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Stock Market Reaction to Political Regime Change in Malaysia

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Abstract: Research Question: How does a change in the ruling party impact the value of actively traded stocks in Malaysia? **Motivation:** The 2018 general election results is a never seen before phenomenon that can be classified as a political risk that affects the value of actively traded stocks in the Malaysian stock market. **Idea:** This study aims to investigate the impact of a change in government on share price and length of time needed for market adjustment. **Data:** The sample is based on 656 listed stocks on 9th May 2018 which was the election date in Malaysia. Data is obtained from Thomson Reuters Datastream. **Method/Tools:** Event methodology is used to identify abnormal returns (AR) and cumulative average abnormal returns (CAAR) as a measure on the impact of the election on stock prices. AR is averaged across firms to minimize other event effects, thus providing a better measure of the effect of the announcement event. The CAAR represent the average total effect of the event across all firms. **Findings:** This paper provide evidence that a significant political announcement such as election results which is followed by a government change would affect the value of actively traded stocks. The impact is found to be significantly positive CAAR on the selected event windows for both pre and post-event day. This study also finds 67 active trading days is insufficient for the market to recover from a political regime change as the stock market appears to be experiencing volatility during the observation period. **Contributions:** This study is different from other studies in two ways: (1) To our knowledge, there is no study that has yet to investigate the impact of a change in the ruling government on the Malaysian stock market; and (2) This study uses event methodology which would neatly capture specific political events such as dissolution of parliament, election results and delivery of 10 key promises by the newly elected ruling coalition and provide insight of not only the impact a change in ruling party but also immediate reforms made by the new government on the stock market.

Keywords: Bursa Malaysia, efficient market hypothesis, event study, political risk, Malaysia 2018 general election.
JEL Classification: D82, G14, G40

1. Introduction

Since independence in 1957, Malaysia has been governed by the same ruling coalition, Barisan Nasional. The coalition consists of various political parties from Peninsular Malaysia and the Borneo states of Sabah and Sarawak. On May 9th, 2018 after a 61-year rule, Malaysia

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witnessed its first federal government change when the opposition coalition party, Pakatan Harapan won 121 seats out of 222, effectively earning majority seats and appointed as the ruling coalition for the next five years. Tun Dr. Mahathir Mohamad (previously Malaysia's 4th Prime Minister) was reappointed as the 7th Prime Minister and a new set of ministers were appointed to fulfil the various roles that have been vacated by the old regime. A new government means that a new set of ministers would be appointed, resulting in a change in policies and future direction of the country.

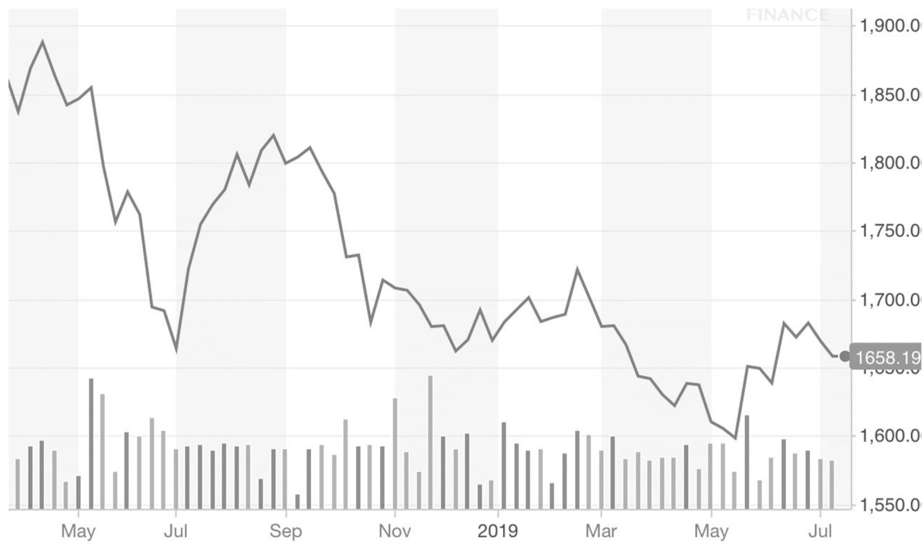
Because the impact and repercussions of a political regime change on the Malaysian stock market has never been documented before, it is important that this change be quantified to determine the impact of political risk on share price. Event study methodology is a common tool used by researchers to investigate the impact of an event on firm value. Introduced by Fama *et al.* (1969), the authors claimed that changes in stock price are due to uncertainties in the market and concerns on whether the firm is able to maintain earnings despite uncertainties. Investors will use whatever information available to reduce uncertainty, therefore political announcements regarding a political regime change would very likely have an impact on future earnings of the firm.

