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The Impact of Political Events - "Name Issue" on an Emerging Macedonian Stock Market

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Abstract

The objective of the research is to investigate the impact of political events – "name issue" on the Macedonian Stock Exchange (MSE). Structural changes in volatility of Macedonian capital market seems to be more a consequence of political changes, especially from the perspective of international politics and the association of the country into NATO and the European Union.

The research analyzes the response of capital markets to political events. Such an event is the summit in Bucharest as the day D (03/04/2008) which certainly had an impact because of prolonged unresolved problem of the name imposed by Greece. Visa liberalization and the day of solving the status of candidate country for accession to the European Union will be discussed too. An event methodology is employed, and the results suggest that the market respond to all political events connected "name issue". The results also indicate that there is no difference between the means of abnormal returns before and after the event.

Sensitivity of the Macedonian investor related to any information connected to the word "name" is enormous. The Macedonian investor belief is that if "name" issue would be solved, regardless of possible negative real economic flows stock exchange will increase. The paper provides information regarding the effects of solving this name issue on Macedonian investor, and his expectation on this issue. But even if it is solved, the global economic crises and difficult economic situation in Macedonia especially this situation will be temporary and due to low liquidity, foreigners may use local optimism to sell their shares.

Keywords: Event studies, emerging markets, Macedonian Stock Exchange

1. Introduction

It is well known in financial literature that the movement of capital markets is a function of economic news. The capital market is a tool of economy and plays an important role as an indicator of its condition. But the economic news is not the only factor affecting the capital markets. Also, the capital market shows how stable political situation in the country is. If the political situation is stable, probably the capital market is stable too. On the contrary, unstable political condition deteriorates the performance of a country's economy that is reflected by price changes in the market as a whole. Political events are many times responsible for the movement of stock prices. Although having no direct relationship with the stock market, political issues or events have been well known to be one of the main factors that affect stock market. Political issues have been so important that investors, before investing their money in a country's capital market, will conduct a study of how stable that country is. In other words, a country whose political situation is stable tends to attract more investors than those with unstable political condition.

Investors and researchers see political risk as an influential factor in the valuation of shares. Political risk is the uncertainty which escalates incidents that have strong political implications, such as elections, changes in government policy, domestic and international conflicts that significantly affect the prices of securities.

This study uses an event study methodology to examine the response of the Macedonian stock market to events connecting the most important political event – "name issue". Since foreign investors are a key factor for dynamic development of the Macedonian capital market, expectations of the Macedonian investors are that resolving the name issue would return the foreign interest in investing on the Macedonian Stock Exchange.

The rest of the paper is organized as follows. Section 1 presents Literature Review. In section 2 we present the Development of the Macedonian Securities Industry. Section 3 describes the events, the data, and the methodology. Section 4 presents the empirical results and section 5 concludes.

2. Literature Review

The emergence of a political event signals a potential change in national policy or uncertainty in social development and thus would presumably cause an impact on the valuation of the capital market. Of course, most of the existing literature studies focus on the impact of economic events in the prices of securities and less empirical studies have been made about the impact of political events. Niederhoffer, Gibbs and Bullock [1970] , Peel and Pope [1983], and Gemmill [1992] studied the behaviour of stock prices during elections in different developed countries and using the profitable trading rule found weak evidence of inefficiency on the time of elections. They argue that changes in government administration caused by the elections tend to affect the financial policy or legislation, which significantly affect stock prices. On the other hand, Cutler, Poterba and Summers[1989], exploring the influence of political events on stock prices, found no evidence of significant impact on non economic events to the movement of U.S. capital market. In emerging countries, Chan and Wei[1996] and Kim and Mei[2001], have made studies on the impact of political events on the capital

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market. In both studies they documented that political events significantly increase volatility on capital market in Hong Kong. Examining three types of risk such as: economic, political instability and variability in the political factors in 45 emerging countries, Le and Zak [2006] found that all three factors are statistically significant, but the most important factor associated with capital flows is political uncertainty. Using analytical estimates for political risk, Diamonte, Liew, and Stevens[1996] concluded that the average income in emerging countries that face reduced political risk is higher by about 11% of those emerging countries facing increased political risk. They also proved that the difference in the impact of political risk between developed and emerging countries is statistically significant. Bilson, Brailsford, and Hooper[2002] presents evidence that political risk may explain some of the variations in market returns in emerging countries, particularly in the Pacific region, but not for developed countries.

