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Political uncertainty and financial market uncertainty in an Australian context

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ABSTRACT

This paper seeks to investigate the influence of political uncertainty, surrounding the Australian federal election cycle, on financial market uncertainty. Measures of political uncertainty are constructed and their relationship with market uncertainty, as measured by implied volatility, explored. Empirical evidence suggests that increasing (decreasing) levels of uncertainty around the election induce higher (lower) levels of market uncertainty. An increasing likelihood of the incumbent party, whose economic policies are presumably well-known, winning the election, reduces market uncertainty. This relationship is stronger when political uncertainty is highest, when the business cycle contracting, and when the level of economic risk is high. Higher levels of political uncertainty tend to be associated with declining levels of outstanding debt, and lower issuance of long-term Government debt, driven by falling demand and higher yields.

1. Introduction

The extant literature suggests that political factors may influence the risk premia inherent in financial assets. Hibbs (1986) suggests that differences in the economic policy of political parties have the potential to move the economy along different paths and results in different levels of return to both stock- and bond-holders. Johnson et al. (1999) examine the returns to several different asset

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classes in the period surrounding U.S. Presidential elections and report that while there is no difference in returns to large-cap stocks, returns to small-cap stocks are substantially higher during Democratic administrations, while Republican administrations result in superior bond market performance. This paper seeks to examine such relationships within the context of an electoral system with the non-U.S. characteristics of variable election timing and compulsory voting. Electoral polling data is utilised to construct measures of political uncertainty and the influence of this ambiguity on levels of implied market volatility and outstanding debt are considered within both an unconditional and economic-state-dependent framework.

Pastor and Veronesi (2012, 2013) theorise a general equilibrium model which suggests that the risk-premium is affected by both economic shocks and non-economic shocks, such as political uncertainty. In their model there is an "old" policy with which investors become familiar with over time. Uncertainty is created since the government can endogenously choose a "new" policy from a range of options at any time. Once the new policy is chosen and announced, investors again learn about its impact. The model suggests that, independent of traditional risk factors, political uncertainty directly affects the risk premium. An important insight from Pastor and Veronesi (2013) is that the composition of the risk premium is state-dependent; in particular, political uncertainty constitutes a large fraction of the premium during economic contractions precisely because policy change is more likely during such times. Kelly et al. (2013) reinterpret this model in the context of an election; empirical evidence suggests that investors are willing to pay more for option protection in light of uncertainty around election results.

Empirical work has produced substantial evidence as to the influence of political outcomes on the stock market with market uncertainty rising as the day of voting approaches and uncertainty about the result increases. Li and Born (2006) study the period 1964–2000 and find that while the mean daily stock return rises in the 3-month period prior to U.S. elections when the outcome is uncertain, it is indistinguishable from the non-election period when the incumbent party is assured of re-election. Goodell and Vähämaa (2013) utilize data from the Iowa Electronic Market, a betting market for the U.S. Presidential election, and find support for the notion that information regarding the probability of a particular election winner reflects information about future macroeconomic policy. Julio and Yook (2012) provide evidence connecting political uncertainty to changes in fundamentals of the real economy as firms reduce expenditures during times of political uncertainty.

Several studies have attempted to form an international perspective on the political uncertainty-market uncertainty relationship: Gemmill (1992) discovers a close relationship between U.K. polling and the FTSE Stock Index, Pantzalis et al. (2000) report that the connection between political uncertainty and the stock market differs in depending on the level of political, economic and press freedom, while Bialkowski et al. (2008) investigate a sample of 27 OECD countries and find that stock market return variance doubles during the week around the election. Importantly, the margin of victory and changes in political orientation of government are key factors in explaining the magnitude of the election surprise.

There has also been some consideration as to how elections may impact the fiscal policy of Government. Drazen and Eslava (2010) examine investment spending by Government in the period around Colombian elections and show that investment spending tends to increase prior to the election, and has a positive impact on the incumbent's re-election prospects. Veiga and Veiga (2007) demonstrate that similar behaviour exists in Portugal, and is more prevalent when the win-margin is small. Cassette and Farvaque (2014) suggest that while the average level of debt has a negative impact on the probability of re-election, pre-election debt accumulation by incumbents increases their probability of re-election. Gao and Qi (2013) investigate the influence of political uncertainty around U.S. gubernatorial elections on the borrowing costs of public debt, measured by yields of municipal bonds, and report that yields increase sharply before elections and then reverse afterwards.

In the sense that elections impact the macro-economy of a nation through the mechanism of fiscal and economic policy followed by the Government, this study is related to the broader field of research into the impact of news announcements on market uncertainty. The general result (Ederington and Lee, 1996; Nikkinen and Sahlström, 2004; Smales, 2013) being that an upcoming macroeconomic announcement creates uncertainty which quickly dissipates once the data is released. Of particular