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Are regulations the answer for emerging stock markets? Evidence from the Czech Republic and Poland

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Abstract

Does the emergence of a stock market require a well-developed legal and/or regulatory system? Although historical work by Neal and Davis [Neal, L., & Davis, L. (2005). The evolution of the rules and regulations of the first emerging markets: The London, New York, and Paris stock exchanges, 1792–1914. *Quarterly Review of Economics and Finance*, *45*, 296–311] and Stringham [Stringham, E. (2003). The extralegal development of securities trading in seventeenth century Amsterdam. *Quarterly Review of Economics and Finance*, *43*, 321–344] suggests that securities markets have successfully developed with little government oversight, numerous authors [including Black, B. (2001). The legal and institutional preconditions for strong securities markets. *University of California Law Angeles Law Review*, *48*, 781–855; Coffee, J. (1999). Privatization and corporate governance: The lessons from securities market failure. *Journal of Corporation Law*, *25*, 1–39; Frye, T. (2000). *Brokers and bureaucrats: Building market institutions in Russia*. Ann Arbor: University of Michigan Press; Glaeser, E., Johnson, S., & Shleifer, A. (2001). Coase versus the Coasians. *Quarterly Journal of Economics*, *116*, 853–899; Mlčoch, L. (2000). Restructuring of property rights: An institutional view. In L. Mlčoch et al. (Eds.), *Economic and Social Changes in Czech Society After 1989*. Prague: The Karolinum Press; Pistor, K. (2001). Law as a determinant for equity market development – the experience of transition economies. In Peter Murrell (Ed.), *The Value of Law in Transition Economies* (pp. 249–287). Ann Arbor: Michigan University Press; Stiglitz, J. (1999). *Whither reform. Ten years of the transition*. Keynote Address, Annual Bank Conference on Development Economics, Washington, DC, April 28–30, 1999; Zhang, X. (2006). Financial market governance in developing countries: Getting the political underpinnings right. *Journal of Developing Societies*, *2*, 169–196] argue that the Czech Republic and other Eastern European governments need more regulation for their newly created stock markets. They maintain that the Warsaw Stock Exchange, which is seen as more regulated, has outperformed the Prague Stock Exchange which is seen as largely unregulated. Thus increased regulations are a key to increased performance. This article, however,

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maintains that the evidence from the Czech experience has been misinterpreted. This article provides an in depth case study of the Czech stock market and finds that (a) Czech capital markets have been hindered by government intervention from their beginning, (b) that the evidence on Poland's superior performance is not as strong as suggested, and (c) that Czech regulators seem to be unqualified, lack the proper incentives, and are unlikely to benefit the market. Under these circumstances it appears that Neal and Davis (2005:311) are correct that increased government involvement is unlikely to improve the situation.
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1. Introduction

After the collapse of communism in 1989, economists, policy analysts, and politicians were optimistic about the adoption of capitalist institutions in Eastern Europe. The Czech government, for example, created nearly two thousand joint stock companies and enabled all citizens willing to pay a small fee to participate in a voucher privatization (Filer & Hanousek, 2001). Although hopes for the development of markets were high, within a few years the stock market exhibited problems. A 1996 article in *Fortune* magazine entitled "The Pirates of Prague" is representative of the general sentiment: freewheeling privateers were bilking shareholders after the mass privatization (Wallace, 1996). Tunneling, a phenomenon in which firm managers, investment funds, and majority shareholders expropriated resources of the companies at the expense of the other shareholders, occurred (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2002). *The Economist* (September 12, 2002) summed up the consensus: "Many now blame the extreme liberal ideas of their architect of reform, Václav Klaus, who was prime minister in 1992–1998. He believed that freeing markets was more urgent than establishing an institutional framework. . .. But today most people believe that Mr. Klaus's big bang created little economic growth, but a kleptocracy as bad as Russia's."

These problems and others have led many to question the existing arrangements and to ponder the necessary prerequisites for capital market development. While writers such as Benston (1998), Manne (1969), and Stigler (1964) argued that forward looking economic agents would contract for arrangements to maximize the value of their shares, Glaeser, Johnson, and Shleifer (2001, p. 854) counter that this group of theories "crucially relies, among other assumptions, on the possibility of effective judicial enforcement of complicated contracts." In Eastern Europe these conditions are not met (Santomero, 1998), so Glaeser et al. argue that regulators must step in to enforce the rules. Others who have written about the Czech stock market reach similar conclusions. Coffee (1999), Mlčoch (2000), Pistor (2001) all argue that the Czech government has been too hands off and that this has led to insider dealings, a decreasing number of listed companies, and an overall lackluster stock market.

In contrast the Polish stock market is portrayed as a model that others should follow. Poland was more explicit in adopting a highly regulated market, and over 1990s the total number of listed companies increased. Authors attribute the increasing number of companies in Poland to the high amount of securities regulation. This now common view is that the emergence of a stock market requires the state to play a significant role promoting and creating order in stock markets (Black, 2001; Frye, 2000; Stiglitz, 1999; Zhang, 2006).

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