



Credible reforms and stock return volatility: Evidence from privatization[☆]



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ABSTRACT

In this paper we investigate how privatization affects stock return volatility. A credible privatization builds investors' confidence through a reduction in political risk. In particular, a privatization program that is maintained over time signals credibility, which reduces political risk and in turn volatility. We further show that privatization is associated with lower idiosyncratic volatility mainly among developed markets, while it is associated with lower systematic volatility in developing markets. Additional tests suggest that the reduction in volatility is greater when privatization sales are carried out through the stock market than through asset sales.

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1. Introduction

Privatization – defined as the deliberate sale of state-owned enterprises or assets to firms in the private sector – is often viewed as a response to the failure of government-owned firms to achieve efficient outcomes, perhaps because such enterprises focus more on promoting political objectives than on maximizing investor profits (see, e.g., Boycko, Shleifer, and Vishny, 1996; Megginson and Netter, 2001; Djankov and Murrell, 2002; Estrin, Hanousek, Kočenda and Svejnar, 2009). In this paper we examine how privatization reforms introduced over the past three decades influence stock return volatility. While prior research provides insights into

how volatility affects investors and the economy (Campbell, Lettau, Malkiel, and Xu, 2001; Wurgler, 2000; Bollerslev, Engle, and Wooldridge, 1988; Bekaert and Harvey, 1997), the question of how privatization affects stock return volatility remains unexplored.

Prior work shows that the introduction of a privatization reform is associated with favorable market sentiment (e.g. Boutchkova and Megginson, 2000; Perotti and van Oijen, 2001; Perotti and Laeven, 2002). However, while a committed government will maintain its privatization program over time, an uncommitted government will reverse the reform to pursue political objectives unrelated to efficiency. Incorporating investor uncertainty about a government's commitment to its privatization program, Perotti (1995) shows that investors delay participation in the program until this uncertainty has been resolved. Accordingly, we argue that maintaining a privatization program over time signals the government's commitment to the program and thus reduces volatility by decreasing the political risk perceived by investors. Consistent with this view, we show that privatization progress (i.e., the sustainability of a privatization program) reduces volatility through the resolution of political risk.

Next, we examine whether the privatization–volatility relation varies with the type of transaction. Megginson (2010) argues that privatizations via share offerings are more transparent than those through asset sales. Assessment of a privatization program's credibility should thus be less difficult, and the resolution of policy uncertainty more complete, for sales via the stock market. We

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find supportive evidence. In particular, privatization sales through the stock market are strongly associated with lower volatility, while privatization sales through asset sales are weakly related to volatility.

We also examine how the privatization–volatility relation varies with the level of economic development. Political risk, and in turn volatility, tends to be higher in emerging markets than in developed markets (Bekaert and Harvey, 1997; Perotti and van Oijen, 2001). This suggests that the effect of privatization progress on volatility should be more pronounced in emerging markets. In line with this argument, we find that the decrease in volatility associated with privatization programs that have been maintained over time is greater in developing countries than in developed countries.

Our work is related to the literature that studies the impact of political events on volatility (e.g., Manning, 1989; Bittlingmayer, 1998; Voth, 2002; Mei and Guo, 2004; Beaulieu, Cosset, and Essaddam, 2005) and relates volatility to political risk ratings (Boutchkova, Doshy, Durnev, and Molchanov, 2012; Bartram, Brown, and Stulz, 2012). We contribute to this literature by presenting novel evidence that the credibility of a privatization reform is related to volatility through the resolution of political risk, particularly the risk of policy reversal. Indeed, Pastor and Veronesi (2012, 2013) discuss the conditions under which political uncertainties increase stock return volatilities and correlations among stocks. Furthermore, Amengual and Xiu (2014) find that resolution in political uncertainty (e.g., Federal Open Market (FOMC) meetings or European Central Bank (ECB) meetings, or speech schedules of the Federal Reserve's Chairman) improves investors' sentiment and leads to lower market volatility. We add to this literature since we focus on privatization, an economic reform that shifts ownership from the government to the private sector. We show that a privatization program that is maintained over a long period of time enables a resolution of political uncertainty, which builds investors' confidence and reduces stock return volatility.