Unlike event studies that focuses on firm announcements, dividend pay-outs, stock splits and other firm related information, the impact of a political event on firm value is manifested differently. This is because, firm related information is usually absorbed quickly into the firm's share price. A change in government, on the other hand, results in a change in policies and this may create uncertainties as to would the firm still be able to maintain its earnings when the policymakers or ruling government change. This paper aims to reveal not only the impact of the recent Malaysian political announcement on share price but also the length of time that is needed for the market to adjust to the change in a new government i.e. political ruling party.

Due to the lack of change in the Malaysian political regime, there have been very few studies focusing on political risk in Malaysia. Among the few is Liew and Rowland (2016) who studied the impact of five most recent political elections in Malaysia from 1995 until 2013. They found that the stock market was unaffected by the elections in the first three elections, i.e. in 1995, 1999 and 2004. However, as the opposition party formed alliances among themselves and attained a larger following, political uncertainty became significant in the 2008 and 2013 elections.

According to the authors, the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBMKLCI) had fallen by 22.88 points two days before the 2013 election, indicating the presence of political uncertainty as investors fear that the ruling party may lose to the opposition. One day after the election results were announced, FBMKLCI hit the highest historical peak and gained 96.29 points. The authors concluded that this indicated resumed confidence by the investors as it has been determined that the same government will be ruling the country for another five years.

The FBMKLCI consists of 30 of the largest companies listed on Bursa Malaysia and is frequently used as an indicator of the Malaysian stock market. Figure 1 depicts the movement of FBMKLCI from April 2018 until July 2019. Since the change in the government administration, the movement of FBMKLCI has been capricious, reflecting the uncertainties in the market following the new government administration. Kumar (2018, July 7) state that FBMKLCI has been persistently negative in the two months following the election, with the stock market experiencing a net foreign outflow of MYR10.77 billion between May to June 2018. It can be seen in Figure 1, for a one-year period between the period of May 2018 until May 2019 FBMKLCI appears to be on a downward trend.



Source: Yahoo Finance (2019)

Figure 1: FTSE Bursa Malaysia KLCI, April 2018 until July 2019

Based on the movement of the index, it appears that negative information is perceived by investors and absorbed by the FBMKLCI for the first year of the Pakatan Harapan government's rule. However, since FBMKLCI only consists of 30 stocks, this scenario may be different for other firms. Hence, this study utilises all firms that are actively traded in the Malaysian stock market. This would allow us to see the overall impact of the political announcement towards shareholders' wealth for all publicly-listed firms in the Malaysian stock market.

Figure 1 also reveal a trickle-down effect on the FBMKLCI as the new government assume control and issue directives such as the introduction of several new policies that would directly affect firm earnings and performance in selected industries. Among them are the abolishment of Goods and Service Tax (GST) to reimplementation of Sales and Service Tax (SST), introduction of a managed float system for the calculation of gasoline and diesel prices, targeted fuel subsidy program to the lower income group, and a review of all the mega projects awarded to foreign countries (Pennington, 2018, December 11; The Star, 2018, August 17; Yong and Ng, 2019, October 7). These changes are among the 10 key promises that the new government had promised to fulfil within the 100 days of being in power.

