

# Buletin de analiză al Centrului de Cercetări Financiar-Monetare

**Nr.18-19/ decembrie 2017 – martie 2018**

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ISSN 2359 – 9014  
ISSN-L 2359 – 9014

# Centrul de Cercetări Financiar Monetare

## Political Influence on the Stock Market

### Introduction

*For a better understanding of the effects of political parties on the stock market in Romania, we must first look at the history. Some stock markets such as the New York Stock Exchange were founded over 200 years ago and functioned continuously with few interruptions, the political context of Romania did not allow for this. Romania gained its independence from the Ottoman Empire in 1877. The first version of the Romanian Stock Exchange was founded in 1881 through a royal decree and officially opened in 1882<sup>1</sup>. Since then, the economy began an ample process of construction and development. The following years were eventful as Romania participated in two World Wars, the stock market was only suspended in the first WW. Shortly after the end of the Second World War, the Communist Party rose to power and in 1948 it officially closed the Stock Exchange. During the communist regime, the incumbent governments made unavailable to the public the means used to increase an individual's wealth, such as the businesses environment or financial institutions. The control that the government had on the industries noticeable even today, as we see on the stock market only a few integral privately-owned companies, while the largest players are partly owned by the Romanian government.*

*The new Bucharest Stock Exchange (BVB) was reopened in 1995, shortly after the fall of the communist regime. Making it one of the youngest stock markets in the region. As a newly developed market, BVB has been characterized by low liquidity in the last two*

*decades. Considering that the Romanian government is an important shareholder of several companies traded on the stock market, we believe that it can exert a prominent influence on it. Therefore, it is left to us to examine which political party has a positive influence on the stock market.*

*Most of the studies investigating the nexus between governments' political orientation and stock market return considered the US stock market, as the long history of the NYSE provided large datasets for the studies.*

*There was already financial folklore on Wall Street saying that right-wing parties in power would lead to better stock returns. Having a more responsible fiscal policy that aims at increasing the business sector would certainly have a positive effect on stock market returns, but implementing the correct measures in an economy has never been easy. There is always the possibility that the Right-Wing party may apply measures that would indirectly harm the private sector producing a decrease in stock returns.*

*On the other hand, the Left-Wing party may apply measures that contradict its political views. However, strengthening the private market would lead to an increase in GDP, which would lead to bigger revenues for the government to redistribute. This change in tactics leads to inconclusive results in correlation with the influence of politics on stock returns.*

*Examining the policies promoted in countries like Romania, the United Kingdom, Germany, and other developed and emerging countries,*

<sup>1</sup> [bvb.ro/InvestorCenter/GhidulInvestitorului.pdf](http://bvb.ro/InvestorCenter/GhidulInvestitorului.pdf)

*we have observed that the political parties in the emerging countries will make compromises to achieve better economic development. In already advanced countries, parties will tend to stick to their core policies and consolidate their position or they begin promoting populist approaches, which may harm the economy.*

*It is important to mention that the stock markets respond not only to a past event but also to the expectations about the future, including the expectation of the winning political party. If investors expect a left-wing party winner that aims at redistributing the wealth, then they will decide to sell their shares, expecting a decrease in the value, which will lead in the future to a down-turn in the stock market as an effect of a self-fulfilling prophecy. On the other hand, if the expected winner is a Right-Wing party, which plans to increase its support for the business environment, the investors will hold their shares or buy more expecting an increase in the price.*

*These expectations can also be misguided by the populist approach, which is widely present on the political spectrum. This approach consists of the false advertisement of sought-after policies by parties that have no intention of fulfilling their promises after elections.*

## **Related literature**

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*As stated before, there is a rich body of research on the political influence in the United States over the stock market return. Stovall (1992)<sup>2</sup> found that during the Republican administration the stock market returns are higher on average. One thing to*

*note is that the performance of the stock market is not constant during the same administration. According to Stovall in the first two years of the presidential term, both the government and the Federal Reserve usually introduce tight policies and the stock market accommodates these policies in the last few quarters of the administration term.*

*Huang(1985)<sup>3</sup> showed that the stock market exhibits higher returns during the Democratic administration. According to Huang the last 2 years in the presidential terms are the best for the stock market returns.*

