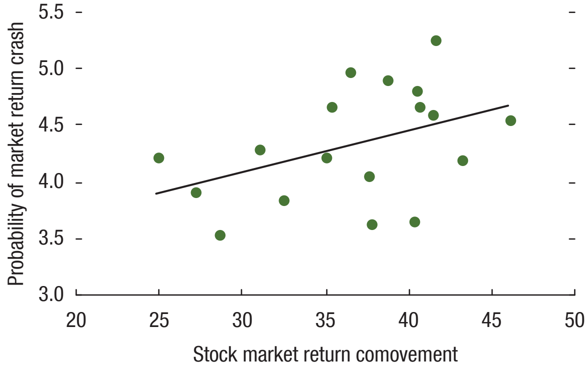
Figure 3.12. Crash Risk

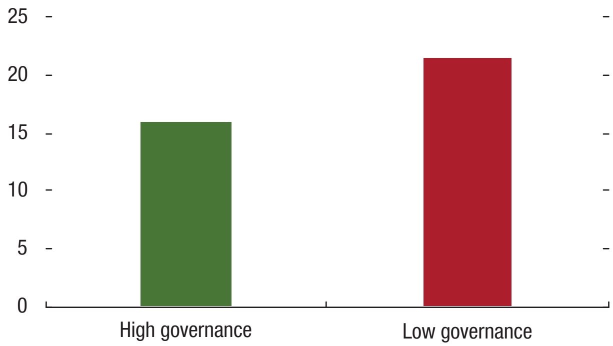
(Percent)

Emerging market economies and firms with weaker governance are more prone to stock price crashes. Better governance fosters financial stability by helping to better align price movements with fundamentals and reduce the risk of extreme price drops.

1. Country-Level Crash Risk[1]



2. Firm-Level Crash Risk[2]



Sources: Bloomberg L.P.; Thomson Reuters Datastream; World Economic Forum, Global Competitiveness Indicators database; and IMF staff calculations.
Note: Using other country-level governance indices, such as the Guillen-Capron minority shareholder rights protection index or the strength of minority investor protection strength (World Bank), yields similar pictures.
[1]Stock return comovement is measured by the R^2 of the regression of weekly stock returns on market factors. Crash risk is the probability of the weekly market return falling below the 5th percentile for each country under a normal distribution.
[2]High governance = firm governance above 75th percentile; low governance = firm governance below 25th percentile. The empirical analysis also controls for the size, leverage, return on equity, state-owned enterprises, and American depository receipts. Results are robust to controlling for country and time fixed effects. Firm-level crashes are defined as occurrences of firm-specific residual returns falling in the 2.5 percent lower tail of a normal distribution. See Annex 3.2 for further details.