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Political Instability and Stock Market: An Event Study

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Abstract

Our study examines the response of stock returns with respect to political instability news using time series data from 1996 to 2023. To test efficiency of market or semi-strong efficiency of Pakistan stock market for political instability news, we used most important technique in economics and finance called event study methodology. We select five events on the basis of data availability, events are put into subgroups based on anticipation window, adjustment window and event date window. We performed event study on stock return of the selected political events. To test the above objectives, first we calculate returns than excess return. We used market adjusted model to calculate excess returns and then we calculate cumulative abnormal returns. The results of our empirical analysis shows that there are significantly excess returns which mean that Pakistan stock market is more sensitive to political instability announcements. Present study increase our knowledge about salient role of political risk in growth of stock market, help market regulatory bodies, firms and investors in the implication of rule and policies that mitigate the political uncertainty.

Keywords: Stock Market, Political instability, Abnormal Return, Event study

1. Introduction

Understanding the stock prices response in the period of crisis is important for investors and researchers to draw a positive cash flow from the investment. various uncertainties prevailing in the stock markets about their future expected cash flow. like domestic and foreign news, firms' specific news that influence a specific sector whereas others influence the stock market as a whole for example political, financial and economic crisis. The impact of these crisis on investors is usually unexpected and unavoidable.

Existing studies has been documented the evidence of pollical crisis with its impact on stock prices (see Obenpong Kwabi et al., 2023, Frijns et al., 2012, Irani et al., 2022, Omar et al., 2017, Charfeddine & Al Refai, 2019; Sulehri & Ali, 2020). They analyze that political uncertainty shows a significant role in explaining the stock prices. Past studies measure political risk as wars, terrorist attack, global political risk and other threats see Cam and Ramiah (2014), Rigobon and Sack (2005), Amihud & Wohl, 2004; Huang et al., 2015b. Like Berkman, Jacobsen, and Lee (2011) show international political delimma have a pricing effect on stocks because it considers market perception as rare disaster. The stability of political environment shows a significant role in economic development of any country because stock markets grow through the contribution of investors who depends on the anticipation of future event. According to (Bloom, 2014; Jurado et al., 2015) political risk will decrease the predictability power of economic agents to forecast the future events. Similarly, Baker et al. (2016) reinforces the events that increase political uncertainty at macroeconomic level, cause of increasing unemployment and reducing economic growth.

Empirical work shows that the economies are highly exposed political instability. And the emerging economy of like Pakistan that has lived with political turmoil in his history see Massod and Sergi 2008, Malik et.al 2009. Aim of our study is to analyze how domestic political unrest affects stock returns. This study incorporated the impact of ruling party who fails to complete their constitutional tenure and shift in regime from democracy to dictatorship as a political uncertainity on stock market. There has been less evidence that examined the performance of stock market under this political instability. In this study, we empirically analyze three main issues that linked the working and response of stock market. First, we investigate the EMH. Second, we are interested to the test the assumption that the prices of stock will adjust at once without any overreaction and this adjustment become smaller if these events occur repeatedly in efficient capital market. Third, we analyze varying impact of same event occurs repeatedly.

Using an approach called event study, the present study investigates effects of political uncertainty on Pakistan stock market. Efficient market hypothesis argued that asset prices reflects all available information if a market is weak form efficient. In the field of finance EMH has been highlighted as mainstream and used to allocate resources specially in the period of crisis. Fama et al (1969) proposed event study that can be used as understanding of these events related to the market security price.

Our study presents the stock market efficiency under the situation of political instability in Pakistan, which contributes to the literature as follows: first articles fill research gap between political instability and stock market efficiency. The stability of political environment is one of the important factor with profound effects on firms' investment decision by foreign and domestic investors. Second, this study analyzes the market efficiency under the multiple windows of same events occur over a period of time.