*Johnson et al. (1999)<sup>4</sup> suggested that neither the Democratic nor the Republican administration provide a significant influence on the stock market. The only distinction found was that during the Republican terms the debt market has a better performance.*

*Chen et al. (2008)<sup>5</sup> found no significant correlation between stock market returns and the political party in the White House. He also noted that regardless of the party in power the last two years of the presidential term show an increase in stock market returns compared with the first two years.*

*The studies on the political influence on the stock market were not contained only in the United States. For instance, a study made by Hudson et al. (1998)<sup>6</sup> for the United Kingdom found out that the stock market responded significantly to both the political opinion polls, which predicted the winner and the election itself. According to the authors, the U.K. stock market exhibited higher returns when the right-wing government was in power. In a study done by Döpke and Pierdzioch (2006)<sup>7</sup> the authors found that neither the left nor the right-wing governments provide a significant*

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<sup>2</sup> Stovall, R. H. (1992). Forecasting stock market performance via the presidential cycle, *Financial Analysts Journal*, 48(3), 5-8.

<sup>3</sup> Huang, R.D. (1985). Common Stock Returns and Presidential Elections, *Financial Analysts Journal*, March-April, 58-61.

<sup>4</sup> Johnson et. al. (1999). Presidential Politics, Stocks, Bonds, Bills, and Inflation, *The Journal of Portfolio Management* 26(1):27-31

<sup>5</sup> Chen, H. & Estes, J.& Richey, G. (2008). Political influences on Dow Jones Industrial Average index returns: perception and reality, *International Journal of Business Research*, Vol. 8, pp. 119-124

<sup>6</sup> Hudson, R., Keasey, K. & Dempsey, M. (1998). Share prices under Tory and Labour governments in the UK since 1945, *Applied Financial Economics*, 8(4), pp. 389-400

<sup>7</sup> Döpke, J., & Pierdzioch, C. (2006). Politics and the stock market: Evidence from Germany, *European Journal of Political Economy*, 22(4), pp. 925-943

*impact on the stock market. Le Bris (2010)<sup>8</sup> found that in contrast to the U.K. market the parties that provided the best returns to the stock market, in France, during their tenure were from the left political spectrum. Siokis and Kapopoulos (2007)<sup>9</sup> provided a different approach to the influence of political parties over the stock market. In their study, they are focusing on the volatility of the stock market. Their results showed that the volatility increased in the periods before the election and during the tenure of the right-wing governments.*

*Returning to the US stock market, a recent study done by Pastor and Veronesi (2017)<sup>10</sup> showed a contrasting image to the Wall Street folklore. In their case, the market does not prefer the right-wing (Republicans) but the American left-wing (Democrats). They explain this phenomenon through risk aversion and its effects on the population. In the authors' vision, the voters are divided into two categories entrepreneurs and government workers. The entrepreneurs are dependent on their skill and the income they are receiving from the firm. When a pro high tax party is governing the entrepreneur would lose a significant amount of the firm's income so it will always vote for the low tax political party. The government worker does not depend on his skill, his job is secure but his income is dependent on how much money the state has this is why he will vote with the high tax political party as his income will increase when the private sector is taxed more.*

*The authors also took into account that if no one would change their status from either entrepreneur or government worker the same party which has the majority of voters would win every time. This is why in their model people choose to become entrepreneurs if the conditions are suitable. To be an entrepreneur*

*there is a need for skill when the risk is high only the superior skilled entrepreneurs would choose to remain on the market the rest will move on to government positions. If the risk on the market is low government workers with low skills would move to become entrepreneurs.*

*With the factor of risk that influence the population that works in the private and public sectors, we can see how this would be linked to the presidential election. The question remains why the markets during a high-risk aversion period (Democratic Presidential Terms) provide better returns than low-risk aversion periods (Republican Presidential Terms).*

*Pastor and Veronesi provided multiple answers to this question. On one hand, only the highest skilled entrepreneurs remain on the market offering better performance for the capital invested in the market, as the low skilled workers moved to the government positions less capital on the private market is wasted on low skilled entrepreneurs. On the other hand, there is the possibility that investors that are also affected by the high tax party would demand a higher risk premium to offset the risk aversion and the income lost from taxation.*

