CHAPTER 2:

LITERATURE REVIEW

2.1 Introduction

Whenever there is a political or national budget announcement, it is a great opportunity to test how the local market behaves. According to Efficient Market Hypothesis, investors are all rational in pricing the securities once the unexpected news surprise arrives. However, unexpected announcement can also mean more risky investment environment where rational investors tend to "play safe" by intentionally under-price the stock price during the initial stage of the announcement and adjust accordingly back to the equilibrium price after the uncertainties dissipate. This situation, which is viewed as a modified version of Efficient Market hypothesis, is known as the Uncertain Information Hypothesis (Brown et al, 1988). Both Efficient Market Hypothesis and Uncertain Information Hypothesis share a common core assumption: The investors are rational. There is, however, a group of financial behaviorists who opine that uncertain investors tend to lose their ability to rationally value the stock price, and thus their overreaction to the news causes the stock to stay away from its equilibrium price (Aktas & Oncu, 2006; McQueen & Roley, 1993) and consequently creating opportunities from above average profit or loss. This irrational behavior of investors can be further explained by using the Overreaction Hypothesis proposed by De Bondt and Thaler (1985, 1987).

In line of this, this chapter reviews some of the literatures including the aforementioned underlying theories that support this study, as well as past researches that examine the relationship between stock market reactions and political and macroeconomic

announcement. The next four sections focus on the review of Efficient Market Hypothesis, Uncertain Information Hypothesis, Overreaction Hypothesis and Market Momentum. Section 2.6 and 2.7 presents some of the literatures related to political economy and political business cycles. Finally, Section 2.8 reviews researches on macroeconomic announcement and market reactions.

2.2 Efficient Market Hypothesis

Whether the market is efficient in reflecting information in the stock price has been a widely controversial topic over the past decades. This extensive research is important as its results have significant real-world implications for investors and portfolio managers. Fama (1970) argued that investors can be confident that a current market price fully reflects all available information about a security and the expected return based upon this price is consistent with its risks. He further divided the overall efficient market hypothesis (EMH) and empirical tests of the hypothesis into three forms depending on the information set involved: (1) weak-form EMH, (2) semi-strong form EMH, and (3) strong-form EMH.

Weak-form EMH states that since stock prices already reflects all security market information, including historical sequence of prices, trading volume, rate of return and other market-generated information such as odd-lot transactions and transactions by exchange specialists, one cannot gain from using any trading rule based on past returns and security market data. Semi-strong form EMH asserts that the current stock price quickly adjusts to reflect all public available information. This semi-strong form EMH

encompasses the weak form EMH because all public information includes all security market information as well as non-market information such as news about economy and political news. One of the objectives of this research is therefore to test the Malaysian stock market efficiency at semi-strong level, by observing how the publicly known political announcement impact the local stock market. The strong-form EMH contends that all information, public and private, has been fully reflected in the stock prices and therefore no one investors can consistently earn above-average risk adjusted return. The strong-form EMH therefore encompasses both the weak and the semi-strong form EMH.

Salameh and Albahsh (2011) conducted an event study to test the semi-strong form EMH on the emerging Palestine Stock market. The objective of this study is to realize the effect of the mandatory disclosure regulation on stock prices. The results show that the Palestine market is inefficient at the semi-strong level and that the abnormal return is significantly greater than zero. In other words, the stock prices do not incorporate the available information immediately, but gradually reflect it. Besides emerging market, Lasfer et.al (2003) has also proven that semi-strong form EMH does not hold for developed market, as positive shocks gave rise to subsequent large abnormal returns and vice versa.

