis more likely  
in less transparent countries (liberalizing)

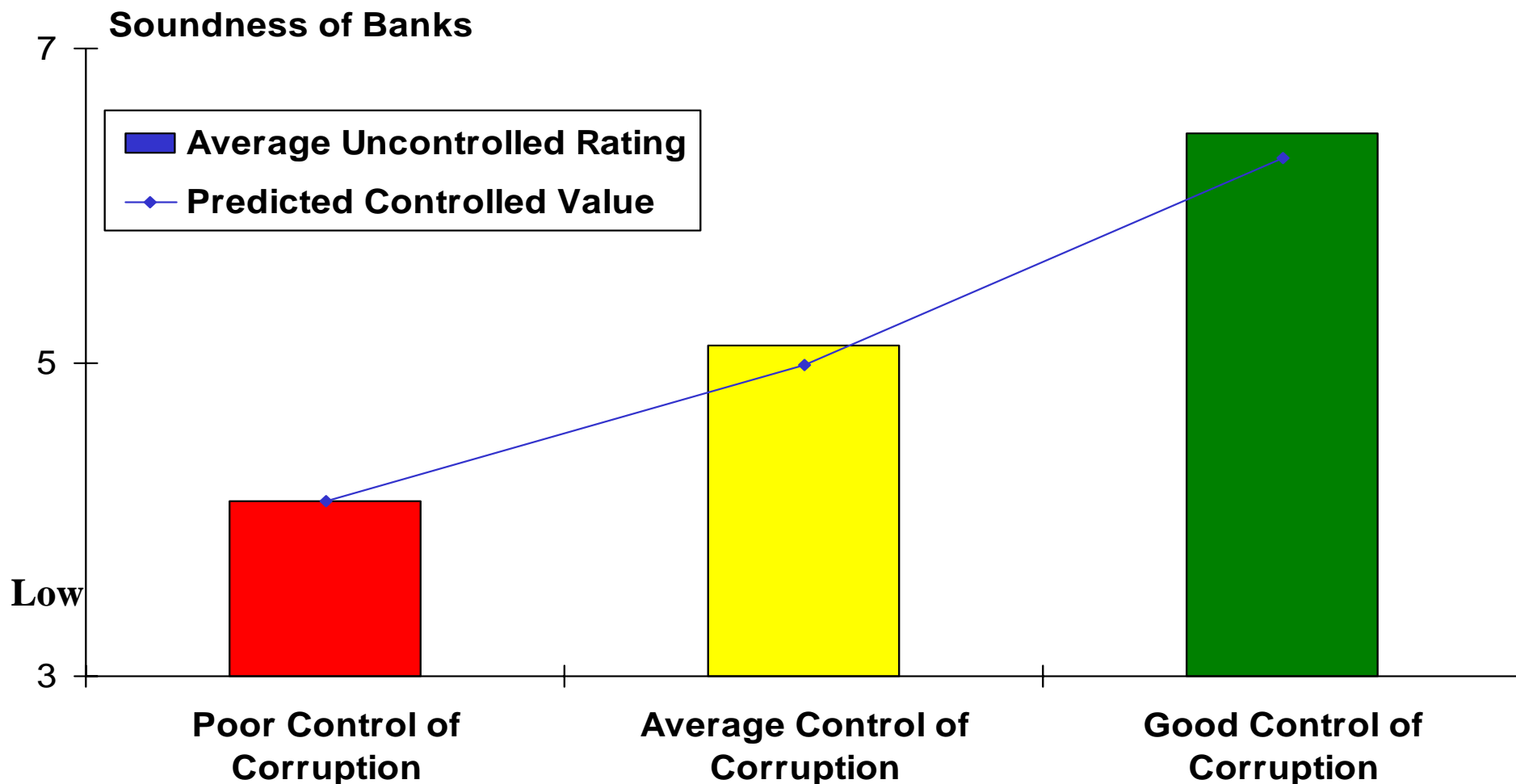
*Acemoglu & Johnson (2004)*: property rights institutions  
matter for growth, I, Financial Market Development

*Kaufmann, Mehrez & Schmuckler (1999)*: Listening to  
data from firms matters for predicting crises

# Misgovernance → Higher Fragility of Financial Sector

## Soundness of Banks vs. Control of Corruption

*(View of the firm, GCS 2001)*



Source: Global Competitiveness Survey, 2001, KK Governance Indicators

## **General Implications -- *departing from convention?***

### ***Challenging popular tenets:***

- **Governance measurement skepticism challenged**
- **Beyond corruption: also governance & transparency**
- **Not only administrative corruption -- *influence peddling and state capture by firms is also key***
- **Private sector not merely the ‘investment climate taker’; while public sector not alone as ‘investment climate maker’**
- **Governance Matters for country growth prospects, and for its financial markets**
- **Capital Market Development as Disciplining for Governance**



# Country Governance and the Stock Market

## 1. *Measurement, Indicators and Analysis:*

- **Assessing country Governance (incl. transparency & corruption) matter for emerging equity market prospects**
- **Integrity (insider trading) of the equity market as well**
- **Understanding Prevalence and Role of Elites and Capture**

## 2. *Some Implications for Emerging Equity Markets*

- **In the short-term: *important for volatility – risk***
- **In the longer term: *for sustained growth prospects***

## 3. *Thus, governance indicators & their analysis matter for market prospects & for optimal portfolio allocation*

# Data for Analysis and Informing Policy Advice, Not for Precise Rankings

*Any data on Governance, Institutions, and Investment Climate is subject to a margin of error. It is not intended for precise country rankings, but to highlight relative strengths and weaknesses and draw analytical and policy lessons. The data and indicators do not necessarily reflect official views on rankings by the World Bank or its Board of Directors. Errors are responsibility of the authors.*

**Further materials & access to interactive data:**

**General:** [www.worldbank.org/wbi/governance](http://www.worldbank.org/wbi/governance)

**Data:** [www.worldbank.org/wbi/governance/govdata/](http://www.worldbank.org/wbi/governance/govdata/)

**Governance Matters IV** by Kaufmann, Kraay and Mastruzzi:  
<http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>