*In a study complementary with the one done by Pastor and Veroni, Wright<sup>11</sup> (2012) examined the link that unemployment might have when the population is voting on who will take the political power. Unemployment is highly related to risk aversion, and an unemployed person doesn't have the needed resources to invest in a risky asset or proposition since the loss of the resources would have a bigger impact on them than an employed person that can replace the losses.*

<sup>8</sup> Le Bris, D. (2015). Stock Returns and Government, France 1871-2008. Published at Université de Toulouse

<sup>9</sup> Siokis, F.& Kapopoulos, P. (2007). Parties, elections and stock market volatility: Evidence from a small open economy, Economics and Politics, 2007, vol. 19, issue 1, 123-134

<sup>10</sup> Pastor, L.& Veronesi, P. (2017). Political Cycles and Stock Returns. Working Paper published by NATIONAL BUREAU OF ECONOMIC RESEARCH

<sup>11</sup> Wright, J.R. (2012), Unemployment and the Democratic Electoral Advantage, American Political Science Review, Volume 106, Issue 4, November 2012, pp. 685 - 702

*The main conclusion of Wright's study was that voters in times of high unemployment prefer the Democrat party no matter who was previously in power, although democrats obtain a bigger share of the vote if the incumbent party in which the unemployment rose was Republican.*

*In the opinion of the author, unemployment has become a partisan issue which means that most voters perceive the Democrat party as best to handle unemployment offering help through redistribution.*

*This conclusion was validated by two major events in American history. The Great Depression of 1929 offered a stunning victory for the democrats as the incumbent president Herber Hoover lost the presidential race to Franklin D. Roosevelt, the republicans also lost the House and the Senate which is a very rare occurrence for an incumbent president. The second event was the 2008 Financial Crisis when the Republican incumbent President George W. Bush was succeeded by the Democrat Barack Obama which also managed to capture both the House and the Senate.*

*According to historic performances Democrats do manage to reduce unemployment which means that risk aversion should also decrease during their tenure leading to a lower stock performance at the end of their mandate. This conclusion is in contradiction with the studies of Huang (1985) and Stovall (1992).*

*One aspect of the political scene that may impose problems on our research is found in a study made by Nordhaus (1975)<sup>12</sup>, according to him the sole objective of political parties is to win elections. This would mean that the parties couldn't be identified as either being on the left or the right spectrum of power since their policies will be chosen to accommodate the majority of voters, so they could win the*

*elections. This idea was previously presented in a study by (Downs,1957)<sup>13</sup> where this behaviour would be named the "opportunistic" model.*

*Their theories are disproved in the case of the United States as there is a clear difference in the administrations of the Democrat and Republican parties. The Democrat party has chosen to represent the lower and middle-class members of the society while the Republicans choose to represent the upper-middle and wealthy members. It is puzzling that the party that represents the interest of the most stock market investors tends to bring a lower return to the market.*

## **Dataset and methodology**

*In our study, we used data for 5 European countries in the category of both developed and emerging economies. The data covers quarterly periods between June 2000 and March 2014. The dataset is divided into 2 sub-groups: emerging markets (Romania and Poland) and advanced economies (United Kingdom, France, and Germany). Although Romania is the centre of the study, the rest of the countries were considered for comparison reasons to see how the political influence affects the stock market in a similar newly formed market, or in an already stable and time-tested market.*

*The political variable used in this study is the political orientation of the party that governs the country. In the case that the governing of a country is provided by a coalition, we will take as an observation of the political view of the party that proposes the prime minister.*

*To reflect the condition of the stock market, we considered the returns of the stock market index (Return). The returns are calculated as the percentage change of the value between*

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<sup>12</sup> Nordhaus, W.D. (1975). The Political Business Cycles, The Review of Economic Studies Vol. 42, No. 2 (Apr., 1975), pp. 169-190

<sup>13</sup> Downs, A. (1957). An economic theory of political action in a democracy, Journal of Political Economy, Vol. 65, No. 2 (Apr., 1957), pp. 135-150

the current quarter and the previous quarter of the main stock index of each country. Each index shows the general stock market trends making a good estimate for the market condition.