This study is different from other studies in two ways. Firstly, to our knowledge, there is no study that has yet to look into the impact of government change on the Malaysian stock market. Secondly, unlike an earlier study on the Malaysian general election by Liew and Rowland (2016) that utilizes ordinary least squares (OLS) regression in their study, this study uses abnormal returns (AR) and cumulative abnormal returns (CAAR) to measure the impact of the political event on stock prices. This would allow us to neatly capture specific political events such as the dissolution of parliament, election day and the delivery of 10 key promises[1] by the newly elected ruling coalition. Therefore, this paper will be able to provide insight of not only the impact a change in ruling party but also the impact of immediate changes

[1] Based on The Star Report card: Pakatan's 10 promises in first 100 days (The Star, 2018, August 17).

implemented by the new Pakatan Harapan government as promised in their 100-day manifesto[2] on the financial market.

2. Literature Review

Efficient market hypothesis postulates that asset prices fully reflect all available information (Fama *et al.*, 1969) and prices will change in response to new information. New information can be due to internal changes such as new appointment, termination or retirement of the management team, or announcements that bear financial impact to the firm such as earnings announcements, capital restructuring etc. New information can also be due to market information or other external news such as changes in government policy, new tax policy, the election of a new president, changes in trade agreements and many more that can result in economic uncertainties. Desai (2011) in his interview with Eugene Fama quotes the economist as saying, "*as economic uncertainties increase, volatility in asset prices will also increase*". Hence a regime change would create economic uncertainties and cause asset prices to change as new information is absorbed by the market.

There already exist a significant number of literatures on the impact of regime change on asset prices in other countries. A study by Pantzalis *et al.* (2000) on the movement of stock market indices around political election dates across 33 countries between the period of 1974 until 1995 found strong abnormal returns leading up to election day in two circumstances; (1) in less free countries won by the opposition, and (2) when the election was called early and the incumbent government lost in the election. This is supported by Ahmed (2017) who conducted a study on the impact of political regime change on the Egypt stock market between the period of 2011 and 2014 and found that although there was a volatility effect in the stock market during the two presidential elections in 2012 and 2014, most sector indices responded positively to both elections. Similarly Smales (2014) in his study on political uncertainty surrounding elections in Australia and its impact on the stock market find that higher levels of uncertainty around the election would result in higher levels of market uncertainty and vice versa.

This is in line with the uncertain information hypothesis proposed by Brown *et al.* (1988, 1993) which states that when analysed separately, immediate price changes induced by either favourable or unfavourable events will be followed by positive returns during the post-event period. This hypothesis also states that the market reacts randomly to information and asset prices may not reflect all available information instantaneously. This is as evidenced in Figure 1 where the FBMKLCI appears to be erratic for the one-year period post GE14 as market participants react to announcements and deliberations made by the new government.

After GE14, there are several factors and events that may have caused the stock market to perform erratically. Firstly, the new government had created and distributed thousands of copies of their election manifesto, Buku Harapan which contained promises on changes that will be implemented should they win the election. After winning the election, 10 key promises were identified and promised by the government to be implemented with the first 100 days of being in office. The 10 key promises and its announcement dates are tabulated in Table 1.

The policy changes as presented in Table 1, implemented by the new government affect companies in different sectors. The impact is experienced by the affected firms at different times i.e. when the decisions are announced to the public. The repercussions of these announcements may have a positive or negative impact towards the particular firms' share price in line with investors' concerns as to how the firm's performance will be affected by this announcement.

[2] 100 days manifesto refers to the Pakatan Harapan's promises to the people of Malaysia on the steps they will take when they become the government. It includes the policies and actions promised by the coalition (Pakatan Harapan, 2018).

Table 1: 10 key promises in the first 100 days manifesto by Pakatan Harapan

No.	Key Promises	Announcement date
1	Abolish the GST and take steps to reduce the cost of living	1st June 2018
2	Stabilise the price of petrol and introduce targeted petrol subsidies	18 May 2018
3	Abolish unnecessary debts that have been imposed on FELDA settlers	8 August 2018
4	Introduce EPF contribution for housewives	15 August 2018
5	Equalise the minimum wage nationally and start the processes to increase minimum wage	14 August 2018
6	Postpone the repayment of PTPTN for all graduates whose salaries are below RM4,000 per month and abolish the blacklisting policy	26 June 2018
7	Set up Royal Commissions of Inquiry on 1MDB, FELDA, MARA and Tabung Haji, and to reform the governance of these bodies	4 July 2018
8	Set up a Special Cabinet Committee to properly enforce the Malaysia Agreement 1963	21 July 2018
9	Introduce Skim Peduli Sihat with RM500 worth of funding for the B40 group for basic treatments in registered private clinics	No date available since it is unsuccessfully implemented during the 100 days period.
10	Initiate a comprehensive review of all mega projects that have been awarded to foreign countries	30 May 2018

Notes: Information above is extracted from The Star (2018, August 17).