Sharp drop in stock prices during turbulent times is a very unique opportunity to test the hypothesis of efficient markets. Unexpected events may create more stress on the market and market participants may lose ability to assess rationally the consequences of the event. In this regard, numerous studies investigate the behavior of the stock prices as uncertainty in the financial market increases after the dramatic events.

There are basically two types of event studies. The first type is market efficiency studies to assess how quickly and correctly the market reacts to a particular type of information. And the other type is information usefulness i.e. to assess the value of the content of released news to company returns. Fama et al. [1969], and Ball and Brown [1968] introduced the event study methodology that is essentially the same as that which is in use today. The study by Fama et al. can be categorized as an efficient market study, while Ball and Brown’s is an informational usefulness study. Fama et al. examined the impact of stock splits on security prices. They found that abnormal returns dissipated rapidly following the news of stock splits. Ball and Brown examined the value of company’s earnings announcements.

3. Development of The Macedonian Securities Industry

Macedonian capital market is represented by the Macedonian Stock Exchange. The modern history of the capital market is associated with structural changes in the 1990s, crossing the country's transition to free market economy. The process of privatization has already resulted in the formation of more joint stock companies which have imposed the necessity of creating the marketing infrastructure for transfer of newly created securities. Although many regional markets passing through the same transition period were established earlier, the constitution of the Macedonian Stock Exchange launched in September 1995. However, the official start of trading on the Macedonian Stock Exchange is considered March 28, 1996, when the first stock bell rang with a very modest amount of trading. Its main function is to provide a central market place for buyers and sellers to transact shares and bonds. The following year was the first year of active operation of the Macedonian Stock Exchange. The years that followed showed that the stock market grew gradually, along with economic development and intensification of reforms. Table 1 and Figure 1 show the development of the Macedonian Stock Exchange, followed by huge growth in the turnover of trading in 2006 and 2007, and a huge increase in the share of market capitalization to gross domestic product. Enormous

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increase in turnover in 2007, with much greater participation in the gross domestic product, was also accompanied by a huge reduction in turnover in 2008, which is not in line with growth in gross domestic product and, above all, that shows the beginning of the global crisis.

Table 1. Development Of The Macedonian Capital Market In The Period 1996-2008 (In Mil. Euro)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP	3.319	3.241	3.150	3.448	3.893	3.839	4.001	4.105	4.325	4.676	5.176	5.791	6.509
Value trading*	0,65	19,20	76,97	25,61	128,12	472,83	94,19	123,41	135,57	145,02	506,91	681,63	202,04
Market capitalization **							523	638	889	1.218	1.780	5.052	2.032
Market capitalization / GDP x 100							13,08	15,54	20,56	26,04	34,39	87,23	31,22

*Volume of trading in shares (of official and regular market) and bonds, ** total market capitalization (shares and bonds). Source - Eurostat, Macedonian Stock Exchange.

The capital market in Macedonia has undergone a robust development since the 2005. During the period 2005 – 2009, the Macedonian Stock Exchange witnessed its first bull and bear market in its short history. At the end of 2004, foreign individuals from Slovenia, taught by their own experience of trading on the Ljubljana Stock Exchange, made their first investments on the Macedonian Stock Exchange, causing the first major movement of stock trading in the spring of 2005. Stressed inflow of foreign investors who were mostly from the region continued in 2006, so that 2007 was the most successful in the short history of the Macedonian Stock Exchange, including the growing number of domestic and foreign investors. Since foreign investors are a key factor for dynamic development of the Macedonian capital market, expectations of the Macedonian investors are that resolving the name issue would return the foreign interest in investing on Macedonian Stock Exchange.