We add several variables to control for the influences exerted by other factors. The variables chosen have the potential of affecting the stock market returns both directly and indirectly. The variables included are:

**GDP** – This variable is often used as a mean of assessing a country's economic condition and welfare. When there is more welfare the level of disposable income increases. This excess can be invested in the stock market.

**Public Debt** – It is used by governments to finance the gap between revenues and expenditure. One additional characteristic that is relevant to our study is the preference of countries to use public debt as a mean of investing in big projects such as infrastructure which contribute indirectly to the enterprises' increased profitability.

**Interest Rates** – Represented by the money market interest rate is a direct competitor to the stock market as they are another opportunity of investing excess money.

With these variables, we aim to explain the returns on the stock market using the following multiple regression:

$$R = a + \beta_1 \times GDP + \beta_2 \times Debt + \beta_3 \times Interest Rate + \beta_4 \times Right Wing + \beta_5 \times Return(-4)$$

Where: Return is the stock market return; GDP represents the percentage change in the gross domestic product. Debt represents the change in public debt. Interest Rate is the change in interest rate. Right Wing represents the right-wing governing party and is a dummy variable. We noted 1 if the governing party has liberal political views and 0 if the party is of socialist political orientation. Return(-4) is the return 1 year before (4 quarters).

We assume that the variables in our equations may not have an immediate impact on the return of the stock market. This is why we will test for the significance of the lagged variables.

## Results

The results of the multiple regression are shown in Table 1. The data in Table 2 shows the level of significance of the results (Prob). We notice that for developed countries the political orientation is not statistically significant.

Value of Coefficients

Table 1	Romania	Poland	Germany	France	UK
Intercept	7.995778	6.527091	0.125290	1.254238	0.194449
GDP	-0.018298	0.220600	0.101916	0.793383	0.291284
Debt	0.458560	0.007613	0.117823	0.109957	0.049167
Interest Rates	-0.020877	-0.032791	-0.004477	-0.017804	-0.004545
Right Wing	-8.024490	-7.622934	2.578093	-2.084245	0.619458
Return (-4)	0.071761	-0.101515	0.073452	0.028302	-0.012663

Value of Significance

Table 2	Romania	Poland	Germany	France	UK
Intercept	0.0156	0.0905	0.3742	0.5762	0.8803
GDP	0.8487	0.1988	0.8902	0.1801	0.2728
Debt	0.2173	0.4622	0.9158	0.9803	0.8202
Interest Rates	0.5588	0.1469	0.8921	0.4394	0.7909
Right Wing	0.0483	0.0529	0.5454	0.4316	0.7422
Return (-4)	0.5881	0.3745	0.5681	0.8241	0.8202

Having considered all variables we conclude that the variable Right Wing which represents the political inclination of the governing party is significant only for the emerging stock markets where the right-wing parties will bring a negative return when in power. For the developed countries this variable brings mixed results. There is a positive correlation between the returns of the stock market and the right-wing governments from U.K. and Germany and a negative correlation between the French right-wing government and their stock market. All the other variables are statistically insignificant for the returns of the stock market.

*In the following section, we analyze the impact of the Right Wing variable in a bifactorial regression, pairing it to the other control variables, one at a time, with the scope of finding if the variables remain or become statistically significant for the stock market return.*

## **Romania**

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### **Return: Return (-5) Right-Wing (-3)**

*Having taken into consideration the variable of Return (-5) which is the BET index from 15 months before, the variable Right-wing becomes significant at a 95% level. The market reacts negatively to the policies enacted by the liberal (right-wing) party generating a loss of 8.24% on the stock market after a delay of 9 months. This delay may be explained by a gap between the implementation of policies and their economic outcome. Return (-5) is statistically insignificant in our model. This model explains 7.9% of the return in the stock market.*

### **Return: Growth (-1), Right-Wing (-3)**

*The variable Right-Wing (-3) is significant at a 95% level. Right-wing parties again brought a loss on the stock market of 7.24%. Lagged GDP growth is statistically insignificant in our equation. This model explains 5.4% of the return in the stock market.*