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1.1. Background of Events

After the political crisis of Imran khan Government in 2022 the current Pakistan economy has suffered from economic slowdown and rising inflation. Pakistan political history has been very turbulent and oscillating between democratic and military rule. Pakistan experienced the down turn in economic growth after the shocks of 1971 war due to political instability. Pakistan lost a huge share of financial as well as human resources but after that it revealed the sustainable economic growth till the year 1988. After 1988, Pakistan economy began to face the political instability in the form alternating period of democracy and authoritarian military government. From 1988 to military coup by general Pervez Musharraf in 1999 Pakistan ruling parties failed to complete its constitutional tenure. From 1999 to 2008 General Pervaz Musharraf was ruled over the country. In 2008, Asif Ali Zardari was elected president, a democratic government who completed its five years constitutional tenure. Then Nawaz sharif party was elected third time and failed to complete its tenure. Imran khan was the elected prime minister of Pakistan and his democratic government also failed to complete its constitutional period.

From 1990 to 2022 the failure of democratic and military regime provides an opportunity to test political crisis impact on the Pakistan stock market. The following events has been selected to empirically investigate its effects:

Event 1. On 6 august 1990, the first women prime minister Benazir Bhutto govt. was dismissed.

Event 2. On 13 April 1993 , the first era of Nawaz sharif was also failed to complete its tenure.

Event 3. On 5 November 1996, the Benazir Bhutto who elected second time, again fail to complete its tenure.

Event 4. On 12 October 1999, the second era of Nawaz Sharif ousted by military coup of General Pervez Musharraf.

Event 5. On 6 September 2008, the election was held in the country and outcome of that is the end of military regime.

Event 6. On 28 July 2017, Nawaz sharif ruling party third time disqualified by supreme court.

Event 7. On 10 April 2022, Imran khan ruling party were failed to complete its constitutional tenure because the opposition party submitted a no confidence motion, which was followed by political crisis in the country on national level.

The rest of this study is classified as follows. Section 2 review of literature on event studies. Section 3 describes research methodology. Section 4 represents and discusses empirical results. Section 5 conclusion.

2. Literature Review

Most of studies provides the insights of political stability have a significant influence on firms' stock price. With the links of country financial stability and political stability, the function of political stability in the determination of stock prices has obtained enlarge attention by the researchers (Hoque & Zaidi, 2020; Omar et al., 2017; Jucá & Fishlow, 2021; Huang et al., 2015a and Hillier & Loncan, 2019; Audi et al., 2023). For example Irani et al., 2022 use short and long run equation of ARDL model to investigate the impact of country specific political and economic risk, global economic policy risk on stock prices of Turkish tourism firms' and find that the increase in political and economic risk , global economic policy uncertainty, and macroeconomic factors cause decrease in stock prices in the long run. Similarly, Huang et al. (2015a), test the small effect of sound domestic political environment on relationship between international political risk and government bond yield. Because one would anticipate that if the local government operates in stable political environment than the less uncertainty expects from the international political crisis. Sound domestic political environment helps to mitigate likelihood of governmental and policy changes and moderate capital risk occurring from global political risk. it is in line with the argument that any negative effect on the future expected cash flow of corporate will discourage domestic stock market investors to participate. That's why, in addition to taking into account the stock return, investors also base their investing plans on the risk element, demonstrating that they are not just concerned with the return of stock but are also worried about the risks of investments.

A current study by Obenpong Kwabi et al. (2023), analyze effect of political uncertainty on stock market by using multiple regression model and take panel data of 42 countries from 2001 to 2019. They conclude that the reduce in stock market size, liquidity and increase in transactional cost occurs due to political uncertainity and they also shows that the institutional quality reduces influence of political risk on development of stock market but not in under developed economies.so their results suggest that countries specifically with emerging economies sustain stock market growth should attempt to reduce political uncertainities with strong institutions. Hoque & Zaidi, 2020; Document that the relationship between global and country-specific geopolitical risk (wars, terrorist attack, tensions between states) and return of stock market of five fragile emerging economies is important because such economies developed fastly and integrated with developed economies in terms of trade and investment. Past researches have also shown that international and domestic political unrest turn out can cause volatility in emerging stock markets (Gkillas et al., 2018; Aksoy & Demiralay, 2019; Ramiah & Graham, 2013; Audi et al., 2022).

