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How Do Political Changes Influence Stock Market Performance In Emerging Economies?

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The stock market is the barometer of the economy that reflects the overall health and direction of economic development and is affected by different factors including social, environmental, and political.

It is important to investigate the effect of political instability on stock market performance, especially in emerging economies. "The link between elections and the economy has been known for a long time. Work from the 1970s pointed out that politicians often boost the economy before elections to gain favour, only to follow up with tough measures like inflation control via higher interest rates afterwards" (Nordhaus, 1975).

General elections have an impact on the stock market. Prior to voting, market volatility often rises due to uncertainty about the outcome. Markets continue to shift following an election as the new government's policy intentions become clear. Findings show that political stability has a significant positive impact on stock market performance, while political instability has a negative impact. A clear margin of victory and a returning incumbent help to lessen uncertainty and volatility in stock markets.

"The effect of elections on financial markets is similarly capricious. On the one hand, it's well known that investors dislike uncertainty. This would point to lower stock market returns in the run-up to an election, then higher returns after the results are in. Yet the evidence doesn't entirely support this. A study from 2000, which looked at 33 countries including the US and UK, found evidence of higher returns before elections" (Adetunji, 2024).

There is a gap in the knowledge regarding the discussion of this issue in the context of the latest time periods and in countries where political instability trends are increasing over time. This paper study aims to explore the relationship between political instability and stock market performance in emerging economies.

Political instability in emerging economies can have a big impact on stock markets. When there's uncertainty about political changes or elections, it can make the stock market more volatile. Investors may become nervous and pull out their investments, leading to market fluctuations. This instability can make it harder for these countries to attract foreign investment and can cause more drastic swings in stock market performance.

Moreover, emerging economies are often more vulnerable to external factors like changes in global commodity prices or economic conditions. This makes the effect of political instability even stronger. By looking at recent trends and historical data, this study will explore how political instability specifically impacts stock market performance in these countries, helping investors and policymakers understand the risks and opportunities better.

I. Political Stability Vs. Instability: Effects On Stock Markets

Political instability, defined as the propensity for a government to collapse either due to conflicts or rampant competition among various political parties, can severely affect economic performance. The relationship between political instability and economic performance is complex, involving various macroeconomic factors. Political instability can lead to uncertainty and reduced investor confidence, which in turn negatively impacts stock market returns and increases volatility.

Elections Uncertainty

Before an election there is political uncertainty. This uncertainty is likely to have direct effects on the real economy, which is then reflected in stock market valuations. "Evidence from the United States indicates that firms reduce investment expenditures during election years by nearly 5%" (Julio and Yook, 2012). "In addition, political risk affects the value of international investment in a country" (Bekaert et al, 2014).

In emerging economies, where political institutions might be less robust and the rule of law less certain, the effects of political uncertainty on markets can be even more pronounced. Investors in these markets often demand a higher risk premium to compensate for the added political risk, which can lead to capital flight or reduced foreign direct investment. This, in turn, can exert downward pressure on stock prices and lead to a more volatile market environment. The sensitivity of emerging markets to political events underscores the importance of stable and predictable governance structures in supporting economic growth and market development.

After an election, political uncertainty is likely to be replaced with policy uncertainty as the priorities of the newly installed government become apparent. Distinct from the intended effect of any economic policy, stock markets react negatively to economic policy uncertainty.

“Research using over 100 years of data finds that greater economic policy uncertainty increases risk and suppresses the returns on shares in companies and industries that are particularly sensitive to government spending or regulation. This includes sectors such as defense, healthcare and finance” (Baker et al, 2016).

The negative stock market effects are most likely to be attributable to economic policy uncertainty affecting the real economy, with investment, industrial production and unemployment all reacting negatively.

Moreover, the globalized nature of today’s economy means that political changes in one country can have ripple effects across international markets. “Changing governments are often associated with pivots in foreign policy and international relations. Shocks to geopolitical risk are associated with lower share prices too” (Caldara and Iacoviello, 2022). Investors in global markets must consider not only the domestic implications of political events but also how these events might affect international relations, trade agreements, and geopolitical stability. For instance, a shift in a country's foreign policy can alter trade dynamics, impacting multinational companies and the broader market. As such, political uncertainty remains a key driver of market behavior, influencing everything from investor sentiment to capital flows across borders.