### **Return: Public Debt (-2) Right-Wing (-3)**

*The Public Debt (-2) and the Right-wing (-3) variables are statistically significant at 95% level. If the Right-Wing party comes to govern, the Return will decrease to 8.92% after 9 months. As public debt increase 6 months before it would bring for each 1% an increase of 0.7% in the stock market. The significance of debt can be explained in two ways. First, the market expects that public debt is used to finance consumptions which will increase firm profit. The second explanation is that the interest rate will increase due to the excess public debt which determines the stock market investors to demand a higher return on their*

*stocks. This model explains 12.57% of the stock market return.*

### **Return: Interest (1), Right-Wing (-4)**

*Taking into consideration the variables Interest Rates and Right-Wing, we find that the Interest Rate variable is now statistically significant in this equation. When the market expects that the interest rates will rise in 3 months by 1% there will be a decrease of 0.5% on the stock market. When the interest rate is expected to increase, some stock market investors will sell their stocks due to a decrease in real return. Right-wing is statistically insignificant. This model explains 8.7% of the return in the stock market.*

### **Return: Right-Wing (-4)**

*If we explain the return of the stock market only with the political variable we find out that the political variable is significant at 95% level and that the stock market will fall to 7.86% in 1 year. This model explains 4.1% of the return in the stock market.*

## **Poland**

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### **Return: Return(-5) Right-Wing (-1)**

*Having taken into consideration the variable of Return(-5), which is the value of the WIG index from 15 months before, the variable Right-Wing becomes significant at a 95% level and will bring a loss on the stock market of 5.82%. Return (-5) is statistically insignificant in this equation. This model explains 7.94% of the return in the stock market.*

### **Return: Growth (-2) Right-Wing (-1)**

*The variable Right-Wing is significant with a 95% probability. Right-wing parties again lead to a loss on the stock market of 5.96%. The GDP growth is statistically insignificant in this equation. This model explains 11.46% of the return in the stock market.*

### **Return: Public Debt(-1) Right-Wing (-1)**

*The Right-wing variable is statistically significant at a 95% level. If a Right-Wing party comes to govern, the return will decrease to 6.64% in 3 months. Public Debt is statistically insignificant. This model explains 9.57% of the return in the stock market.*

### **Return: Interest (-3) Right-Wing (-1)**

*The Right-Wing is statistically significant but not the Interest Rate. The right-wing party will lead to a decrease of 7.08% in 3 months. This model explains 11.08% of the return in the stock market.*

### **Return: Right-Wing (-1)**

*If we explain the return of the Polish stock market through a plain regression only comprising of only the political variable, the results show that the right-wing variable is significant at a 95% level. If the right-wing party comes to power, the stock market will fall by 6.47% in 3 months. This model explains 1.1% of the return in the stock market.*

## **Germany**

### **Return: Return (-3) Right-Wing (-2)**

*Having taken into consideration the variable of Return (-3) which is the DAX index from 9 months before, the variable Right-Wing is statistically significant. A right-wing party will generate an increase in the stock market of 3.08% in 6 months. Return (-3) is statistically insignificant. This model explains 3.62% of the return in the stock market.*

### **Return: Growth (-3), Right-Wing (-2)**

*In this equation, both variables are not statistically insignificant.*

### **Return: Public Debt(-3) Right-Wing (-2)**

*The Public Debt and Right-Wing variables are statistically insignificant.*

### **Return: Interest (-3), Right-Wing (-2)**

*In this model, although the Right-Wing is not statistically significant, the Interest Rate exerts a significant influence on the stock market return. With a change of 1% in interest rate, the return would increase by 0.08%. This model explains 11.36% of the return in the stock market.*

### **Return: Right-Wing (-2)**

*The unifactorial model shows that the Right-Wing exerts no significant impact on the stock market return.*

## **France**

### **Return: Return (-3) Right-Wing (-2)**

*Having taken into consideration the variable of Return (-3) which is the CAC40 index from 9 months before, the variable Right-Wing is statistically insignificant. Return (-3) is also statistically insignificant in this equation. This model explains 0.09% of the return in the stock market.*

### **Return: Growth (-1), Right-Wing (-2)**

*In this equation both the variables, Right-Wing and Growth are statistically insignificant.*