It has been an increasing interest among academics, investors and policy makers to analyze the stock market efficiency stock market under the situation of political unrest for capital allocation, risk-reduction strategies, future economic and financial policies. the relationship between political crisis and economic development is a subject of discussion because uncertainty that arise from government changes has real indications for business. Companies continue to have low levels of debt in the face of political instability, according to Lv & Bai, (2019). According to Julio & Yook, (2011) businesses cut their investment expenditure by 4.8% compared to prior years during election years. According to Asongu, 2012; increase in stock market value depend on the policies that are the outcomes of good governance. Negative effects of a political crisis on a company's stock price, however, might not be as severe as those of a financial crisis, or else they might not have the same influence on a company's core profitability. Therefore, the adverse effect of a political crisis on the stock price may be due to other factors, such as the psychological response of investors. To put it another way, a political crisis may cause markets to become pessimistic, which might result in panic selling by investors, which would lower stock prices. An illustration of this is Taiwan stock market meltdown, which was brought on by a political crisis surrounding contentious presidential election.

Ismail, I., & Suhardjo, H. (2001) conducted an study on domestic political events affected the Jakarta Stock Exchange in context of emerging economies. The stock market anomalies were examined over a period of 100 estimate days and 11 event days. From 1999 to 2001, a selection of significant political events was chosen. They came to the conclusion that the whole market and the industry as a whole had no response or reaction to any of the occurrences. The mean of excess returns was the same before and after the incidents. Only two out of 11 events, respectively in which they observed that the stock market react as a whole and it is because these political matters are common in Indonesia. Omar et al., 2017 examined response of prices of crude oil, government bonds, and stock market indices in the period of crucial international turn out and conflicts. They conclude that events are connected with positive and large abnormal returns on oil and bonds using a constant mean return event analysis, advising that owners investment in these two asssets classes may protect investors from falling stock prices during global crises. Similarly, Huang et al., 2015 examines effect of international political risk on government bond rates in 34 debtor nations by considering a comprehensive database of 109 global political crises from 1988 to 2007. They show a positive and substantial link between inter-national political risk and government bond rates by using the political risk as a proxy of total international political crises and controlling for country-particular economic variables. Kolaric & Schiereck, 2016 examine how the recent terrorist events in Paris and Brussels have affected market dynamics of airline stocks. The adjustment of stock returns, according to what we discover, is compatible with the expectation of effective capital markets. We demonstrate that terrorist incidents in Paris and Brussels had a significant short-term effect on estimation of airline firms by analyzing 27 of the top U.S., Canadian, and European airlines.

Research by Javed, A. Y., & Ahmed, A. (1999) which assessed effects of the nuclear testing on KSE, was regarded as first study in context of event study in Pakistan. Two nuclear experiment events, were included in study, and its effects were empirically tested on stock market returns. considering the ARCH Model, KSE's trading volume, variance, and average returns were examined from April 1995 to June 1999. Findings showed that trading volume and volatility levels rose at KSE while Indian nuclear testing had a considerable negative influence on average rate of returns. The average rate of returns was unaffected by Pakistan's nuclear testing. Another study by Malik et al. (2009) also conducted on effects of President Gen(R) Pervaiz Musharraf resignation on Pakistan stock market. But this study used a sample of daily stock prices and trading volume from February 18, 2008 to February 18, 2009 to examine impact of Pervaiz Muhsaraf's resignation on stock prices and volume of the KSE 100 index on August 18, 2008. Pre-event data was collected between February 18 and August 17, 2008, while post-event data collected between August 18 and February 18, 2009. The correlation between stock market returns and trade volume was studied at using the Phillip Perron test. The findings showed a correlation between stock market returns and trading volume that was favorable, and that association grew stronger after the ex-president Gen. (R) Pervaiz Musharraf's resignation, which had a favorable effect on the Karachi stock market. However, a number of other political events, including the Mumbai attacks and the election of Asif Ali Zardari as Pakistan's president, occurred in the post even period but they didn’t measure the impact of these events. Tabassam et al., 2016 conducted study on outcomes of political uncertainty on Pakistan economic growth. They used yearly time series data that were subsequently divided into different quarters to capture interim effects, examine impact of political turmoil on Pakistan's economy and its volatility over the course of the previous 22 years. In this study they used terrorism, elections, regimes, and strikes as political instability proxies. Models like ARCH and GARCH have been considered to assess how political unpredictability has affected Pakistan's GDP growth.

