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Evaluation Report of the Doctoral Thesis
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"Privatization and Stock Market Creation: Evidence from Transition Economies"

Summary evaluation

Based on my evaluation of the thesis manuscript, I conclude that this thesis is carefully crafted and satisfies high academic standards. In my opinion, the thesis by Zuzana Fungacova fulfils all the conditions for gaining the Ph.D. degree in Economics; therefore it is recommended.

General remarks

This thesis consists of three chapters investigating privatization, stock market development, and massive delisting in the transition economies. The first chapter studies the relationship between the privatization method implemented and the consequent capital market development using a sample of transition countries in Central and Eastern Europe. Chapter 2 employs micro firm-level data to estimate the determinants of massive delisting, with a focus on Czech Republic. And the last chapter analyzes the delisting phenomenon in Slovak Republic and compares it with Czech Republic. Three essays together show that because of mass privatization and mandatory listing, the emerging stock markets in most of the transition countries do not function well in a short and medium term. Further, there are massive delisting waves in Czech Republic, Slovak, and some other transition countries. Chapter 2 and 3 investigate and compare the determinants of massive delisting in Czech Republic and Slovak. Findings in general suggest that privatization exerts a negative impact on the creation of stock market and subsequent performance. Delisting, however, serves to correct the wrong decision of the privatization authorities by cleaning the market of unsuitable shares. In the long run delisting is positive for the stock market development.

Overall, this thesis provides new evidence of how privatization plays a role in the emerging stock markets. One unique characteristic of transition stock markets is that they were created to not only to serve corporate sector but also to facilitate transforming ownership from state to private sector. Therefore, it is interesting to see how emerging stock markets function differently from other economies. Moreover, much of research on privatization analyzes at a micro firm level, but its effect on the macroeconomic performance is discussed insufficiently. This thesis contributes by establishing a possible connection between privatization and the functioning of stock markets. Each chapter employs a valid methodology and carefully constructed data set. The results are intriguing and have useful implications for the policy makers. In the following part, I provide comments for individual chapters.

Chapter 1:

Positives:

(1) This chapter investigates an interesting question of how privatization influences the development of stock market in the transition economies. Extant literature has looked into various institutional and macroeconomic factors that may affect economic growth. However, the role of privatization is not given too much attention. In another strand of literature, the impact of privatization on firm performance has been studied extensively, but not much work addressing its implications on the stock market at a macro level. Combining these two areas, the author is able to establish a possible link among privatization, financial systems and economic growth. The research question is well motivated and worthwhile to study.

(2) Different from conventional view which claims that privatization is beneficial in improving productivity and efficiency of the companies, this chapter finds that privatization exerts a negative impact on the development of stock market in the short and medium term. The author further argues that this is because in most transition countries stock markets were mainly established as a byproduct of the privatization process rather than as a capital source for the corporate sector. The lack of transparency causes negative investor sentiment, and thus privatization does not contribute to the financial market development.

(3) In estimating how mass privatization affects stock market development, the paper takes into account of contemporaneous effect as well as one and two years lag effect. By doing so, it provides more insights on the evolutional effect of privatization on capital market development. It is an interesting finding that the negative effect of

privatization on some aspect of stock market development actually takes more years. Hence, the functioning of stock market in mass privatization countries would seem to lag the development of other transition economies, which could be considered as the price for establishing stock market only as a kind of "by product" of mass privatization.

(4) Given the data availability and quality problem of transition countries, the author takes into consideration of many factors when constructing and cleaning the data. For example, by creating suitable dummy variables, economic shocks such as unstable economic conditions, Russia crisis, and some shocks to the stock markets are accounted for. Also, since some countries do not have good quality data for some time points, and some countries have not proceeded far enough in the transition process to make it possible to investigate the effect, the author uses an unbalanced panel for the final analysis, and clearly illustrates how missing values are treated in the regression.

<u>Limitation and potential improvements</u>:

(1) Privatization processes exhibit a large degree of variability across countries. As the author shows in the appendix table, besides mass privation there are also other methods of privatization such as direct sales and MEBOs. How do they affect stock market development? Since investors' demand and government policy may vary depending how privatization is implemented, it is very plausible to see different privatization methods impact market development differently. Therefore, instead of only distinguishing between mass privatization and all others, it could be more interesting to test how market reacts differently towards different privatization methods. The implication could also be helpful for the government policy makers to choose a suitable privatization method.

(2) Legal environment, regulation, and institutional framework are also key determinants of stock market development. For example, stock market development is more likely in countries with strong shareholder protection because they do not fear expropriation as much. Pistor (2000) constructs an index of shareholder protection for transition countries. In chapter 1, the author could consider using it as an additional control for the impact of legislation.

