Chapter 1

INTRODUCTION

1.1 Background of the Study

Stock market is an instrument of the economy of a country. Nowadays, it plays an important role in reflecting the country's well-beings. It also reflects how stable a country's political condition is. If the political situation is stable, it is more likely that the stock market will also be stable. On the contrary, unstable political condition deteriorates the performance of a country's economy that is reflected by price change of the market as a whole.

It is believed that stock market is influenced by many factors such as economic, non-economic, and political events. According to the proponents of fundamental approach, the economic climate is the major factor in determining the primary trend of the stock market. They consider the stock market to be a reliable barometer of a country's economy. They believe that stock prices are a reflection of future expectations of the economic well-beings of the country. Basically there are two categories of economic issues that influence the stock market: microeconomics and macroeconomic issues. The influences of microeconomic issues such as company performance, merger, change in strategy, financial statement announcement, dividend or capital investment announcement are always responded by the investors in stock market.

Furthermore, macroeconomic issues such as change in interest rate, exchange rate, inflation, and the government regulation do affect stock market. Unlike microeconomic issues that affect individual companies, the effect of macroeconomic events are absorbed by a larger group of companies such as an industry that is affected by a particular government policy. In some cases, they affect the stock market as a whole.

Non-economic events such as natural catastrophes, nuclear reactor accidents, airplane crash, and earthquake are believed to have a significant effect on certain companies or a group of companies. They believe that non-economic events also convey important new information to the market.

Although having no direct relationship with stock market, political issues or events have been well known to be one of the main factors that affect stock market. A stable political condition tends to increase the economic performance of a country. Furthermore, a stable political environment reflects lower political risk. 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.

Some issues such as a human right abuse, governmental change, social unrests, and other political phenomena, are some of the main factors that influence the stock market particularly of the emerging economies such as Indonesia, Malaysia, Thailand and the Philippines. The often-observed link between dramatic political events and large market moves clearly supports the above assertion. For example, a study by Diamonte et.al. (1996) concluded that political risk represents a more important determinant of stock returns in emerging than in developed markets.

There have been some studies that attempt to examine the stock price reaction to political events. Some examples of such studies include: governmental change (Asri, 1996), clashes over a political party's head office (Suryawijaya and Setiawan, 1998), war and peace news (Shapiro and Switzer, 1999), Sino-British negotiations and Tiannanment incident (He, 1999), etc.

This study extents a previous research by Asri, and Suryawijya and Setiawan on the response of stock market to domestic political events in a number of ways. Like the previous studies, this study uses an event study methodology to examine the response of stock market to relevant news. However, unlike the previous studies that used one event, this one employs more political events to better assess the stock market reaction. In addition to negative characteristic events, positive events are also considered in this study. Finally, an attempt had been made to explain the observed abnormal returns for the most recent events.

1.2 Research Question

The two central questions being investigated are: Do domestic political events affect stock market? And do the average returns before and after the event differ significantly? These questions can be achieved by analyzing the movement of the market indexes both composite and sectoral due to political events.

1.3 Objectives of the Study

This study mainly has two objectives. First, as a way of testing the market efficiency. The Efficient Market Hypothesis (EMH) can be defined as one in which all the relevant information is widely and cheaply available to investors and the prices of securities fully reflect that information rapidly and accurately. This study attempts to investigate the stock market reaction to the domestic political events. If the market is efficient, then we would expect that the market reacts immediately after the events. Contrarily, if the market is not efficient, it may be possible for anyone to take advantages from the available information to earn from the abnormal returns. The second objective of this study is to evaluate whether each industry will respond in the same pattern to the available information. The results of this study will indicate if the domestic political events convey important new information to the market that is reflected across all industries or only in particular industries. We would expect that each industry would respond in the same way.

1.4 Scope of the Study

This study focuses on all sectors or industries listed in the Jakarta Stock Exchange (JSX), namely: agriculture, mining, basic industry, consumer, property, infrastructure, finance, trade, manufacturing, LQ45, and miscellaneous industries. The basic industry comprises of firms producing products such as cement, tiles, porcelain, glass, metal, chemical products, plastic and packaging, pulp and papers, etc. The LQ45 index refers to the index of 45 companies whose shares are most actively traded in the stock market. That is, companies whose shares are most liquid. The miscellaneous industries are those that do not fall into any one of the above-mentioned industries. Firms that fall into this category are producing products such as heavy machinery, automotive and its components, textiles and garments, cables, and electronic products.

The data used in this study are daily closing price of market indexes including composite index and the index of each sector. The data was primarily obtained from the Jakarta Stock Exchange website on June 2nd, 2001. The JSX website address is: www.jsx.co.id.

This study is also limited to the indexes traded from April 28th, 1999 to February 28th, 2001.

1.5 Limitation of the Study

Stock returns change very rapidly. A major limitation of this study, therefore, is that it does not seek to explain the daily movement in the stock returns, short-term, or daily movement in stock returns is of interest mainly to speculators; non-speculative investors are probably more interested in the long-term pattern of returns than in their daily, or short-term, behavior.

The second limitation lies on the political nature. The nature of politics in Indonesia always changes very rapidly from time to time. We do not expect that investors can use the past political histories results to base their decision to earn abnormal returns in the future. Therefore the findings of this study do not attempt to provide any information about the strategy to earn abnormal returns in stock market. Rather, this study is only meant for academic purposes.

A third limitation in this study is that a subjective approach is employed in screening and selecting the political events. Therefore misclassification of an event may occur, or at least a failure to appreciate its full context. In effect, it may affect the findings.