In light of the above-mentioned studies, there is a significant gap to be researched in the context of Pakistan. Because most of the past study assessed economic effect of only certain political events on Pakistan financial market. Javed and Ahmed (1999) and Malik et al. (2009) only examined one event and no larger conclusions on analysis of KSE over trend were made. Masood, O., & Sergi, B. S. (2008) did a comprehensive study on impact of various political events on KSE returns, but for years up to 2006. Additionally, they concentrated on measuring political uncertainty in Pakistani stock market and the likelihood that certain events would occur next year in comparison. The recent changes in the political and economic climate highlight the need to explore how recent political uncertainty affect stock market returns that our present study investigate So, present study is expected to fulfill this gap and to contribute significantly to existing literature.

It has been observed through literature review that Event studies remain a important method for examining effect of various events on financial markets. Recent researchers has considered event study methodology to analyze effect of political events, natural disasters, financial crises, and many other types of occurrences on stock prices. Aktas, 2006 conclude that the new information would have a distinct economic impact on various firms, stock prices are predicted to respond differently in the efficient market in response to unfavorable political developments. Despite challenges that arise when using event studies in the legal context, this method remains a valuable tool for researchers and practitioners alike. As per the researchers and authors basic methodology of event studies, which involves analyzing the stock price reactions of a company or market to a particular event. Which shows that Event studies have been widely used in finance and economics to analyze effect of various events, such as news about earnings, mergers and acquisitions, and changes in regulations.

Our present study contributes to existing literature by testing short run response of stock return to political instability news over a period of time. Here, we select five political events to study and find out the impacts of these five events on Pakistan stock market. we have employed event study methodology. our study is different from existing work because we have considered several events while most of the studies used single event in Pakistan context see Javed and Ahmed (1999) and Malik et al. (2009).

3. Research Methodology

To understand the connection between political instability & stock market returns, one of the most famous and important technique in quantitative finance that allows you to measure and quantify the impact of new facts and figures by studying the stock return dynamics around event date are used called event study approach. Event study has gained lots of momentum and popularity as an econometric technique since the 1980 and the 1990 when it has been developed and can be consider one of go-to techniques to test for market efficiency. An event study can be used to find out impact of a specific event see Mackinlay, 1997. Stock price fluctuation surrounding an event has been extensively studied using event studies (Ashley, 1960; Ball & Brown, 1968; Fama, 1981; EUGENE F. FAMA, LAWRENCE FISHER, 1969). We have likewise followed the same approach to examine effect of political instability on prices of stock and afterwards assess market efficiency. By efficiency of market, we imply that there shouldn't be any abnormal returns and that stock prices should accurately represent all information, both publicly and privately available.

For carrying out the event study we used the closing price of KSE all share index. This study have a total of seven events and out of which we have selected five events because of availability of data. The logic behind this approach is that unexpected event has new information, which the stock price does not represent. Here, unexpected would imply both overestimation and underestimating, so it would be interesting to find changes in stock price around event. Event study timeline based on event date (announcement date), anticipation window is of 15 days before event, Adjustment window is of 15 days after event date and estimation window is of 52 days.