(3) There might be a typo in Table 1.2 (estimation of the main model for market capitalization to GDP). As shown in the table, the coefficients of the privatization dummy without trend are not significant for both contemporaneous effect and one year lag. But the author interprets them as significant. In the paragraph below the table, it is stated "The significance of the privatization dummy without trend further indicates that there was a sudden change in market capitalization following the implementation of the mass privatization scheme." This might be a small typo in the table or the author should change the interpretation.

Chapter 2

Positives:

(1) This chapter documents an unusual phenomenon of massive delisting waves in Czech Republic. In 1997, there are four waves of massive delisting in the country. An interesting question is why so many listed companies were excluded from public trading within such a short period of time. To explore the reason behind massive delisting, the author conducts a good analysis of the history and development of Prague Stock Exchange. How privatization plays a role in the delisting process is also analyzed. It is suggested that stock market creation in Czech Republic seems to be a pure administrative

decision to serve the transformation of ownership. After a short period of active trading, many companies are delisted and the stock market is cleaned up for better functioning. Other company specific reasons are also identified such as company size, profitability, and ownerships. However, most of these reasons are connected to privatization.

(2) Unlike the first chapter where aggregate country data are used, chapter 2 estimates various determinants of shares delisting employing a micro level data on both listed and delisted companies during the period 1993 – 2004. It is shown that the pre-privatization and post-privatization characteristics of the companies are significant factors of delisting. It also implicates for the policy makers that it would have been possible to prevent massive delisting if these factors had been taken into account when deciding which companies to place on the stock exchange for public trading.

(3) The regression takes many factors into account. For example, in estimating the determinants of massive share delisting, the author separately examines delisting factors in both pre-and post-privatization periods. This helps to better understand how privatization affects share delisting. At the same time, firm characteristics are well accounted for, including firm size, profitability, sales, growth, ownership share of the National Property Fund, average price of shares, etc. After baseline regressions, the author also differentiates subgroups of companies based on delisting reasons, i.e. issuer's request, or authority's request, or bankruptcy related reasons. Comparison is carried out and marginal effect is analyzed as well.

<u>Limitation and potential improvement</u>:

(1) Czech Republic applied to join the EU in 1996. And as the author documented, the four waves of share delisting happened in 1997. What is the relationship

between EU integration process and stock market clean-up activity? The author should consider whether the massive share delisting could be driven by the process and prospects of EU integration.

(2) Are there any correlations associated with potential earning management while listing and subsequent delisting?

(3) Is there any role of the current or expected economic environment in such decision making?

(4) Are there any issues related to regulations or fee structures or taxes associated with the sample time period?

Chapter 3

Positives:

(1) This chapter investigates the delisting waves in Slovak and compares with Czech Republic. These two countries are the first two transition countries where stock markets emerged. They also share culture background and privatization process. However, the delisting strategies are implemented in different ways and subsequent stock market development varies significantly. Therefore, it is interesting to see how delisting strategy by exchange authorities may affect the stock market development after delisting. As the author phrased in the title, Czech's delisting movement is like a "big bang" strategy, i.e. a lot issues were delisted within a short period of time; while on the other hand, Slovak authorities adopts a more gradual approach, i.e. the government works with individual companies and tries to keep them listed until they have to exist. As a result, stock market development for the two countries differs significantly. Czech stock market benefits from a rough cleaning and increases transparency quickly. However, Slovak has

never experience a real recovery compared with Czech Republic. It suggests that stock exchange authority is an important factor affecting the further functioning of the market, controlling everything else equal.

Limitation and potential improvement:

(1) Information content, reflecting the extent to which firm-level and market-level information capitalized into stock prices, is a crucial issue for the functional efficiency of stock market. Previous literature has documented that stock prices tend to move more together in emerging economies than in rich economies (Morck, Yeung, and Yu, 2000). Further work also relates this phenomenon to the many factors such as institutional development, legal regimes, corporate governance, and capital market openness (Wurgler, 2000; Bushman et al., 2002; Durnev et al., 2004). Yet, the role of privatization is not specifically studied. This thesis addresses a related issue by establishing the connection between privatization and stock market development. And the author further explains that mass privatization worsens the information asymmetry between investors and listed companies and consequently exerts a negative impact on the stock market. However, how information content (or transparency) is affected by the privatization process is not directly examined. As a potential future work, it could be interesting to do so. And whether delisting improves stock market informativeness could also be worthwhile to investigate.

(2) At the beginning the author sets up a framework in which privatization, stock market development and economic growth in transition countries are linked together. In the following chapters, much effort is made to explore how privatization plays a role in the emerging stock markets. But how economic growth is affected is insufficiently

discussed. Future research could extend to examine the impact of emerging stock market development on the economic growth variables.

Overall, I commend the author for a job well-done. It is a contribution to our understanding of emerging stock markets. I would request to consider my suggestions as applicable in revising your papers in the future. With regards to the degree requirements, I would urge you to think hard and decide with extreme objectivity to incorporate some of the comments that are feasible within the time constraints. The rest you can consider before sending them out for publications in good journals.

References:

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