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Privatization and stock market liquidity ☆

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Abstract

This paper shows that share issue privatization (SIP) is a major source of domestic stock market liquidity in 19 developed economies. Particularly, privatization IPOs have a negative effect on the price impact – measured by the ratio of the absolute return on the market index to turnover. This result is robust to the inclusion of controls for other observable and unobservable factors, having also considered the endogenous nature of the decision to privatize.

We also provide evidence of a positive spillover of SIP on the liquidity of private companies. This cross-asset externality is one implication of liquidity theories emphasizing the improved risk diversification opportunities and risk sharing brought about by privatization. This externality stems from both domestic privatization IPOs and cross-listings.

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1. Introduction

Financial market development is mentioned as one of the primary objectives of share issue privatization (SIP) programs in developed economies. One of the first experiments to foster the domestic stock market through privatization was carried out in Germany during the 1960s by the Adenauer government (Esser, 1994). More recently, the promotion of investors' participation and the revitalization of national exchanges have been top priorities of privatization programs not only in the United Kingdom, but also in France, Spain, and Italy (Vickers and Jarrow, 1988; Dumez and Jeunemaître, 1994; Chiri and Panetta, 1994).

A remarkable wealth of evidence shows the correlation between financial market development and privatization. For instance, stock trading volume in developed countries outside the US grew from a little over $400 billion in 1983 to more than $12 trillion in 2002, while massive privatization plans were in progress (Megginson, 2005). Yet, stock markets develop also in the absence of privatization. Indeed, the US experienced an exponential growth in capitalization and turnover during the same years with only limited privatization. So does privatization contribute to the development of stock markets?

Some theories suggest that it should. Due to the positive externalities generated by listing decisions, privatization initial public offerings (IPOs) may jumpstart an economy's stock market by improving investors' diversification opportunities (Pagano, 1993; Subrahmaniam and Titman, 1999). Moreover, SIPs involving the floating of shares in both domestic and international exchanges (SIPs with cross-listings) reduce informational barriers to foreign investment and enlarge firms' shareholder base (Mendelson, 1985; Chiesa and Nicodano, 2003) thereby boosting liquidity in the domestic market. Despite the relevance of these issues, a comprehensive empirical analysis concerning the impact of privatization on equity markets in developed countries is still missing in the literature. This paper aims at filling this gap.

We relate measures of privatization to a fundamental aspect of stock market development: market liquidity. A deeper secondary market allows companies to raise capital at a lower price (Ellul and Pagano, forthcoming) by reducing investors' required return (Amihud and Mendelson, 1986). Furthermore, liquidity – rather than capitalization – provides incentives for information acquisition to financial analysts. This in turn stimulates the use of stock-based managerial incentive schemes, which may enhance corporate performance and growth (Hölmstrom and Tirole, 1993). Empirically, the initial level of stock market liquidity is a robust predictor of economic growth and capital accumulation, while initial capitalization is not (Levine and Zervos, 1998; Levine, 1997).

In order to capture the variation in market liquidity we first construct an aggregate measure of the price impact, inspired by the Amihud illiquidity index (Amihud, 2002). Price-impact measures for the US stock market have usually been computed as averages of the price impact of individual companies (see for example Acharya and Pedersen, 2005). In contrast to this approach, we compute the price impact of the stock index, i.e. the ratio of the absolute return on the index to total trading volume, and show that our proxy moves closely together with the average of the individual price-impact measures.