Event study methodology also allows you to test whether the stock market has anticipated the effect the event would have on the stock price so it allows to test market efficiency. So for anticipation testing we need to select the anticipation window. For selecting the length of an anticipation window is more of art than science but convention is that 5 to 15 day is generally enough for studying political announcements.so we will take an anticipation window for 15 days. It is more important for market efficiency concerns the adjustment window. The adjustment window just as the anticipation window mean the sequence of trading days directly right after the event day that allows us to test whether there has been any significant price change after the market should have already reacted to new information being released it mean that if there are significant changes in prices after news then market is inefficient in incorporating information and has either under reacted to news release if direction of adjustment is same as direction of the event effect or overreacted if the directions of those effects are reversed.

3.1. Data and Summary Statistics

In this section, we explain the data that used in this paper. Since we analyze stock market efficiency to announcement of ruling party fail to complete its tenure, we collect the KSE All Share Index data consists of 890 firms listed on Pakistan Stock Exchange. To avoid survivorship, bias this study include both active and dead companies. Basic purpose of this study is to analyze impact of events on stock Market. To obtain purpose of this research the data on daily stock return of KSE all Share index has been taken from Thomson Reuters data stream. Study employs time series data from 1996 to 2023.

3.2. Models Estimations

In this study the abnormal changes in stock prices are examined by well-established event study methodology. Han & Ming, 2018 conducted a systematic study of the event methods. In a rational market, the stock prices reflect all the available information that observed relatively over a short term period can be used to anticipate events economic impact see Mackinlay, 1997. According to Fama, 1970 and Ross, S. A., Westerfield, R., & Jaffe, J. F. (1999) studies shows that stock market reflects all available informations and investors should get only normal return and no excess return. In efficient market there is no excess return. Pakistan stock markets are efficient to these events if the occurring of that event cannot be caused to get abnormal return.

To analyze effect of political instability on stock return first we calculate the stock returns of KSE all share index. We calculate return by using formula:

$$R_{i,t} = ln\left(\frac{P_{i,t}}{P_{i,t-1}}\right)$$

Here,
$R_{i,t}$: is return on security i at time t.
$P_{i,t}$: is stock i closing price at time t.
$P_{i,t-1}$: is the stock closing price at time $t-1$.
i: refers to company
t: refers to time
Three models mainly used in calculating abnormal stock return: the constant mean rate of return model; market adjusted index rate of return model; and the market model. In this study we used market adjusted model. Abnormal rate of return of market adjusted model is difference between the return of our stock and return of kse 100 index as it is the benchmark of the Pakistan stock exchange. The advantage of using market adjusted model if you have small estimation windows the measurement error of alpha and beta can be quite large so you sometimes can be just better off by simply subtracting the market return. If you have small estimation window and beta close to 1 it's better to use market adjusted model. After calculation abnormal return we are concerned about the standard deviations of that abnormal returns that we would use for hypothesis testing to find out how significant the deviation of abnormal returns from zero in our period of interest.
As, we have calculated the normal stock return as mentioned above, now we are going to calculate the abnormal return:

$$Ab.R_{i,t} = R_{i,t} - R_{t,m}$$

Where,
$Ab.R_{i,t}$ is the abnormal return of each stock at time t.
$R_{t,m}$: is the return of market at trading day t.
The null hypothesis of our study is:

$$H_0: Abnormal\ Return = 0$$

Cumulative average abnormal return is calculated by adding abnormal return over the event window, anticipation window and adjustment window and to check if information is reflected earlier or later in order to better analyze impact of political instability news on stock returns.

$$CAR_{i(t1,t2)} = \sum_{t2}^{t=t1} AR_{i,t}$$

Then we used t-statistics to check the significance of cumulative abnormal return.

$$t - stat = \frac{CAR}{\frac{\sigma * CAR_i(t_1,t_2)}{\sqrt{N}}}$$

The larger t-statistics, it is less likely actual value of parameter could be zero. A significant t-statistics implies the existence of positive and negative of positive and negative abnormal returns resulting from political instability and it leads to the null hypothesis rejection. t-values are significant at event date shows market has not been fully efficient in incorporating any news release. The sign of adjustment window is same as the event effect itself meaning that market has underreacted to the negativity of the event impact so the investors have underestimated how detrimental the effect of releasing a news was. Therefore, one can conclude that the model is given significant empirical results and we can safely assume that the announcement of such a political news has not been incorporated in the stock prices information timely into the stock price.