Despite the potential for political events to impact the stock market, the relationship is not always straightforward or predictable. While elections and changes in leadership can introduce uncertainty, the market is influenced by a myriad of factors, and other events can overshadow political developments. For example, economic indicators, global crises, or significant policy announcements can have a more immediate and substantial effect on market movements. “It’s hard to detect a meaningful and long-lasting effect either from the elections or changes in political leadership, particularly as other events can often move markets more. For instance, the dramatic drop in the FTSE in 2020, a few months after the 2019 election, was linked not to Boris Johnson’s landslide victory but to the COVID pandemic” (Adetunji, 2024).

Corporate Investments

Political uncertainty is an inevitable part of the electoral process, particularly in emerging markets where political institutions may be less stable. Elections often bring with them the possibility of significant shifts in government policies, which can have profound effects on the business environment. In such contexts, firms face the challenge of navigating an uncertain landscape where the rules of the game may change depending on the outcome of the election. This uncertainty can lead to hesitation among firms to commit to long-term investments, as the risk of unfavorable policy changes looms large.

“Corporate investment tends to be lower just before national elections for a large sample of countries around the world. Controlling for investment opportunities and the economic environment, corporate investment rates drop by an average of 4.8% in the period leading up to elections relative to investment rates in non election years” (Yook et al, 2012).

Firms tend to become more cautious around elections and hold back on investment expenditures until the uncertainty surrounding the election outcome is resolved. “Within countries, the reduction in capital expenditures is larger when the election outcome is more difficult to predict. Across countries, we find that the effect is larger for countries with fewer checks and balances on executive authority, a less stable government, and a higher ratio of central government spending to GDP. We also find that changes in investment around national elections are larger for firms in more politically sensitive industries” (Yook et al, 2012).

Two important ideas emerge from the studies. First, the political situation of a country appears to matter for firms' real investment decisions. The normal political process including the elections and the possibility of policy changes due to change of political party or changes by the incumbent party influence the way firms make investment decisions. Second, the results from various studies highlight the importance of uncertainty in corporate investment dynamics. “Changes in the degree of political uncertainty lead to cycles in investment expenditures” (Bernanke 1983).

The reduction in investment is more pronounced in countries with weaker institutional frameworks, fewer checks and balances, and higher levels of government intervention in the economy. This suggests that the strength and stability of political institutions play a crucial role in mitigating the negative effects of election-related uncertainty on corporate investment. In more stable political environments, firms may feel more confident in their ability to navigate potential policy changes, leading to less dramatic fluctuations in investment levels during election periods.

Study of emerging markets

The relationship between political instability and negative impact on stock markets is more pronounced in emerging economies compared to developed ones, which often have greater institutional stability and political resilience. For instance, political instability in Nigeria and Pakistan has been shown to have a significant negative effect on economic growth. Taking a case study of Pakistan as an emerging market affected by political instability we delve deeper into how political changes can influence stock market performance in emerging economies.