In his study, Lee (2020) finds that the impact of economic reforms such as the implementation of 10 key promises introduced by the new ruling party affect economic growth and weakened the fiscal capacity of the government. Among them are: (1) the change from GST to SST resulted in a revenue gap amounting to RM22 billion in 2019; (2) an expenditure of RM150 million was required to stabilize and control the price of seven essential goods and services and review of companies such as Padiberas Nasional Bhd., Puspakom, Pharmaniaga Bhd. and MyEG Services Bhd. was made on their monopoly over the supply of certain goods and services; (3) introduction of targeted petrol subsidies to the lower income group; (4) an offer to acquire four tolls in 2019 amounting to a total cost of RM6.2 billion; (5) review and downsizing of mega projects such as the East Coast Rail Link (ECRL), the Kuala Lumpur – Singapore High Speed Rail (HSR), Mass Rapid Transit 2 (MRT2) and the Trans-Sabah Gas Pipeline and many others.

After GE14, FBMKLCI drastically lost value after the historical win by Pakatan Harapan, where the information of a government changes and along with it the uncertainty of introduction of new policies and cancellation of old policies is absorbed by the index. Pastor and Veronesi (2010) concurs, stock prices should respond at each step of the way with bigger price responses following bigger increases in the probability of a policy change. In their study, they found that on average, stock prices fall at the announcements of policy changes – the price fall is expected to be large if uncertainty about government policy is large. The authors conclude that policy changes increase volatility, risk premia and correlations among stocks.

According to Franck (2020, Feb 27), historical analysis shows that market corrections that result in a 13 per cent decline can take about four months to recover to prior levels, on average. CNBC and Goldman Sachs analysed 26 market corrections in the United States since World War II and found that market corrections with an average decline of 13.7 per cent recovers within a period of four months. While bear markets with an average decline of more than 30 per cent takes about 24 months to recover. In the case of Malaysia, it is uncertain how long will the market recover after a political regime change, hence for this study, a 100-day benchmark is used in line with the 100-day manifesto presented by Pakatan Harapan.

Event study methodology is commonly used to measure security price reaction to some announcement or event (Binder, 1998) and the length of time needed by the firm(s) to recover from the event. Introduced by Fama *et al.* (1969) the practice of calculating abnormal returns (AR), average abnormal returns (AAR) and cumulative average abnormal returns (CAAR) have become a familiar method in event study research. This method has been established as one of the techniques that can be used to produce valid results about the average effect of an event on sample firms (Binder, 1998). Based on the focus of interest in this study and the above literature discussion, the hypothesis for this study are as follows:

H_0 Regime change are associated with insignificant abnormal market returns over the selected event windows.

H_a Regime change are associated with significant abnormal market returns over the selected event windows.

3. Methodology

3.1 Sample Selection and Data Collection

As mentioned above, this study aims to determine the impact of the political regime change in Malaysia stock market with reference to the 14th General Election 2018 (GE14). The date 9th May 2018 was the election day in Malaysia and is selected as event day (t_0) in this study. But due to the public holiday on that day and the new government declared another two days of public holiday, the announcement date (t_0) selected for this study is the next trading day, which is 14th May 2018. This study is interested to see how the investors react to the news i.e. Election Commission announcement of the polling date, official campaigning period, the poll results and also the 10 key promises in the first 100 days manifesto by the new government that would give impact to stock prices in Malaysia.