Our study also contributes to the literature on market-oriented reforms and volatility. Bekaert and Harvey (1997), for example, compare pre- and post-liberalization volatility in emerging markets and find that financial liberalization reforms do not increase market volatility. We extend this literature by showing that credible privatization reforms are associated with lower volatility.

The remainder of the paper is organized as follows. Section 2 summarizes the literature on privatization, political risk, and volatility. Section 3 describes the sample construction and defines the variables used in the analysis. Section 4 discusses the methodology and presents descriptive statistics. Sections 5 and 6 present our empirical findings and robustness tests. Section 7 concludes.

2. Literature review: volatility, privatization, and the political risk channel

In this section we first summarize the literature on the importance of volatility for investors and the economy. Next, we discuss how political uncertainty is related to volatility. We then summarize prior work and develop on how privatization programs influence the systematic and idiosyncratic volatility of a country's stock returns through the political risk channel.

2.1. Volatility, investors, and the economy

Prior work shows that volatility has implications for both investors and the economy. At the investor level, an upward movement in the idiosyncratic component of volatility affects an investor's portfolio and hedging strategies. As pointed out by Campbell, Lettau, Malkiel, and Xu (2001), the number of stocks

needed to fully diversify a portfolio depends on their idiosyncratic volatility and the correlation among stocks. To maintain a well-diversified portfolio, an investor must compensate for an increase in idiosyncratic volatility with a corresponding increase in the number of stocks. Further, investors require a risk premium for carrying volatile stocks whose payoffs are correlated with the stochastic discount factor (see, e.g., Cochrane, 2001), and thus an increase in the systematic component of volatility implies a higher cost of capital (Bollerslev, Engle, and Wooldridge, 1988; Bekaert and Harvey, 1997). Furthermore, there is evidence that idiosyncratic volatility could predict expected stock returns (e.g., Ang, Hodrick, Xing, and Zhang, 2006) or future earnings (Jiang, Xu, and Yao, 2009).¹

At level of the economy, Wurgler (2000) shows that countries with a lower correlation among stocks, and hence higher average idiosyncratic volatility, allocate capital more efficiently. However, higher systematic volatility may prevent new firms from raising capital through IPOs as the cost of capital rises. Hence, systematic volatility may increase the value of the option to delay investment, affecting overall economic development (see Bekaert and Harvey, 1997).

2.2. Political uncertainty and volatility

Governments influence markets through various rules such as taxes, laws, regulation of competition etc. Unexpected changes in those rules can elicit strong market reactions. Indeed, what frightens investors is when they do not know the government's next move. This perceived political uncertainty has been related to drops in stock prices and market volatility. Indeed, Pastor and Veronesi (2012) develop a model in which a firm profitability follows a stochastic process. The model allows government policy to affect the process mean. The policy impact on the mean is uncertain and the market learns about this impact through realized profitability. Uncertainty about the policy declines over time due to learning, unless a policy change triggers a discrete jump. The model shows the conditions under which government changes its policy: policy change occurs when its effect on firm profitability is perceived as sufficiently unfavorable or when the government derives an unexpected large amount of political benefits from the change. Following a policy announcement, investors face two uncertainties: there is uncertainty about whether the policy will change or be maintained; and there is uncertainty about the effects of the new policy. The model shows that stock prices drop, at the announcement, when the old policy was not perceived as having a negative impact on profitability, because policy changes are expected only after downturns (i.e. periods of low profitability). The model shows that political uncertainties increase stocks volatilities and correlations among stocks (Pastor and Veronesi, 2012, 2013). Consistent with this result, Amengual and Xiu (2014) show that resolution in political uncertainty shifts investors' sentiment and leads to lower market volatility.

Next, we discuss how a government policy such as privatization can affect the market volatility through the resolution of political uncertainty.

2.3. Political risk channel

Political risk refers to the risk of political events that affect firm profits or investments (e.g., expropriation or nationalization of property or resources, inconvertibility of currency, regulations on operations; see Robock, 1971; Howell and Chaddick, 1994;

¹ Bali and Cakici (2008), however, find that the relation between idiosyncratic volatility and expected stock returns varies with the data frequency and methodology used to calculate the portfolio and their returns.

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