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RESEARCH SUMMARY

Making Markets Work Better: The Importance of High-Quality Institutions

Financial market failures are often followed by calls for government intervention to correct issues such as unstable prices or market crashes. However, governments may share part of the responsibility for market failures because they establish and oversee the institutions (or sets of rules) within which markets operate.

In "The Informational Efficiency of Cross-Listed Securities and the Quality of Institutions," Benjamin M. Blau and Ryan J. Whitby argue that the quality of a country's institutions, including its political and judicial systems, plays a key role in the success and failure of markets. They find that the informational efficiency (the ability of markets to incorporate information into prices) is greater for securities of companies located in countries with higher-quality institutions.

In finance, stock prices are said to be most efficient and reliable when they fully reflect all the information that is available to market participants at any given time. Reliable price signals play a vital role in the flow of capital to firms and the overall savings behavior of individuals. Because of the importance of reliable price signals, identifying a link between institutional quality and price efficiency in financial markets is crucial.

THREE KEY TAKEAWAYS

- *Institutional quality matters*. Overall, the findings suggest that security prices best reflect available information when institutional quality is highest. To the extent that policymakers are concerned about financial market inefficiencies, improvements in institutional quality may help address these concerns.
- *Political stability is associated with greater informational efficiency*. The strongest results are found when examining political institutions. The less stable the political system, the longer it takes security prices to incorporate relevant, market-wide information. As political stability in a particular country improves, so does the informational efficiency of the securities.
- *The weakest evidence involves the rights of shareholders relative to boards of directors*. The weakest results from the study come from looking at how corporate governance rules affect efficiency. The study does not find strong evidence that more liberal corporate governance rules (such as guaranteeing shareholders' right to challenge incumbent boards of directors) are associated with greater informational efficiency of the securities.