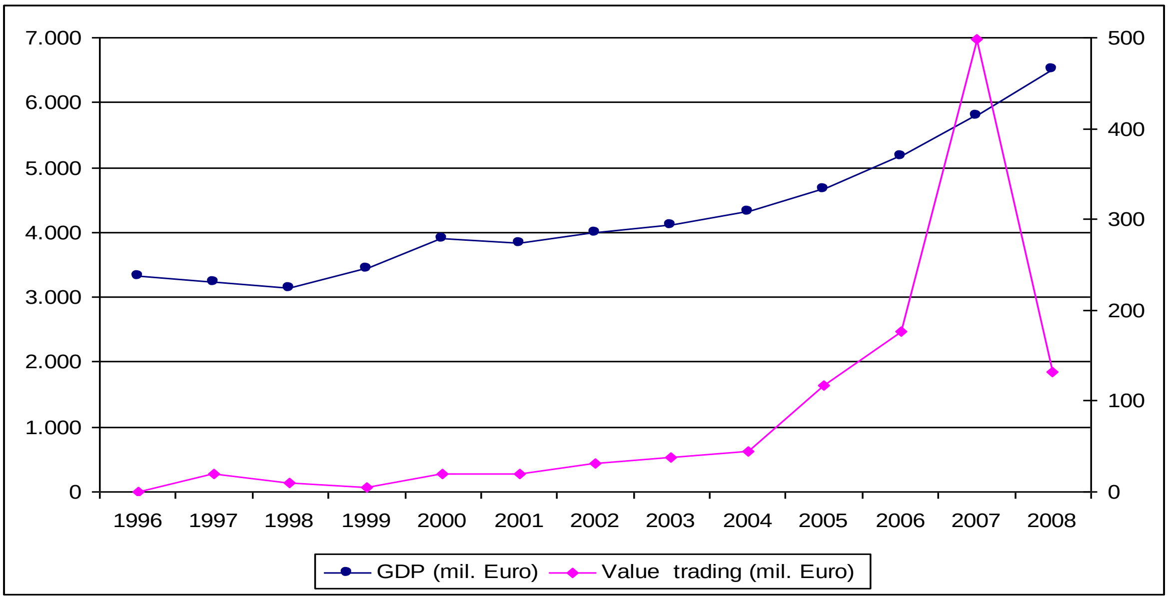

Figure 1. Movement Of Gross Domestic Product And The Turnover Of The Macedonian Stock Exchange (Excluding Block Transactions) For The Period 1996 To 2008

3.1. “Name Issue”?

The Macedonia naming dispute refers to the disagreement over the use of the name *Macedonia* between Greece and the Republic of Macedonia. Greece opposes the post-1991 constitutional name of its northern neighbor, citing historical and territorial concerns resulting from the ambiguity between it and the adjacent Greek region of Macedonia. Greece also objects to the ambiguous use of the term *Macedonian* for the neighboring country's main ethnic group and language. The dispute has escalated to the highest level of international mediation, involving numerous attempts to achieve a resolution, notably by the United Nations.

The provisional reference *the Former Yugoslav Republic of Macedonia* (FYROM) is currently always used in relations involving states which do not recognize the constitutional name, *Republic of Macedonia*. Nevertheless, all United Nations member-states, and the UN as a whole, have agreed to accept any final agreement resulting from negotiations between the two countries. The ongoing dispute has not prevented the two countries from enjoying close trade links and investment levels (especially from Greece), but it has generated a great deal of political and academic debate on both sides.

Negotiations aimed at resolving the dispute are ongoing. There are three things that NATO means for Macedonia. First, it means improved security. Second, it means making a step ahead toward the club of stable, established democracies. And third, NATO means an added value to the investment climate.

4. Research Methodology

Event study is used to analyze the response of capital markets to domestic political events. Many events cannot be accurately classified according to the time and length of appearance.