### **Return: Public Debt(-2) Right-Wing (-2)**

*Although the Right-Wing variable is statistically insignificant, the Public Debt is bringing for each 1% a significant increase of 1.48% in the stock market. This model explains 5.4% of the return in the stock market.*

### **Return: Interest (-4), Right-Wing(-2)**

*Both the Right-Wing and Interest Rates variables are statistically insignificant.*

### **Return: Right-Wing (-2)**

*The plain equation shows that the Right-Wing variable is statistically insignificant.*

## **United Kingdom**

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### **Return: Return (-3) Right-Wing (-1)**

*Having taken into consideration the variable of Return(-3), which is the FTSE 100 index from 9 months before, the variable Right-Wing becomes statistically insignificant. Return (-3) is also statistically insignificant in this equation.*

### **Return: Growth (-2), Right-Wing (-1)**

*Both variables in this model are insignificant.*

### **Return: Public Debt(-1), Right-Wing (-1)**

*Although the Right-Wing variable is statistically insignificant, the Public Debt is bringing for each 1% an increase of 0.32% on the stock market. This model explains 6.1% of the return in the stock market.*

### **Return: Interest (-2) Right-Wing(-1)**

*Both variables included in the model are not statistically significant.*

### **Return: Right-Wing (-1)**

*In this equation, we try to measure the effect that the Right-Wing variable has alone on the stock market return, our results also show that this variable is statistically insignificant.*

## **Conclusions**

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*We conducted this study by asking ourselves what is the significance of the different political measures, dividing them on the political nuance of socialism (left) or liberalism (right) on an emerging stock market such as Romania's. For this purpose, we also took into consideration Poland's case. The estimates showed similar results for both countries. But also unexpected.*

*It is part of the common knowledge that from a liberal point of view, the market should not*

*only be free but encouraged to function to assure an efficient outcome without government intervention. Yet for both countries, we can see a significant negative relation between the right-win party and the stock market.*

*To explain this peculiar fact, we can look at the formation of the risk premium. The risk premium is the difference between the return of a portfolio and the risk-free rate. It represents a minimum reward for investing in a riskier asset. When there is a trend of risk aversion, the demand for risky assets is low and the supply must compensate its return. When risk appetite is higher the risk premium becomes lower. From the study conducted by Pastor and Veronesi (2017), we see that the main reason for the political cycle is determined by the current society risk appetite. When the risk aversion is high, the left-wing party wins, when the risk aversion is low, the Right-Wing party wins. As a result, when the right party wins due to a low-risk aversion, the stock market premium decreases and so does the stock.*

*Another approach is about the political inclinations of the parties. We have considered in our dataset left-wing declared parties, but some measures they promoted are not leftist. This phenomenon is called populism where parties will apply measures different from their political views to attract voters. Both Poland and Romania were affected by the Communist Regime both at political and economic levels. The parties founded in the 90s may incline to use policies that are not from their political spectrum to gain voters since they are not restricted by their political decision history.*

*For Romania, there were only two control variables statistically significant, while for Poland there were none. In the case of Romania, we have said that an increase in public debt is beneficial for the stock market due to the expectation of investors that public debt will be allocated to finance consumption which will lead to an increase in firms profit.*

*In the case of the significance of the Interest Rates variable, we assume that investors that anticipate an increase in the interest rates will sell their stocks because of a decrease in their discounted flows.*

*We have also taken into account three European developed countries to see how the inclination of political parties affects a well-established stock market. All of these countries have a different social and traditional background, bringing diversity in the way of economic thinking.*

*The results regarding the influence of political orientation are not statistically significant. In a developed country where the private market is clearly defined, the influence of the political parties diminishes and the actions taken by the government does not have an impact on the return of the stock market. Looking at the previous studies indicating for the US that political orientation significantly impacted the stock market, we can theorise that the results for Europe are different due to a smaller polarization between the party ideologies.*

*In conclusion, we can see that for the emerging economies the political influence exerts a significant impact on the stock markets, the right-wing parties leadin to negative returns, while for developed countries, given there are no polarizing views between the parties, the political influence is not significant.*