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The dynamics of privatization, the legal environment and stock market development ☆

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Abstract

In this paper, we examine under which conditions privatization is an effective means to develop local stock markets for a panel of 61 countries over the last twenty four years. By addressing the endogeneity between privatization and stock market development, we show for the 1980–98 period that the initial legal environment is a significant contemporary determinant of stock market development, while privatization is not. When we examine the dynamics of privatization in interaction with the legal environment, we find that privatization has a two-year-lagged effect on stock market development in emerging markets, and a one-year-lagged effect in developed countries. Results for the 1999–2003 period seem to be largely affected by the global crash that followed the Asian crisis.

JEL classification: G15; G18
Keywords: Privatization; Law; Stock market development; Emerging markets; Developed-markets

1. Introduction

The considerable growth of capital markets around the world over the last two decades, and their increasing integration, has put forward the necessity for governments to prioritize the development of domestic stock markets. Policy makers as well as supervisory and international donor agencies (i.e., the International Monetary Fund (IMF) and the World Bank) now put an

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unprecedented emphasis on policies that aim to develop financial markets (World Bank, 2002, 2005), including privatization of state-owned firms.

In this paper, we analyze the impact of privatization on stock market development in an international sample of developed and developing countries. Specifically, three main issues call for our attention: (1) first, does privatization has a contemporaneous effect on stock market development? To answer this question, we characterize privatization by its intensity and method (i.e., private sales to strategic investors or share issues on the stock market), and model the reform as endogenous to stock market development. (2) Second, does the level of institutional development affect the relation between privatization and stock market development? (3) Third, what are the dynamics of privatization? In other words, are the effects of the reform on stock market development contemporaneous or lagged in time? These issues are particularly important in a context where privatization is put in place worldwide, and which governments and politicians often justify by their desire to develop domestic stock markets and create popular capitalism.

Our study makes several contributions to the literature: First, we address the endogeneity between privatization and stock market development (SMD henceforth) since recent studies show that the reform is unlikely to be exogenous (Bortolotti, Fantini, & Siniscalco, 2003; Megginson, Nash, Netter, & Poulsen, 2004). Indeed, in most previous studies that examine the postprivatization performance of former state firms, SMD is implicitly assumed to be exogenous (Boubakri, Cosset, & Guedhami, 2005a, b; D'Souza & Megginson, 1999; Megginson, Nash, & van Randenborgh, 1994) [2].

Another contribution is that we use an international sample of 37 emerging markets and 24 developed countries, and employ a wide array of SMD indicators that characterize stock market size, liquidity and concentration, to tackle the conceptual shortcomings that each indicator may raise if it is taken separately, as it is done in the literature (Demirgüç-Kunt & Levine, 1996, 1999).

Finally, this paper also goes beyond the existing literature on the determinants of SMD in two ways: first, by including institutions that are directly related to stock market integrity, namely the extent of insider trading regulation and enforcement, and second, by considering the overall legal environment rather than political risk alone (Perotti & van Oijen, 2001).

Our main results can be summarized as follows:

We first show that privatization has no *contemporaneous* (i.e., simultaneous) impact on SMD. Next, when we examine the inter-temporal effect of privatization on SMD, we find that if the initial legal environment is efficient, the method of divestiture and the reform intensity have a more or less lagged effect, depending on the level of country economic development. For example, we find that in emerging markets the method of privatization (i.e. privatization through share issues) has a *two-year-lagged effect* while privatization intensity has *a one-year effect* on stock market size and liquidity. In developed countries instead, the method of privatization has no inter-temporal effect on SMD, but privatization intensity yields a one-year-lagged improvement in stock market size and liquidity. These benefits materialize in the presence of an initial legal environment.

For both sub-samples of countries, the results also indicate, in line with La Porta, Lopez-De-Silanes, Shleifer, and Vishny (LLSV henceforth, 1997, 1998), that the legal origin significantly affects the level of SMD. Specifically, markets in civil law countries are less developed than markets from common law countries. However, the quality of law enforcement (i.e., Law and Order) yields different results. Law and Order is significantly related to individual measures of

[2] The reader is referred to Megginson and Netter (2001) for an extensive literature review on privatization.