For those political events that are accompanied by large changes in prices, there is evidence that the event occurred and had an effect on a particular day. Such an event is the summit in Bucharest as the day D (03/04/2008) which certainly had an impact because of prolonged unresolved problem of the name imposed by Greece. Visa liberalization and the day of solving the status of candidate country for accession to the European Union will be discussed too.

The objective of the research is to investigate the impact of domestic political events on the stock market. Specifically the objective is to examine:

- Whether domestic political events generate abnormal returns to security holders; and
- Whether the average abnormal returns before and after the events are significantly different.

4.1 Events Identification

Structural changes in volatility of the Macedonian capital market seems to be more a consequence of political changes, especially from the perspective of international politics and the association of the country into NATO and the European Union. Hence, stock return volatility on the Macedonian capital market is more influenced by domestic political and economic developments rather than global events. Political risk is very important for international investors because political events often have a dramatic effect on the capital market.

Hence, if there is a widely accepted view that foreign investors would come to a greater extent in the Macedonian capital market, and in other economic spheres, only if we have security that would guarantee membership in NATO, we can assume the impact of no accession to this membership. For those political events that are accompanied by large changes in prices, there is evidence that the event occurred and had an effect on a particular day. Such events are

1. The Summit in Bucharest as the day D (03/04/2008) which certainly had an impact because of prolonged unresolved problem of the name imposed by Greece.
2. Visa liberalization as the day of announcement D (20/10/2009) and
3. The day of solving the status of candidate country for accession to the European Union as the day D (07/12/2009).

While Event studies aimed at the post of corporate news have particular impact on stock prices of companies, the impact of political developments point towards the market (index) by the perception of the predominance of demand or supply of shares. The political situation in Macedonia has a large impact on the foreign and domestic investors' perception to buy shares. Sensitivity of the Macedonian investor related to any information connected to the word "name" ***i***s enormous. The Macedonian investor belief is that if "name" issue would be solved, regardless of possible negative real economic flows stock exchange will increase.

4.2. Data

The data used in this study are daily returns of market index MBI10. The data was primarily obtained from the Macedonian Stock Exchange. This study was also limited to the indices traded from 11th November 2007 to 15th December 2009.

4.3 Hypotheses

There are two hypotheses used in this study:

1. H_0: Domestic political event produces zero abnormal returns.
   Ha: Domestic political event produces significant abnormal returns.
2. H_0:Average abnormal returns post-event are not different significantly from those of pre-event.
   Ha: Average abnormal returns before and after the event are significantly different.

4.4 Methodology

Event methodology is employed in this study to analyze the response of the stock market to political events. The choice of an appropriate length of the event period is an empirical question, since too long period allows other news events to offset the ones that are of interest to this study, while too short may mean the effect of the event not to be fully observed. The nature of the political situation in Macedonia, is mainly replaced by incoming information regarding the name issue imposed by Greece, which is the main problem for Macedonia's entry into international associations. The estimation period will be 100 days prior to the event period. If the event period is 5 days before the event and five days later, i.e. 11 days, then the estimation period is 105 days before the event. The estimation period is the time period to determine the expected returns of the indices. An event period is a time period used in the calculation of abnormal returns.

The time line for this study employing 100 days of estimation period and 11 days of event period may be described as follows: In this study, the mean-adjusted returns model is employed to estimate normal or expected returns. Mean-adjusted returns are event period returns minus a constant, the constant being the average return during its estimation period. Mean-adjusted return is employed because it is seen as the most appropriate compared to other models such as market models and market-adjusted model, when an event seems to affect the stock market as a whole. Since political events do not affect certain share prices or certain industrial indices, the employed mean-adjusted return model is better than the market model and the market-adjusted model.

The mean-adjusted return model assumes Mean return over the T periods within the estimation period:

$$R^* = (1/T)\sum_{j=1}^{T} R_j \tag{1}$$

where

T = number of days in the estimation period.