The investigation period is from 28th March until 17th August 2018, yielding 97 daily observations. The data will be divided into two sub-periods. The first sub-period examined from 28th March to 14th May 2018 and called as pre-event window (28 days observation period). Four selected event windows are chosen to capture the important date before polling date i.e dissolution of Parliament (t_{-29} days), nomination process and official 11-day campaigning period (t_{-6} days) and early voting begins (t_{-2} days)[3]. This is important to see the socio-political conditions before the election (Welsh, 2018). While the second sub-period examined is from 14th May 2018 to 17th August 2018 (marking 100 days as a new Malaysia) and called as post-event window. Eight[4] selected events windows are chosen based on the announcement of the successful or unsuccessful delivery of 10 key promises in Pakatan Harapan's election manifesto in first 100 days. The idea is to see the impact of the new government key promises on the financial market.

For the sample selection, initially it was 812 listed companies in Bursa Malaysia. Due to unavailability of data, the final sample was 656 listed companies only. Daily stock closing prices and the market index, namely the Kuala Lumpur Composite Index (FBMKLCI Index), were obtained from *Thomson Reuters Datastream.*

3.2 Event Study Methodology

The method that is most suitable so far in measuring the reaction of security prices to the election day of Malaysia is event study methodology. An event study is able to measure the magnitude of the abnormal share price performance at the time an event is announced, i.e. the election which resulted in a change of government and provide a measure of the (unanticipated) impact of this event on security prices.

[3] If the date is fall on the weekend or public holiday, the next trading day will consider as event window.
[4] One of the promises is unable to fulfil during the first 100 days and another two promises shared the same date.

The study applies the market model, Fama *et. al* (1969) a one factor ordinary least squares (OLS) regression equation to estimate the expected returns. This is the approach to estimate the relationship between a share's returns and returns on the market (FBMKLCI). So,

$$E(R_{jt}) = \alpha_{jt} + \beta_{jt}R_{mt} + \varepsilon_{jt} \tag{1}$$

where α_j and β_{jt} are regression coefficients and ε_{jt} is the error term. Having calculated estimates of α_j and β_{jt} with data from an estimation period, the expected return is given by inserting the estimated values of α_j and β_{jt} together with the actual return on the market (Armitage, 1995). The effect on the rate of returns on security *j* is as follows:

$$AR_{jt} = R_{jt} - E(R_{jt}) \tag{2}$$

Then the average abnormal returns *(AAR)* for a sample of N securities for each day are calculated as:

$$AAR_t = \frac{1}{N}\sum_{j=1}^{N} AR_{j,t} \tag{3}$$

where *N* is the number of firms with abnormal returns on day *t*.

The AR is averaged across firms to minimize other event effects, thus providing a better measure of the effect of the announcement event. The cumulative average abnormal return (CAAR) represents the average total effect of the event across all firms, thus:

$$CAAR_t = \sum_{i=\pm jt}^{n} AAR_i \tag{4}$$

To determine the significant value of the CAAR for the selected event windows, one sample t-test is conducted.

4. Results and Discussion

To determine the impact of the election day on the Malaysian stock market, specific events before and after the election day was chosen to be a selected event window. The results of the CAAR and the *t*-statistic for each of the selected event windows are presented in Table 2.

Prior to election day all selected event windows show positive CAAR with significant t-value at 1 per cent level, respectively. The beginning of the official 11-day campaigning period shows the highest CAAR for pre- announcement event windows. This finding shows that the market reacts to the event and respond to the political uncertainties causing asset prices to change. For post-election event windows, only one window shows negative CAAR which is at day 4 with -0.82 per cent with significant t-value at 1 per cent level. The negative CAAR may results from the shock election win made by the new government. Another seven selected event window shows positive CAAR with significant t-value at 1 per cent level, respectively. The positive and significant value of CAAR point out that investors are reacting to the successful implementation of the key promises made by the new government and absorbed the new information effectively. These findings support results found by Smales (2014) which reported that the political uncertainty surrounding elections can give impact on the stock market and would result in higher levels of market uncertainty and vice versa. Moreover, the finding found by Brown *et al.* (1988, 1993) which states that immediate price changes induced by either favourable or unfavourable events will be followed by positive returns during the post-event period.

