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Military regimes and stock market performance☆

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ABSTRACT

We examine whether military regimes harm stock market performance by investigating stock returns in ten emerging markets under military and civilian rule. We find no evidence of military regimes having a significantly negative impact on stock returns. In the case of Thailand and Pakistan, we find a significant positive military return premium. These returns cannot be explained by economic cycles, stock market cycles, or returns volatility. Our findings are robust to worldwide stock market movements, tests for spurious regression bias and randomization-bootstrap tests. Our results contradict the common view that military rule has a negative impact on stock market performance.

1. Introduction

Shifts between civilian and military governments are extensively studied by historians, political scientists, and sociologists but rarely by finance academics. Political scientists such as Huntington (1968) assert that military intervention in politics can reveal both the political and institutional arrangements of that society. As compared to developed markets, the political situation in emerging markets is often more unstable with changes in government and political leaders observed more frequently. There are several factors that cause these frequent changes in government. In the case of the military seizure of political power, this can be due to economic issues, ineffective government, or corruption and the abuse of power by politicians. Often shifts in power create internal political conflicts that can lead to civil unrest.[1] To restore order in a country, military

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[1] For example, Sylvia and Danopoulos (2003) document that the overthrow of President Hugo Chávez of Venezuela in April 2002 led to continuous protests and created a division within the society.

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interference in politics is regularly seen following such incidents (Pinkney, 1990). Generally, the period of military rule lasts until the state is in order and a proper general election is held to find a new democratic leader. This transition may be quick or drawn out. In some instances military rule lasts for a long period of time and this invariably leads to a long period of political uncertainty (May et al., 1998).

We examine stock market performance during periods of military rule to test the view that such military interference in politics has an adverse effect on financial markets. This is the main contribution of this study. Despite the fact that the stated aim of military intervention is often to restore order in a country, studies such as May et al. (1998) find that apart from social implications, direct political involvement by the military generally suppresses economic growth and freedom. This in turn lessens the country's overall credibility. As a result, this lowers investors' confidence and influences their investment decisions in financial markets. Both local and foreign investors could delay or suspend their investments due to the perceived risks and uncertainties. Nonetheless, there is not yet any direct empirical evidence showing the effect of military rule on stock returns. This study fills this gap in the current literature.

Our study focuses on emerging stock markets of countries that have a history of military rule. An investigation of these markets is valuable for investors, particularly during such periods of military interference, since these markets are important venues through which investors diversify and hedge against the country-specific uncertainty of their local stock markets. Bekaert and Harvey (2002) find that politics in emerging markets plays a significantly higher role and appears to be more highly intertwined with public and business administration than in developed markets. Moreover, emerging markets generally possess a less mature political system than developed markets given that most of them are relatively new democratic countries (Dinç, 2005; Khanna and Palepu, 2000; Winichakul, 2008). Consequently, the political situation in emerging markets tends to be less stable compared to developed markets. For this reason, these markets are inclined to have higher frequencies of political upheavals than developed markets and, as a result, military involvement in politics can be seen more regularly to resolve such political conflicts. An investigation of stock markets in those countries that have a history of military interference provides important information for investors with regard to their portfolio formation and allocation of investment funds.

Ten emerging markets in which the countries have a history of military rule are identified and we find evidence of a military return premium in over half of markets studied. However, these returns are only significant in two markets being those of Pakistan and Thailand. The stock returns under military governments for these two markets are significantly higher than under civilian governments. This finding holds when allowing for world returns correlations, persistence in dummy variables, and randomization-bootstrap robustness checks. Therefore, the empirical findings from this study highlight the fact that a military government is a stock price factor for Pakistan and Thailand and military governments in themselves do not appear to increase the risk level of investors' portfolios. We find no evidence of significant stock market under-performance in any of the emerging markets studied. This contradicts the customary view of financial markets during period of military rule.

The paper proceeds as follows. Section 2 discusses prior evidence regarding political regimes and stock returns. Section 3 describes the data and methodologies used in this study. Section 4 provides the results from the regression analysis. Section 5 reports the additional robustness tests. Section 6 discusses the results and Section 7 concludes the paper.

2. Prior evidence

Existing evidence that links the relationship between different political regimes and financial markets remains scant. Prior literature such as Freeman et al. (2000) and Block (2003) documents the relationship between democracy and foreign exchange rates wherein they find that democracy reduces the likelihood of a currency crisis in emerging markets. However, Wang and Lin (2009) who examine the Taiwanese stock market during the pre- and post-democratization periods find that there is a significant negative effect of democratization on stock market returns. Despite the existence of some literature on the relationship between democracy and financial markets, no prior literature thus far directly examines the effect of military rule on stock market returns. Nevertheless, there are a number of studies that investigate the link between political parties and stock markets under different government administrations. Specifically, these studies examine the effect of political cycles on stock returns or the differences in stock returns under left- or right-wing governments. Our study is therefore focused on filling this gap in the literature.