The excess return (also referred to as the abnormal return or the prediction error) over a given period is the difference between the observed or actual return for that period and the expected or predicted return for the same period:

$$ARt = Rt - R^* \tag{2}$$

where
ARt = Abnormal index return or prediction error in day t in the event period;
Rt = Return in day t in the event period; and
R*= Mean return over the T periods within the estimation period.
Standard deviation of the daily returns during the estimation period from t–105 through t-6 is calculated as follows:
The standard deviation of daily returns in estimation period is:

$$\sigma = \sqrt{\frac{\sum_{j=-105}^{j=-6}(R_j - R)^2}{99}} \tag{3}$$

where

σ = Standard deviation of returns in the estimation period. Each abnormal return for a given day in the event period can be tested by using the following equation:

$$\text{t-statistic}=\frac{AR_t}{\sigma} \tag{4}$$

To test the first hypothesis and to determine whether there are significant abnormal returns, we compute t-statistics. If the t-statistic is significant on the day of the event but insignificant on the days following the event, a reasonable conclusion can be drawn that the event affects the returns but that it does not contradict the efficient market hypothesis. In contrast, if the t-statistic continues to be significant on the days following the event day, a conclusion that the market is not efficient will be made. If the significant t-statistic is observed before the event occurs, the event might be anticipated.

In order to test the second hypothesis, first, we need to calculate average abnormal return before and after the event, that is, the averages of 5- day abnormal returns before and after the event.

$$AR^*_{before} = \frac{\sum_{t=-5}^{t=-1} AR_{before,t}}{5} \tag{5}$$

Where AR*before = average abnormal return before the event day.
and

$$AR^*_{after} = \frac{\sum_{t=1}^{t=5} AR_{after,t}}{5} \tag{6}$$

Where

AR^*_{after} = average abnormal return after the event day.

Secondly, we calculate standard deviation of average abnormal return before and after the event:

$$\sigma_{before} = \sqrt{\frac{\sum_{j=-5}^{j=-1}(AR_{before,t} - AR^*{}_{before,t})^2}{n-1}} \tag{7}$$

and

$$\sigma_{after} = \sqrt{\frac{\sum_{j=5}^{j=1}(AR_{after,t} - AR^*{}_{after,t})^2}{n-1}} \tag{8}$$

In order to test the difference of means, a pooled standard error of the difference between means of the samples must be calculated first. The formula to calculate the combined standard error of difference between means is as follows:

$$\sigma_{pre-post} = \sqrt{\left(\frac{(n_1-1)\sigma_1^2 + (n_2-1)\sigma_2^2}{n_1+n_2-2}\right)\left(\frac{1}{n_1}+\frac{1}{n_2}\right)} \tag{9}$$

Where

σ_1^2 is the variance of pre-event period;

σ_2^2 is the variance in the post-event period;

n_1, n_2 is the number of days in the period before and after the event.

The statistical t-test is used to observe whether there is a difference between the means of each abnormal returns pre and post-event period. In this study, it is the difference between means of the five days abnormal returns before and after an event. To calculate t, the following formula is used:

$$t = \frac{AR^*_{after} - AR^*_{before}}{\sigma_{pre-post}} \tag{10}$$

5. Results Analysis

5.1 Non-acceptance in NATO

Macedonia did not get acceptance in NATO on 04/03/2008, and MBI-10 saw a record daily fall in its history and lost 8.4% of its value. But despite a record decline in MBI-10 index of daily level, achieved a total turnover of the stock of 76.7 million denars is among the top five best trading days in 2008, so some new restrictive measures were not taken by the Board of Directors of the Macedonian Stock Exchange.

