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Democracy, political risks and stock market performance

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A B S T R A C T

This study examines the impacts of democracy and political risk on stock market. Using annualized panel data for 49 emerging markets for 2000–2012 we find evidence that democracy and political risk do have impact on stock market returns and the relationship between democracy and political risk is parabolic, i.e., there is a threshold level of democracy after which political risk begins to decline. Also our results suggest that decreases in political risk lead to higher returns.

1. Introduction

There are many real life events which propose that stock market performance and political stability might be strongly related. However, there exists hardly any empirical research testing this relationship. The beginning of 2011 witnessed the Arab Spring, which consisted of large pro-democracy demonstrations against dictatorships in the MENA region that even escalated to civil war in Libya. The riots began in Tunisia and spread to Egypt, Libya and several other countries, leading to political instability in the entire area. Because the unrest seemed to be transmitted from one country to another, investors became more and more worried; for example, on January 27, 2011, Egypt's benchmark index, the EGX 30, dived 10% and even the world's major markets in the USA, Europe and Asia tumbled because the protests were expected to continue moving to other oil producing countries in the area. The unrest in Egypt lasted for all of 2011 because the Egyptian military, which seized control

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of the government after the revolution, refused to release power to the democratically elected government. Between January 3, 2011 and January 2, 2012, the EGX 30 index lost almost 50% of its value, dropping from 7073.12 to 3679.96.

In 2006, after several months of political crisis, the Thai military ousted the elected prime minister from power and, together with the ruling elite, appointed a new prime minister in 2008 to lead the country during the next several years, which consisted of more-or-less violent demonstrations between the supporters of the ousted prime minister and his opposition. The political instabilities led foreign investors to reduce their exposure to the Thai market, dragging down prices for a period; however, because the demonstrations remained peaceful, the markets calmed and began to rise.

Latest examples of the relationship between unstable political environment and stock market performance are offered by the political turmoil in Ukraine in 2014, which led to conflict with Russia and collapsed the Russian stock market, and the demonstrations for democracy in September 2014 in Hong Kong which had negative impacts on Hong Kong stock market.

The effects of political risk have been found to be statistically significant in emerging stock markets (see, e.g., Erb et al., 1996a, Diamonte et al., 1996; Perotti and van Oijen, 2001). Moreover, the ever increasing international capital flows could reinforce the impact of political turmoil on stock markets. Lensink et al. (2000) support this by providing evidence that an increase in political risk leads to increase in capital flight. Although these studies incorporated democracy as a part of their political risk component, there has not been a study to our knowledge that examined whether democracy can affect the behavior of the stock markets.[1] This study aims to fill the gap by investigating the effects of democracy and political risks on the stock market performance for a set of emerging markets. Several studies on democracy and political risk (see, e.g., Gleditsch and Hegre, 1997; Hegre et al., 2001; Reynal-Querol, 2002a, 2002b; Rock, 2009 and their references) have observed that the semi-democracies are more prone to conflicts, corruption and other political risks than full democracies and autocracies. This reflects that the semi-democracies, unlike full democracies and full autocracies, have not yet established strong institutions that might prevent protests and other anti-government activities, which makes these countries more vulnerable to political instabilities. Thus, it might be argued that democratization initially increases political risk and reduces it only after a certain threshold level of democracy has been reached. For this to hold, democracy's relationship with political risk could be described by a U-curve that indicates that the countries at the ends of the curve have smaller political risks than the countries in the middle (see Figs. 1 and 2, in which the x-axis presents the level of democracy and the y-axis represents the political risk level for several emerging markets). The quadratic polynomial in the figures describes this nonlinear relationship between democracy and political risk: $polrisk = \beta_0 + \beta_1 dem + \beta_2 dem^2$, where $polrisk$ denotes the countries' political risk, dem represents the democracy level and dem^2 its square. It is notable in this that although the coefficient β_1 is negative, β_2 is positive, which indicates that, after passing a threshold level, the higher levels of democracy decrease political risk, in this functional form.

The main question this study aims to answer is the following: Do democracy and political risks have effect on stock market performance or are the markets immune to the political environment? As a by-product of our analysis, we also contribute to the political risk sign paradox (see below and Section 2.3) and identify several determinants of emerging stock market returns.

There is no commonly accepted theory relating democracy to stock market returns; thus, the issue between their relationship is mainly empirical. On the one hand, consistent with ICRG (International Country Risk Group) classifications, the lack of democracy, or democratic accountability, is part of the total political risk; thus, it should be priced in share prices together with other risks, following Erb et al. (1996a). On the other hand, Perotti and van Oijen (2001) find that political risk has a positive sign that indicates that politically safer countries have higher excess returns than markets with more political risk; supporting this, Diamonte et al. (1996) posit that portfolios that experienced decreases in their political risk also produced larger returns than portfolios with increased political risk.

[1] However, institutions related to democracy and their stock markets have been studied. The relationship between democratic elections and international stock returns has been examined before by Foerster and Schmitz (1997); Panzalis et al. (2000); and Bialkowski et al. (2008), for example.