2.2.1 Stock Price Behavior and Efficient Market Hypothesis

The concept of behavioral finance was first being formally discussed in a paper called ‘Does the stock market overreact?” published by Werner F. M. De Bondt and Richard Thaler in *The Journal of Finance* (Sewell, 2007). This research intends to find out

whether “overreaction” of market participants affects stock price and if it does, to what extent. De Bondt and Thaler (1985) discovered that the “loser” portfolio outperformed the “winner” portfolio by 25%. This actually implies that a possible contrarian strategy can be developed based on previous market stock price to gain above average return in future and thus, suggests the market is in weak-form inefficiency. Salameh and AlBash (2011) conducted an event study to test the Palestinian stock market at semi-strong level. Results show that mandatory disclosure do affect stock price significantly and that the abnormal return of stock price is significantly greater than zero hence suggests that the Palestinian stock market is market inefficient in semi-strong level. However, a similar test on the market efficiency in semi-strong level performed by Aktas and Oncu (2006) presents a different result. They test the impact of a political announcement on the Turkish stock market and found that there is no overreaction and underreaction of the stock market on the announcement, thus suggest that the Turkish stock market is in its semi-strong form efficiency.

2.3 Uncertain Information Hypothesis (UIH)

Many attempts to consistently prove the existence of EMH have in fact failed. That is due to the fact that the market participants do not usually adjust prices immediately after arrival of unexpected information (Shachmurove, 2002) because they are uncertain about the underlying risk. The Uncertain Information Hypothesis (UIH), as proposed by Brown et al. (1988) can be viewed as a modified version of the EMH, as it models the rational behaviors of market players in an uncertain environment (Musa and Moshed, 2003). Theoretically grounded on the core assumptions of EMH that investors in the capital

markets are rational in making decisions, the UIH further proposed that although the investors are able to determine the direction of the coming news, they are however unable to identify the embedded risk and impact of the news surprise.

Investors' behavior in situations of major uncertainty caused by unexpected events can be explained by Uncertain Information Hypothesis (UIH) proposed by Brown et al. (1988). This theory predicts that announcement of dramatic financial news will increase the risk and expected return of the affected firms systematically and stock prices tend to react more strongly to bad news than to good news (Yu et al., 2010). In general, stock will be underpriced in environment full of uncertainties initially when the news surprise arrives. As the uncertainty has been clarified a few days later, prices would usually go up to reach their new equilibrium price (see Figure 2.1). Yu et al. (2010) discover that upward price adjustments always follow large stock price decline due to the arrival of bad news. However, no significant reversal pattern was found on stock price after announcements of good news. Therefore, the author concludes that stock market tends to overreact to bad news and underreact to good news.

A study conducted by Shachmurove (2002) intends to test whether the Efficient Market Hypothesis, the Overreaction Hypothesis and Uncertain Information Hypothesis (UIH) are supported for the thirteen smaller European stock exchanges. The findings show weak statistical support for UIH from the test of post-event volatility. Only two countries show significant statistics following positive and negative news surprise. However, when testing on CARs, six out of thirteen countries' return profiles show support for UIH under

favorable scenarios but four countries show an overreaction of stock price when good news arrive. Results from the rest of the countries are inconclusive.

Musa and Morshed (2003) use the daily return of Dhaka Stock Exchange (DSE) to test UIH. The authors explain that when a new surprise arrives, investors view its uncertainty as additional risk and require additional premium thus causing them to underprice the stock. The implication behind is that when the uncertainty has been removed later, post-negative events abnormal return will be positive and post-positive events abnormal return will be non-negative. However, the results from their test failed to support UIH in this case.

2.4 Overreaction Hypothesis

The Overreaction Hypothesis (OH) was discussed by DeBondt and Thaler (1987) based on the evidence of US stock market that the loser portfolios over the past three to five years tend to outperform the winner portfolios over the next three to five years period. The OH contradicts EMH from two fronts: First, the OH assumes that investors are not always rational in making decisions; at times, they are guided by their intuition instead of rational thinking. Second, according to OH, the post-event stock returns are predictable and therefore arbitrage trading opportunity is possible. This contradicts the core implication of EMH that security returns is unpredictable and arbitrage trading profits do not exist.