Table 2: CAAR and the *t*-statistics for the selected event windows

	Event windows	Events	CAAR	*t*-statistic
Pre-Election	t_{-29}	Prime Minister Najib Razak tabled the Election Commission's redelineation report in Dewan Rakyat	0.59	-39.9862**
	t_{-22}	Formal dissolution of Parliament	3.84	-36.2578**
	t_{-6}	Official 11-day campaigning period begins	3.91	-14.1214**
	t_{-2}	Early voting begins	3.04	-6.7860**
Post-Election	t_{+4}	Stabilise the price of petrol and introduce targeted petrol subsidies	-0.82	-32.0001**
	t_{+11}	Initiate a comprehensive review of all mega projects that have been awarded to foreign countries	1.00	-11.3689**
	t_{+13}	Abolish the Goods and Services Tax (GST) and take steps to reduce the cost of living	0.79	-13.3023**
	t_{+29}	Postpone repayment of Perbadanan Tabung Pendidikan Tinggi Nasional (PTPTN) for all graduates whose salaries are below RM4,000 per month and abolish the blacklisting policy	8.00	-7.6125**
	t_{+35}	Set up Royal Commissions of Inquiry on 1Malaysia Development Berhad (1MDB), Federal Land Development Authority (FELDA), Majlis Amanah Rakyat (MARA) and Tabung Haji, and to reform the governance of these bodies	5.57	-6.5518**
	t_{+48}	Set up a Special Cabinet Committee to properly enforce the Malaysia Agreement 1963	2.79	-7.8044**
	t_{+60}	Abolish unnecessary debts imposed on FELDA settlers	0.38	-10.0518**
	t_{+65}	• Equalise the minimum wage nationally and start the processes to increase the minimum wage • Introduce Employees Provident Fund (EPF) contribution for housewives	2.91	-11.0116**

Notes: ** Denotes statistical significance at 1 per cent level.

The finding found in this study also consistent to the EMH which stated share prices reflect all available information (Fama *et al.*, 1969) and prices will change in response to new information. The announcement of the successful or unsuccessful of the key promises and the events before the pooling day refer to the new information that might affect the financial market and economic uncertainties as a whole. Hence a political regime change is the key event that would create economic uncertainties and give impact to the share prices as new information is absorbed by the market.

Figure 2 shows FBMKLCI, AAR and CAAR for 656 companies for the period of 95 active trading days, (t_{-29}, t_{+65}) and separates the AAR and CAAR for pre and post-election day, respectively. The highest CAAR is 8.40 per cent at day 29 after announcement and the lowest is -3.33 per cent at day 7 prior to the announcement. On day 29 after election day, the good news absorbed by the market whereby the new government successfully fulfil one of the important promises which is postponed the repayment of PTPTN for all graduates whose salaries are below RM4,000 per month and abolish PTPTN's blacklisting policy. The lowest CAAR may results from the nomination process and beginning of official 11-day campaigning period. A key campaign issue in GE14 was influential of the media social (Welsh, 2018). This include its synergies with political advertising.