The average abnormal return in the period before the event was 0.67 and testifies for

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investors hope that the admission into NATO was almost certain. The uncertainty about the event and the variety of information obtained led to great intraday volatility, actually in the beginning of the trading an expectation that the admission to NATO was resolved, but after 11 a.m. the news that there was no acceptance and that the delegation was on their way home was announced. The announcement of the news reflected in the stock prices, so by 11 a.m. prices of some shares reached their maximum and then followed dramatic fall. Table 2 shows that foreigners also followed the same information. The table depicts foreigners' trading the day before the event and the day of the event; it is shown that the day before the event foreigners were only selling shares, while on the day of the event they were buying and selling shares with the same pace. So in the period after the event the average negative abnormal return amounts -0.34. The statistic t-test used to test the significance of the difference between the means of five-day abnormal returns before and after the event (-0.83), shows that the alternative hypothesis, however, cannot be rejected, in fact there is no significant difference in the average abnormal returns before and after the event.

Table 2. Foreigners Trading On The Macedonian Stock Exchange, 2 And 3 April 2008, Expressed In Denars

	Sell	Buy	Neto
02/04/2008	51.609.069,00	2.325.540,00	-49.283.529,00
03/04/2008	21.999.712,00	22.712.844,00	713.132,00

There was no significant abnormal return in the event period. However, on the day of the announcement the abnormal return turned to negative and significant. Therefore, we can reject the first hypothesis.

5.2. Visa liberalization

Next event that inspired great joy among the Macedonian citizens is the long-awaited visa liberalization. On 19/10/2009, the Commission on Civil Liberties, Justice and Home Affairs of the European Parliament backed the abolition of visas for Macedonia, Serbia and Montenegro from January 2010. On 20/10/2009, all mediums reported the news, but the news was in favor of the speculative movements on the market with large price movements. Bull market comes after a long period of decline and stagnation in the share price. The main stock index MBI10 has risen more than double, after it reached its bottom in March when was only 1590.00 points, while on 16/10/2009 it was 3922.29 points, reaching the highest value in 2009. Stock Exchange reacted to the positive trends in world markets and to the information about coming out of recession in most global economies, although in Macedonia there was no sign of economic revival. Larger price growths in the stock market began in the second half of September, and were especially prominent in early October. The atmosphere was inflamed with optimism that Macedonia would receive a positive recommendation from the European Commission to start negotiations for membership in the Union, so in only two weeks (from early October until mid-October), the Macedonian Stock Exchange underwent a dramatic increase of 30% in the value of the index MBI10. The growth of the stock prices did not happen as a result of the financial results of companies, but based on expectations for developments on the political scene.

The euphoria that engulfed the Macedonian investors, although there were no real grounds, hoping to be repeated 2007, quickly slackened after the first big fall. This increase in the index was only fuelled with the event for visa liberalization, so that the event was already anticipated, as investors followed the trend. Two days before the announcement of visa liberalization, i.e. 16.10.2009, the index undergone a record fall while on the day of announcement it has grown by over 5%, but however the next days a fall was again registered. The constant R in the estimation period is 0.55.The average abnormal return in the period before the event is -0.35, and the average abnormal return in the period after the event is -2.04. The explanation that the visa liberalization was only a supplement to update the prices, it followed that testing the models using the study of events would only confirm the inefficiency of the market with t-statistics that are significant on the day of the event, as in the fifth, fourth and second day before the event, and the second and fourth day after the event. Therefore, we can reject the first hypothesis- Domestic political event produces significant abnormal returns.

The second hypothesis, however, cannot be rejected; there is no significant difference in average abnormal return before and after the event.

About the sensitivity of the Macedonian capital market on information relating to resolving the name dispute and the subsequent entry into NATO and the EU, testifies the behavior of the investors on 2/12/2009, when a wrong information was posted in particular wrong translation of the statement of Deputy Foreign Minister of Greece, Dimitris Drucas was given that “it is impossible to start negotiations without FYROM name solution”. With help from Google, this statement was translated as "without solution to the name dispute negotiations on Macedonia's accession to the European Union will be opened”. After inspecting the news that regarding all the elements was sensational, Macedonian investors realized that the error in translation would have led to delusion again.

After posting the wrong information the index has grown, actually in the last 30 minutes of trading the index has raised from 3064 to 3102 points. Specifically, relying on the computer translation of Google inspired the Macedonian public to one more euphoric episode before December 7 and the final decision of the Council of the European Union when and whether our country will begin accession negotiations.

