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Was the collapse of the communist bloc a game changer in the stock markets? Left-wing vs. right-wing political preferences and stock market development

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ABSTRACT

The fall of communism in Eastern Europe is a historical event which had political, social and economic repercussions worldwide. Our research examines the association between stock market development and the way that left/right-wing power was exercised. Our results show that this historical event was a game changer! Up until the fall of the communist bloc in 1991, the power of the left was negatively associated with stock market development, however over the post-fall period this association becomes positive. Additionally, our findings also show that the left/right-wing conflict is only determinant in the case of emerging economies, which may be explained by the fact that these countries are less-developed institutionally and economically, and thus provide more scope for political preferences to overcome institutions.

1. Introduction

One of the most intriguing questions about comparative politics and finance is why some economies do not create the necessary mechanisms for improving their financial development, despite all the evidence that finance can promote economic growth (Schumpeter, 1959; Bencivenga & Smith, 1991; King & Levine, 1993; Levine, 1997 and others). Accordingly, there is still an ongoing debate regarding the forces behind the different governance structures that are prevalent in each country. A series of papers by La Porta et al. (1997, 1998, 1999) has set the basis for the legal origins school, which argues that the origin of the legal system largely explains these differences in governance and finance across countries. Others cite culture as the key explanatory factor (Stulz & Williamson, 2003; Hofstede, 2004; Licht et al., 2007 and others).

Both legal origins and culture have been criticized as being insufficient explanations, as they are unable to explain changes over time, given their static nature (Rajan & Zingales, 2003; Perotti, 2013). The politics school especially criticizes the legal origins hypothesis (Roe, 2003), arguing that identifying whether the dominant political powers within any economy want to create a more competitive financial environment is more important than the origin of the legal system or culture in terms of investor protection and financial development. Ever since Roe (2003)'s pioneer work questioning the legal origins hypothesis

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which brought politics to the centre of the debate, several key theoretical and empirical studies have been carried out using this rationale.

The political argument is generally separated into political preferences (interest groups and ideologies) and political institutions (rules and systems that shape the political arena) (Gourevitch & Shinn, 2005).

In this paper, we focus on political preferences as the explanatory factor for stock market development, analyzing the importance that a major historical event has, such as the collapse of the communist bloc had. Our contribution to the existing literature lies in our new approach to the question of whether left-wing political preference is negatively or positively associated with the development of capital markets. The theoretical and empirical literature has so far presented contradictory answers to this question. We reconcile previous findings, by arguing and demonstrating that the collapse of the communist bloc was a game changer. Accordingly, our results show that, up until 1991 (the fall of the communist bloc), the power of the left was negatively associated with stock market development, as the agenda of the left focused on the direct protection of labour through legal rules and public policies, adopting an anti-capitalist view. However, a change of discourse during the post-communist period led to left-wing parties embracing minority shareholder protection and capital market development as ways of indirectly protecting labour.

Furthermore, contrary to Roe's (2012) idea that the left/right conflict is more relevant for stock markets in developed countries, our results indicate that this is only relevant for developing countries. An explanation is that in emerging countries, the left/right-wing conflict is key to overcoming the interest of the elite in preventing competition and in changing the misleading idea of the non-elite that investor protection only favours large capital owners. However, in the case of developed economies, the conflict is less important, due to the greater and a more fair distribution of income per capita, the strength of the legal system, higher average investor protection, and more reliable and stable political institutions.

The rest of the paper proceeds as follows: firstly we present the debate of the literature on political preferences and finance, presenting the empirical evidence and specifying our research question and hypotheses. This is followed by the methodology section, which describes the research methods, variables, sample and models. Next, we present the results and robustness checks. The final section discusses the implications and the contributions of the study, as well as its limitations.

2. Theory and hypotheses

The seminal works by Roe (2000, 2003) place social democracy as the central political variable. In social democracies, government power is used to restrict capital for various social purposes, such as to protect and benefit labour (Roe, 2003). The rationale is that social democratic governments give voice to the claims of various stakeholders, at the cost of shareholder protection, which results in less-developed stock markets and in concentrated ownership as a tool which is used by blockholders to protect their interests and balances the distribution of power within the firm. Along the same line, Perotti and von Thadden (2006) centre their argument on the interests of the median voter, who has no financial capital, but has some human capital (as they constitute the majority of the electorate). The authors argue that workers are risk averse, as labour risk cannot be diversified, and thus they prefer more stable bank lending systems.

Social democracy is not the only way to analyze political preferences. Gourevitch and Shinn (2005) explore ways in which owners, managers and workers are able to join forces in different coalitions. They show that owners and managers can create alliances in order to contain workers' demands; workers and managers can join forces to secure employment and stable wages, and workers and owners can work together to contain managerial agency costs. They also call attention to the possibility of sector coalitions, rather than class coalitions (e.g.: firms interested in international openness, vs. firms interested in protecting their dominance in the domestic market). Pagano and Volpin (2005) consider different coalitions between managers, employees and shareholders in differing legislative structures, as a way of explaining the degree of outside shareholder protection, and they pay particular attention to the dynamics of shifting coalitions among these three groups.

Roe (2012) argues that different key political struggles in the developed and developing worlds are decisive for capital markets. In developed economies, conflicts occur not only between owners of capital vs. those who are not owners (*haves vs. have-nots*), but also between capital owners themselves (*haves vs. haves*). Among the "haves vs. have-nots" conflicts, Roe (2012) mentions that there are clashes between: 1) government power vs. private power, 2) populism vs. power, 3) business elites vs. masses, 4) social democracy vs. capital markets. Among the "haves vs. haves" conflicts, the author mentions: 1) banks vs. stock market capitalism; 2) managers vs. capital markets, and; 3) controlling shareholders vs. capital markets. In relation to developing economies, Roe (2012) also mentions other political factors which are more decisive for finance and governance, such as: inequality, political stability, the interest of the elite in preventing competition, and the non-elite's misleading understanding that investor protection only exists for the protection of the elite's capital from incursions by the "have-nots".

In terms of political preferences, we use social democracy as a central element (following Roe, 2000, 2003 and Pinto et al., 2010), and concentrate on the association between the strength of social democracy (translated into left wing politics and the power of labour) and stock market development. Social democracy is measured here as being the control of government by left-wing parties, which is a good central political variable for preference aggregation, for several reasons: 1) it has been used by previous research, and thus we can compare results; 2) it incorporates several of the conflicts identified by Roe (2012), both in developed and developing regions; 3) it is straightforward to measure and there are plenty of data available. Furthermore, being in favour of the use of the left-right dimension as a measure of political preference, Roe and Siegel (2009)