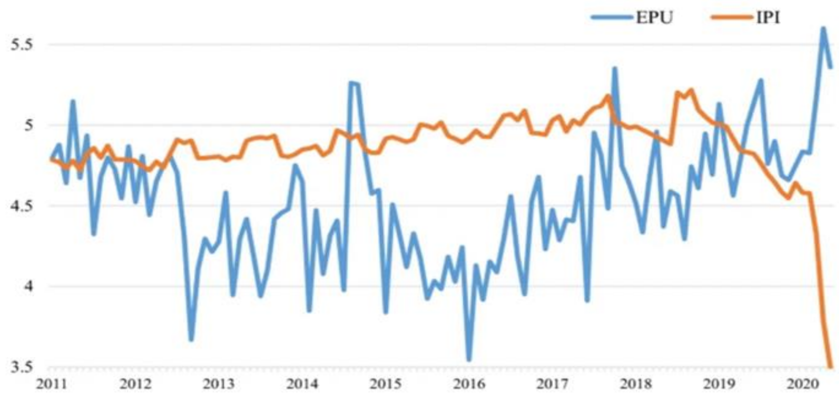
Case Study: Pakistan

Political instability can greatly impact an economy, and this is often reflected in the MSCI (Morgan Stanley Capital International) index value. In the context of Pakistan, political instability has been shown to have a particularly negative effect on the stock market, leading to a decline in the value of the MSCI index. The MSCI value index measures the performance of stocks in Pakistan using market capitalization data from the Pakistan Stock Exchange, providing investors with insights into the overall performance of the region's economy and the associated risks and potential returns on investment.

"Research findings indicate a strong correlation between political instability and a decline in the MSCI value index in Pakistan, particularly in emerging economies. This correlation has been supported by previous studies, which have demonstrated that increases in political instability tend to coincide with decreases in the MSCI value index. Investors may pull their money out of the country's stock market, leading to a decline in the value of the MSCI index and stocks" (Mai et al, 2023).

It is important to recognize that the MSCI index value serves as only one indicator of Pakistan's economic growth and decline. Other factors, such as investment, exports, and government policies, also significantly impact the country's economic performance.

The following graph shows the trend of EPU (Economic Policy Uncertainty) for the period 2011–2020. The overall EPU index captures a critical period for the economy of Pakistan. "Frequent changes in governments over the years have increased economic uncertainty and stagnation in economic decision making. For more than a couple of years in the last decade, especially from 2010 to 2012, Pakistan witnessed a bloody and intense war on terror. This war on terror and severe energy shortages can be explained in an "eventual sense" by the high level of the EPU index during the period from 2011 to mid-2012" (Wen et al, 2021).



EPU and IPI in Pakistan (2011M1–2020M5)

Source: Springer, 2021

The above graph illustrates the relationship between Economic Policy Uncertainty (EPU) and Industrial Production Index (IPI) in Pakistan from 2011 to 2020. The data shows that lower levels of EPU do not necessarily correspond with higher economic growth, as indicated by the IPI. The graph reveals an asymmetry, where increases in EPU have a more significant negative impact on economic growth than decreases in EPU. Notably, during the 2013 political unrest following the election results, the graph recorded the highest level of uncertainty, yet this did not lead to a proportional decline in economic growth.

In 2015, a reduction in EPU was associated with economic improvements due to favorable economic indicators such as inflation, fiscal balance, and foreign exchange reserves. However, from 2016 onwards, factors like a widening current account deficit and rising inflation gradually increased EPU levels. Political instability in 2018 further exacerbated uncertainty, impacting economic growth. The situation temporarily improved in mid-2019 following economic stabilization efforts in collaboration with the International Monetary Fund. However, the onset of the COVID-19 pandemic in early 2020 led to unprecedented levels of EPU, severely hindering Pakistan's economic recovery. This analysis underscores the strong link between political instability and economic performance in Pakistan.

This case study highlights the significance of political stability for maintaining investor confidence and sustaining economic growth in Pakistan, an emerging market that remains vulnerable to the adverse effects of political turmoil.

Can Political Changes be good for Emerging Economies?

"When political stability comes with having one party or a coalition of parties in office for a long time, it may eventually be detrimental. The economy may do well in terms of attracting foreign direct investment because stability means a predictable political environment. However, other aspects of the society might suffer because of complacency, lack of competition, and opacity. The economy eventually suffers because of these. Consequently, stable governments do not necessarily lead to higher economic growth" (Hussain, 2014).

We can take India's example as another case in point. India's performance on the economic front in the first 30 years of post-independence era, which epitomized political stability, exhibited only 3 to 3.5 percent level of economic growth, lowest in the last seventy years. In contrast, in the last 30 years when India saw as many as four Prime Ministers, industrial growth rates jumped to higher levels, something that had not happened before.

Case Study: India

Elections in India have far-reaching implications, influencing not just the political scene but also the stock market and economy. Political transitions can cause changes in government policies, economic priorities, and laws, affecting a variety of industries and businesses.

