

Privatization, political risk and stock market development in emerging economies

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Abstract

This paper investigates whether privatization in emerging economies has a significant indirect effect on local stock market development through the resolution of political risk. We argue that a sustained privatization program represents a major political test that gradually resolves uncertainty over political commitment to a market-oriented policy as well as to regulatory and private property rights. We present evidence suggesting that progress in privatization is indeed correlated with improvements in perceived political risk. Our analysis further shows that changes in political risk in general tend to have a strong effect on local stock market development and excess returns in emerging economies. We conclude that the resolution of political risk resulting from successful privatization has been an important source for the rapid growth of stock markets in emerging economies. © 2001 Elsevier Science Ltd. All rights reserved.

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1. Introduction

The rapid evolution of capital markets in developing countries has emerged as a major event in recent financial history. Portfolio flows to emerging countries rose tenfold from 1989 to 1995 (IFC, 1997) and kept rising until the recent crises. Local

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stock markets also grew considerably in size. The aggregate market capitalization of the countries classified by the IFC as emerging markets rose from US\$488 billion in 1988 to US\$2225 billion in 1996. Trading on these stock markets rose in similar magnitude, growing from US\$411 billion to US\$1586 billion in that period (IFC, 1997).

These remarkable developments followed a crisis period when foreign debt and large government deficits had undermined confidence in these economies. A critical policy change in many of these countries has been the establishment of large privatization programs. The known benefits of privatization are a reduction in public debt, improved incentives and efficiency,¹ and better access to capital. Sales to the private sector led to an inflow of foreign capital and technological transfers (Sader, 1995) and increased integration of local firms in international trade patterns.

The earliest extensive privatization plans were launched in the early 1980s in Chile and the UK. These programs were deemed successful and were mimicked by many developing and industrialized countries. From 1980 to 1987, a total of 696 privatization transactions were recorded by Candoy-Sekse (1988), of which 456 took place in developing countries. The importance of sales in developing countries thereafter increased significantly. Privatization revenues climbed from US\$2.6 billion in 1988 to US\$25.4 billion in 1996, amounting to US\$154.5 billion over the whole period (World Bank, 1997, 1998). The privatization database of the World Bank reports more than 3000 transactions in developing countries.

While the privatization process in developing countries has been studied extensively, little attention has been given to its impact on the development of the local equity markets. The coincidence of the emergence of local stock markets and the progress of privatization begs the question to what extent these developments are related.

As many countries carried out privatization sales through offerings on the local stock exchange, sales certainly led to increases in market capitalization.² However, this direct effect of privatization does not account for much of the growth in local stock markets. Total sale revenue of US\$154.5 billion in 1988–1996 represents only a small fraction of the increase in market capitalization over that period. In addition, many privatization transactions were not carried out through public issues and some took place in countries not classified by the IFC as an emerging market. Thus, although privatization appears to be associated with stock market development, the recent magnitude of market development by far exceeds their direct impact: thus there must have been both a reduction in discount rates and/or new private issues.

¹ For an assessment of welfare gains from privatization see Galal et al. (1994). For evidence on efficiency gains see Claessens and Djankov (1997) and Boubakri and Cossets (1998).

² In Chile, by 1993 the three largest companies listed on the exchange were all privatized firms. With a market value of over US\$10 billion, they represented almost 25% of the market's capitalization. TelMex is easily Mexico's major listed firm, representing 18% of the market's capitalization in 1993. In Argentina the shares of YPF, Telecom and Telefonica added up to about 50% of total market capitalization in 1994. Around 30% of Malaysia's market capitalization in 1992 was contributed by privatized stocks. (Euromoney, 1993–4).

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