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Corporate governance strength and stock market liquidity in Malaysia

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Abstract

Purpose – The purpose of this paper is to examine the impact of corporate governance strength on stock market liquidity in an emerging country, namely, Malaysia, by constructing a corporate governance score that captures both internal monitoring mechanisms (board of directors' characteristics, audit committee's characteristics and internal audit function) and external monitoring mechanism (audit quality).

Design/methodology/approach – The study uses a sample of 2,020 yearly firm observations in Bursa Malaysia over the period 2009-2012. The ordinary least square regression and several estimation methods such as two-stage least squares using instrumental variables (IV-2SLS) and dynamic GMM are employed.

Findings – This study finds a significant positive association between corporate governance effectiveness and stock market liquidity. The finding is robust to alternative liquidity measurements, to alternative estimation methods, and to endogeneity bias.

Research limitations/implications – This result implies that the firms with effective monitoring mechanisms mitigate information asymmetry which leads to less adverse selection problems among traders.

Practical implications – This study provides implications for regulators to help design regulations that enhance stock market liquidity. This study could also help investors and traders to formulate their trading decisions, and enables firms to know the importance of strengthening the corporate governance monitoring mechanisms.

Originality/value – This study constructs a corporate governance effectiveness measure by combining both internal and external monitoring mechanisms. These mechanisms have not been constructed together in one score in the corporate governance literature and the impact of internal audit function, as an internal monitoring mechanism on liquidity, has yet to be examined.

Keywords Malaysia, Stock market liquidity, Corporate governance strength

Paper type Research paper

1. Introduction

Stock market liquidity is a key factor for well-functioning stock markets due to its important repercussions for several parties. Having a liquid market is essential either for developed and emerging countries, as a highly liquid market means efficient allocation and a tool for economic growth (Bencivenga *et al.*, 1996; Levine, 1991). Liquidity is a critical pre-condition for financial market growth and development (Wang, 2013). One of the issues that have been examined in terms of liquidity is corporate governance, in that effective corporate governance is a crucial for enhancing the investors' confidence and broadening and deepening the capital market. Effective corporate governance serves to protect the shareholders' rights by mitigating perverse insider behavior.

It is recognized that developed and developing countries are introducing corporate governance reforms. However, empirical evidence about the impact of corporate governance on stock market liquidity is still limited. For developed countries, a study done by Chung *et al.* (2010) in the USA examined this relationship and found that highly effective governance leads to

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