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Hurting without hitting: The economic cost of political tension

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ABSTRACT

Political tension that causes diplomatic strain rarely escalates into direct violence or war. This paper identifies the economic effects of such non-violent political tension by examining Taiwan's sovereignty debate. Non-violent events harming the relationship with mainland China lead to an average daily drop of 200 basis points in Taiwanese stock returns. The impact is more severe on firms openly supporting the Taiwanese pro-independence party. Through a series of tests, we show that this economic penalty is targeted at pro-independence firms that are economically exposed to mainland China via either investments or exports.

1. Introduction

While it has been documented that violent political disputes can negatively affect stock prices (e.g., Abadie and Gardeazabal, 2003; Zussman and Zussman, 2006; Guidolin and Ferrera, 2007), other cost factors of political tension have largely been left unexplored. This paper studies the non-violent diplomatic disputes between China and Taiwan in order to identify the cost of political tension that can be attributed to the use of political power or economic pressure. The study also merges with research on the value of political connections (e.g., Fisman, 2001; Faccio, 2006; Acemoglu et al., 2014) by demonstrating that the cost of tension is partly attributable to economic and strategic targeting of political opponents.

To elaborate, the paper uses two different data sources to examine how increased political tension in Taiwan's sovereignty debate affects stock returns. The first source involves major political events dating back to 1995 that constitute the basis of our event study. Although none of the events directly led to violent confrontations, the results show that Taiwanese stock returns fell, on average, by 400 basis points over the course of two days (the announcement date and the following trading day), which is the equivalent of a drop of approximately 200 basis points in daily returns. Moreover, the adverse effect is long-lasting, suggesting that the political tension had a real economic impact. The second source comprises data collected since 2006 using a survey that asks the Taiwanese public about its short-term expectations on political tensions with mainland China. Our analysis shows that the cost of political tension is more comprehensive than previously documented, as months of expecting an increase in political tension are associated with stock returns for Taiwanese firms

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that are lower than average. In other words, both current and expected political tensions are associated with declines in present stock returns.

The paper also explores the channels through which political tension affects stock returns. In particular, it reveals that the cost of political tension, in part, stems from economic pressures targeted at selected companies. Because the main political debate in the cross-strait relationship centers on the issue of Taiwan independence, we study the impact of political tension on firms associated with either of the two opposing political axes in Taiwan. We determine a firm's political association based on the political connection of its founders and/or managers, which we obtained from online search records linking them to either of the two major opposing political coalitions (e.g., through party membership, close personal ties, public statements). Using this unique hand-collected dataset, the paper uncovers a differential stock price reaction, where Taiwanese firms politically connected to the pro-independence coalition (''anti-China'' firms) are more negatively affected than firms publicly supporting a Chinese national identity (''pro-China'' firms). Evidence shows that Taiwanese firms labeled as ''unfriendly'' to mainland China see their stock prices suffer disproportionally in times of political distress.

The analysis further shows that these economic pressures on political opponents are concentrated on Taiwanese firms with high mainland exposure through either exports or investment. We also examine whether the detrimental effect on exporting firms is likely to stem from either the reactions of mainland consumers or mainland authorities. We find that firms offering brand-name consumer products to mainland China are not significantly more vulnerable to changes in political tension, which implies that Chinese consumers do not actively boycott Taiwanese products and that the economic impact is more likely to originate from a politically strategic government response.

The paper also offers two additional results that supplement our main conclusions. First, the negative impact of political tension extends to Chinese stock returns, where the impact is less severe, which is consistent with the mainland's economic and military strength vis-à-vis the island of Taiwan. Second, even though all our events are non-violent ex-post, they may still involve the risk of war ex-ante, creating a separate stock market effect that further adds to the cost of political tension. This cost is separately identified by documenting that firms located relatively close to potential military conflict zones experience a larger drop in stock returns when tension rises.

The paper differs from other studies on political instability and stock market reactions in three aspects. First, existing studies mostly examine stock market outcomes within violent settings, such as World War II (Frey and Kucher, 1999; Waldenström and Frey, 2006), the Iraq War (Amihud and Wohl, 2004; Rigobon and Sack, 2005; Wolfers and Zitzewitz, 2009), the Basque conflict in Spain (Abadie and Gardeazabal, 2003), the Angolan Civil War (Guidolin and Ferrara, 2007), the Israeli-Palestinian conflict (Zussman and Zussman, 2006; Zussman et al., 2008), and the Arab Spring (Acemoglu et al., 2014). In contrast, we propose a framework to assess the impact of non-violent political tension and identify the channels through which the cost of it occurs. We then examine the case of Taiwan and mainland China using two measures of political tension. These measures are obtained from historical events and survey data, but they do not cover periods of physical confrontation. Instead, the events comprise relatively softer acts, such as speeches or statements by political figures, the surveys capturing expected political tension, which offers a relatively subtle measure of the public's political sentiment.[1] Thus, the study focuses on the financial impact of a shift in the general political climate, which offers broader implications, as the majority of international political conflicts do not escalate into direct violence.

Second, by measuring political tension using both historical events and public opinion surveys, this paper captures and compares he effects of both realized/current and expected/future political instability. Our results show that realized distress events strongly affect stock returns. However, our findings also show that even the expectation of future tension is associated with a statistically significant and economically relevant decline in average daily stock returns (approximately 25 basis points). Moreover, because the data from public opinion polls cover a relatively stable period in the cross-strait relations, the results also indicate that political tension is inherently costly at all times, not just times of concrete conflict or immediate crisis.

Third, the paper contributes by exploring the mechanism through which political tension ends up being costly, showing that both economic pressure and risk of war are at play. This is possible by examining the heterogeneous effects on firms across political connections, geographical locations and their degree of economic linkage with China. To our knowledge, only Fisman et al. (2014) have examined the detailed channels of economic pressure under cross-country tension, although in a setting absent of heterogeneity across political connections.[2] As described above, evidence shows that the price of political tension originates not only from the threat of military action but also from economic pressures primarily targeting companies with mainland exposure and that are considered hostile towards the Chinese authorities. Consistent with anecdotal evidence, these results empirically verify that the political tactics mainland China utilizes align with historical threats made by Chinese officials. For example, the Taiwan Affairs Office—a Chinese agency responsible for setting and implementing policies related to

[1] This also differs from, e.g., Berkman et al. (2011), who despite including (but not limiting themselves to) non-violent events, focus on the risk of selective and extreme disaster. Additionally, rather than studying the effects on stock prices, related literature analyzes the dynamics of violent conflict (Jaeger and Paserman, 2006, 2008) or examines the impact of military hostility and mistrust on house prices (Besley and Mueller, 2012) and international trade (e.g., Martin, Mayer and Thoenig, 2008; Guiso et al., 2009; Glick and Taylor, 2010).

[2] The objective and approach in their study differs in that they examine domestic industry effects and compare the results across two nations that vary along cultural dimensions such as language, history and structure, whereas we examine two groups that share a common ethnic and cultural background but differ primarily in their political ideology. This follows from our additional objective to measure the effect of purely opposing political views on stock returns, as opposed to the effect of cultural aversion. Fisman et al. (2014) focus on two particularly stormy episodes in the Sino-Japanese relationship, whereas our study also considers relatively stable periods absent of immediate crises.