While elections cause short-term volatility, the long-term repercussions are largely defined by the ruling party's economic changes and policies. Historical examples are critical for better understanding this relationship.

The following table shows performance of the Sensex in the past five Lok Sabha election periods to gauge how the markets moved three months before and three months after the elections.

Voting Phase	Sensex Points 3 Months Before Election	Sensex Points 3 Months After Election	Difference
September 5 - October 3, 1999	4,141	5,005	864
April 20 - May 10, 2004	5,591	5,192	-399
April 16 - May 13, 2009	9,709	15,667	5,958
April 7 - May 12, 2014	22,386	26,638	4,252
April 11 - May 19, 2019	38,673	37,332	-1,341
April 19 - June 1, 2024	72,488.99	76,468.78	3,979.79

Source: Groww, 2024

The following are the trends that emerged six months after the election results:

Year	Part in Power	Consequence (After Six Months)
2004	UPA (United Progressive Alliance)	The Sensex shot up by 13 percentage points after the public viewed Dr Manmohan Singh and P Chidambaram as reform-friendly.
2009	UPA (United Progressive Alliance)	The Sensex remained nearly unchanged, with no significant policy change compared to UPA-1.
2014	NDA (National Democratic Alliance)	Policy reforms the Modi government undertook at the initial stage, such as fiscal consolidation and curbing inflation, drove up the Sensex by nine percentage points.
2019	NDA (National Democratic Alliance)	A decline in the GDP growth rate and subdued market performance were due to the global economic and domestic consumption slowdown.

Source: Groww, 2024

An analysis of the impact of elections on the Indian market and economy finds that, while short-term volatility is unavoidable during election years, the long-term trajectory is defined by the government's policy actions and capacity to foster a favorable business environment. The government's stability, whether in the form of a majority or a coalition, is critical for fostering investor confidence. Furthermore, historical trends demonstrate the relevance of policy continuity and economic reforms in determining market performance.

While elections create volatility, the emphasis should be on the government's capacity to provide stability and implement effective policies for long-term economic growth. Finally, educated investment decision-making usually evaluates the larger economic landscape and reforms, rather than being primarily impacted by elections.

II. Implications For Policymakers And Investors

The relationship between political instability and stock market performance in emerging economies highlights the crucial need for stable governance to foster economic growth. The findings of this study underscore the importance of creating a stable political environment through constitutional reforms and addressing underlying issues like poverty and inequality. Governments and policymakers should focus on enhancing transparency, accountability, and good governance to boost investor confidence and stabilize markets. By implementing these measures, they can create a more predictable and secure environment that supports long-term economic stability.

For investors, understanding the impact of political instability is vital for making informed decisions. Strategies such as diversifying investment portfolios, focusing on sectors less sensitive to political changes, and staying updated on political developments can help mitigate risks. Companies operating in politically unstable regions should consider risk management practices, including geographic diversification and hedging against political risks, to protect their investments and ensure operational resilience.

III. Conclusion

The study reveals that political changes, particularly instability, have a notable impact on stock market performance in emerging economies. Political uncertainty can lead to increased market volatility and decreased investor confidence, which often results in reduced stock market returns and economic growth. The case studies of Pakistan and India illustrate that political instability can affect market performance, with instability in Pakistan correlating with declines in stock market indices, while political transitions in India have shown both short-term volatility and long-term growth depending on government policies.

For policymakers, the findings emphasize the importance of fostering political stability through effective governance, transparency, and addressing underlying issues like poverty and inequality. Such measures can mitigate the adverse effects of political instability on markets and create a more predictable economic environment. Investors, in turn, should adopt strategies to manage political risk, such as diversifying portfolios and focusing on less politically sensitive sectors.

However, effective governance—characterized by transparency, accountability, and inclusivity—is crucial for leveraging political stability into sustainable economic progress. “Not all forms of political stability are equally development friendly; much depends on the extent to which stability translates into good governance” (Hussain, 2014). We can conclude that strong governance is important for meaningful development.

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