4. Empirical Results

If stock market is efficient, prices should reflect all information that is accessible and there shouldn't be any excess returns. As a result, it is difficult to generate abnormal returns by analyzing historical price and volume data, or by trading on knowledge that is either publicly accessible or insider. It indicates that markets are robust and effective. If there is no abnormal returns in the event window, then the news of political instability has already been included into prices of stock, no connection between an abnormal return and political instability is find. However, if stock prices reflect the political instability news around event date, means there are abnormal returns. It will be interesting for investors, portfolio manager and researches to see whether excess return are positive or negative. We analyze impact of each event on stock return. Further, we have three event windows Event date window, Anticipation window and Adjustment window.
Table 1 represent the cumulative abnormal return of each window and table 2 shows the t-statistics of each event cumulative abnormal returns either it statistically significant or not.
The above results shows cumulative abnormal return and statistical significance of each events. The market adjusted model shows that there is a significant impact of political news on stock price. In each event window like anticipation, adjustment and event day itself generating abnormal return in Pakistan stock market. Table 2 shows the significance of each event and all five events are statistically significantly greater than 2 so we are fail to accept the null hypothesis of

abnormal return is equal to zero. It means that Pakistan stock market is inefficient and not incorporating news or information into the stock prices.
The present study results mainly support recent contributions to literature on effect of political instability on Pakistan stock market outcomes, which have found that the market performance is inefficient. Impacts find the quantitative significance of each event.

Table 1: Cumulative Abnormal Return of KSE

Event Window	Event 1	Event 2	Event 3	Event 4	Event 5
Event Date	0.0356	0.0888	0.089	0.044	-0.76
Anticipation	-0.268	-0.1901	0.301	-0.0096	0.050
Adjustment	0.393	0.278	0.2789	0.3308	-0.12

Table 2: t-values of cumulative abnormal return

Event Window	Event 1	Event 2	Event 3	Event 4	Event 5
Event Date	3.097	6.5	6.5	3.5	5.6
Anticipation	-5.1	3.6	5.7	-1.9	-2.1
Adjustment	7.4	5.3	5.3	6.3	-2.3

5. Conclusion

The present study aimed is to testing Pakistan stock market efficiency. This study analyzed impact of political instability on stock returns. We investigate the impact of ruling party who fails to complete their constitutional tenure and analyzed the efficiency of Pakistan stock market, using daily data of KSE all share index from 1996 to 2023.
By using event study methodology, we find that these five events have an effect on stock returns. specially we find that the market is under reacted because the sign of event date return is same as the adjustment date return. Additionally, we find that the last event has a negative effect on cumulative abnormal return. Our results represent that the political instability has a strong, positive, negative, and substantial influence on stock market outcomes and performance influence by political announcement.
This study contributes to existing literature by developing knowledge of stock market behavior when there is political instability in a developing economy like Pakistan. It would be interesting to test these events with other market models and compare their results. Our empirical findings are helpful for investor, firms and regulatory bodies. An investor who is interested to make diversified international equity portfolio can incorporate information regarding political risk in their portfolio selection. The outcomes of the current study cannot be generalised because it was only conducted for one country. But diversified portfolios are always attractive for shareholders, thus the current research findings are crucial for investors. To facilitate investors globally this research can be further expanded for other emerging economies and use more sophisticated statistical methodologies to facilitate investors.

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