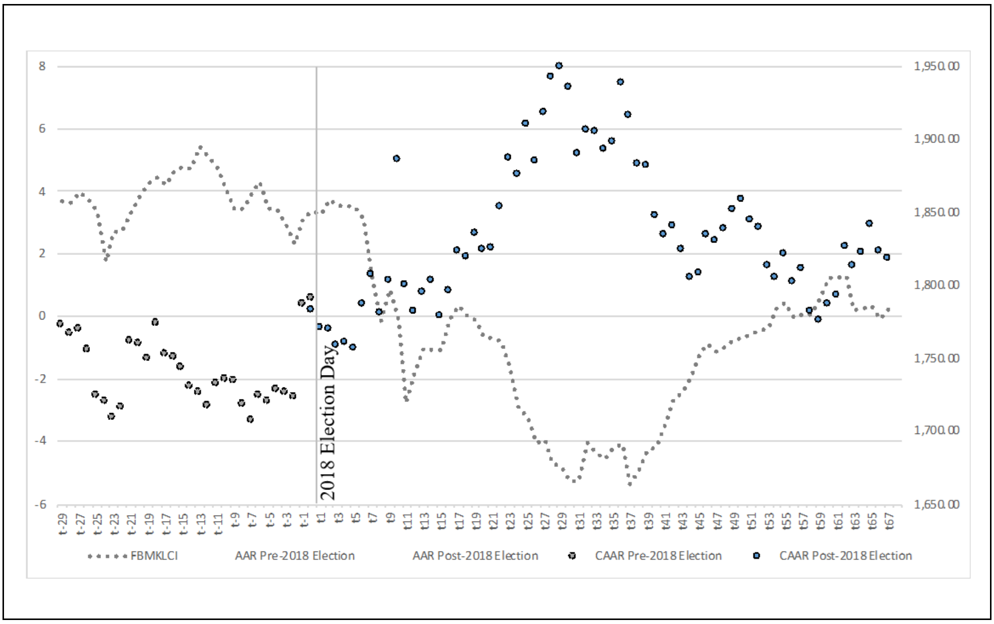


Figure 1: FBMKLCI, AAR and CAAR for companies listed in Bursa Malaysia for 95 active trading days

The trend reveals that positive abnormal returns before election days which started from day 29 until two days before the election day was significant to the news released on 10 April 2018 (21 active trading day prior to event) by the Election Commission chairman Hashim Abdullah which announced that the general election will took place on Wednesday, 9th May 2018. Investors respond negatively to the news that polling day will fall during a weekday and detect suspicious agenda in the selection of polling date. This is in line with findings found by Brown *et al.* (1988, 1993) which states that the market reacts randomly to information and asset prices may not reflect all available information instantaneously.

Day 5 after the election day marks as a turning point for positive abnormal returns. This shows that investors react to the events and news spread in the market and start trading actively. This led the price to increase with investors earning positive returns. Increases in expected returns are directly linked to increases in stock variability induced by the events themselves (Brown *et al.*, 1988, 1993). Then two days after the announcement on the set up Royal Commissions of inquiry on 1MDB, FELDA, MARA and Tabung Haji and to reform the governance of these bodies was made, the CAAR start to decline drastically. This could be due to the heavy scandal in these institutions (including money-related issues) which give negative perception to the investors and they absorbed the information negatively. More than that, the market under pressure impacted by the new government's 100-day election manifesto (which is due on 17 August 2018). The investor perceived the news negatively and create a panic market by their judgment. According to Brown *et al.* (1988, 1993) short-run behaviour of stock prices following unexpected and substantial news announcements does not reveal evidence of anything but rational judgment by investors. The degree of selling pressure during the campaigning period and the poll results may affect the stock market's performance post-election (NST Business, 2018, April 9). Additionally, the stock market investors expect the ruling Barisan Nasional to win comfortably in GE14. This could be the reason stock prices fluctuate, sometimes rapidly and dramatically, due to unexpected poll results.

In Figure 2, it is also evident that post-election day, FBMKLCI performed opposite to CAAR from t_3 to t_{57}. As stated earlier, FBMKLCI comprises of 30 of the largest companies in the stock market and it appears that the change in ruling government, as well as the introduction of new policies by the new government is perceived as negative news by investors, therefore a negative impact can be seen by the reduction in the value of 30 of the largest companies in Bursa Malaysia but the impact is not the same to the other 656 actively traded companies.

5. Conclusion

The aim of this study was to find the impact of a political announcement i.e. the results from the GE14 (which resulted in a regime change) on share price and the length of time that is needed for the market to adjust to the announcement. Similar to Pantzalis *et al.* (2000) and Ahmed (2017), we find there is significant abnormal return on the selected event windows for both pre and post-event day. This study also finds that the market reacts to the events and new information released within two to five days prior to the announcement of the event.

It can also be concluded that post-election announcement, the impact of a political regime changes to the stock market based on FBMKLCI is not reflective with CAAR of actively traded stocks in the Bursa Malaysia. The index appears to have a negative reaction to the political regime change while actively traded stocks in Bursa Malaysia experienced significantly positive CAAR.

Moreover, a 100-day benchmark or 67 active trading days is insufficient for the market to recover from a political regime change as the stock market appears to be experiencing volatility during the observation period. It is recommended for future studies to utilise event periods of longer than 67 observation days to see the length of time needed for the stock market to fully adjust to the news.

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