5.3. December 7th and the final decision of the Council of the European Union when and whether our country will begin accession negotiations.

However, on 2/12/2009 the index rose by 4%, while on December 7th - the day when Macedonia did not get a date for negotiations, fell for 4%. The average abnormal return in the period before the event is -0.28, and is not different from the average abnormal return in the period after the event -0.21. T-statistics are significant on the day of the event, as in the third day before the event (the day of Google mistranslation), and the fourth day after the event. Therefore, we can reject the first hypothesis. Domestic political event produces significant abnormal returns.

The second hypothesis, however, cannot be rejected; there is no significant difference in average abnormal return before and after the event.

Further analysis of the impact of political events on the capital market is not necessary since the Macedonian investor is sensitive only to the word "name" and is convinced that resolving the name issue will cause dramatic rise in the prices of shares.

Expectations will actually be the driving force for the local investors to push the market with the hope that foreign investors will immediately come to our market. But in the time of the euphoria in the first half of October, foreigners used the euphoria or provoked it more in order to reduce their positions in the Macedonian capital market, which is shown in Table 3.

Table 3. Foreigners Trading From 01/10 To 10/15/2009 On The Macedonian Stock Exchange, Expressed In Denars.

Date	Forigners sell	Forigners buy	Neto
10/01/2009	16,502,887.00	1,467,900.00	-15,034,987.00
10/02/2009	4,398,994.00	950,989.00	-3,448,005.00
10/05/2009	5,183,033.00	2,769,486.00	-2,413,547.00
10/06/2009	8,390,746.00	2,545,179.00	-5,845,567.00
10/07/2009	5,457,627.00	2,651,830.00	-2,805,797.00
10/08/2009	10,260,080.00	6,330,432.00	-3,929,648.00
10/09/2009	17,082,893.00	1,130,507.00	-15,952,386.00
10/13/2009	23,732,440.00	5,637,170.00	-18,095,270.00
10/14/2009	16,268,101.00	3,135,274.00	-13,132,827.00
10/15/2009	11,947,237.00	1,529,932.00	-10,417,305.00

6. Summary And Implication

Political issues in particular “name issue” is very important for the capital market in Macedonia. Uncertainty regarding the question of the name Macedonia and entry into international associations is large and optimistic expectations can be easily created with the statements of politicians depending on the interpretation of individuals. So before each event an optimistic atmosphere is created that the solution is found. It certainly encourages rumors and the stock market responds with positive movement.

In this study, 3 events connecting the most important political issue are analyzed and similar responses have been obtained. According to the results of the analysis composite index responded to the political events on the day of the event i.e. the Summit in Bucharest as the day D (03/04/2008) which certainly had an impact because of prolonged unresolved problem of the name imposed by Greece, Visa liberalization as the day of announcement D (20/10/2009) and The day of solving the status of candidate country for accession to the European Union as the day D (07/12/2009). In most cases, the information is fully incorporated with the expectations that the problem will be solved. We do find that there is evidence of an event being anticipated. In the case of event 2, for example, a significant abnormal return occurred a few days before the public announcement.

In fact, the people have considered political issues as a common phenomenon. In other words, political issues have become part of the people’s life in the country. So the main factor that impact stock exchange movements is any information about the “name issue”, statements that it might be solved moves the stocks prices. Such statements help speculators to create rumors or information about some of the events had actually been circulating among the public.

During the research we went through, if we could identify like that, two negative, one positive and one false event. We saw that the positive event, fuelled the speculative activity because when the investors were looking at the rise on the stock market, they believed that it was caused by the announcements about the visa liberalization, besides the fact that those investors did not have any real explanations why the resolution of this issue should impact the capital market.

Regarding what happened with the false announcement about the resolution of the "name issue", we can assume what could have happened if only the desirable solution has been reached. The expectations of the local investors would have moved the prices, but in the short term, having in mind the whole economic situation of the country as well as of the environment, where the foreign investors come from.

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