The weak-form efficient market hypothesis which argues that investors are not able to outperform the market using historical information was being questioned by Hsieh and

Hodnett (2011). The researchers contend that in reality the stock prices always overshoot due to investors' overreaction behavior. Using the stocks in JSE stock exchange from 1 January 1993 to 31 March 2009, their study yield similar results as De Bondt and Thaler (1985) where the loser portfolio experienced a greater mean reversal than the winner portfolio over the period of study and that the mean reversals for past winners and losers are found stronger with longer formation period. Similarly, using UK stock price data, Clare and Thomas (1995) conclude that past losers have outperformed the past winners subsequently over the period from 1955 to 1990. The first explanation behind this phenomenon, according to the authors, is due to the size effect.

2.5 Market Momentum

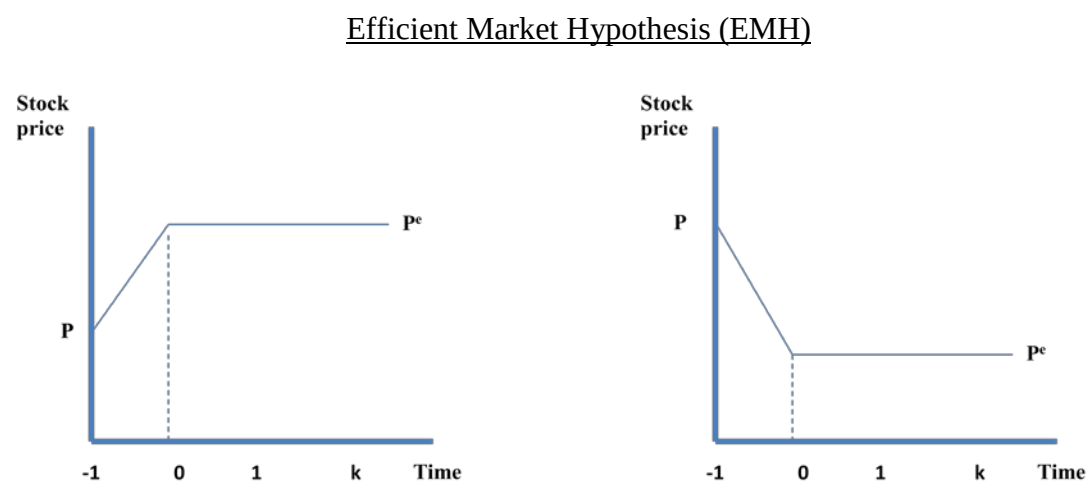
According to Shefrin (2007) finance behaviorist contend that stock returns feature momentum, a phenomenon where recent loser stocks continue to underperform and winner stocks continue to outperform the market in the short-term. Three possible explanations were given for this observation.

The first explanation is that investors underreact to new information. The second explanation is that investors are overconfident with a stock and subsequent arrival of confirming information will further lead the overreaction behavior of the investors (Spyrou et al., 2007). The third explanation is based on the Prospect Theory which suggests that risk aversion investors tend to sell off their stock at a gain relative to the purchase price when a positive news arrive, thus slowing down the increase of stock price. On the other hand, when bad news about a stock arrives, aversion to sure loss

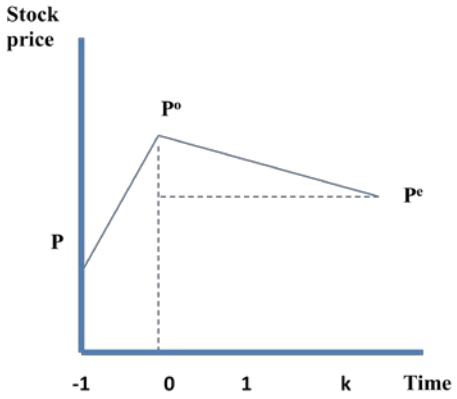
predisposes investors to hold their loser portfolios, therefore retarding the decrease of the stock price (Shefrin, 2007). Lasfer et al. (2003) define market momentum as a phenomenon where positive shocks are followed by positive abnormal returns and negative shocks are followed by negative abnormal returns.

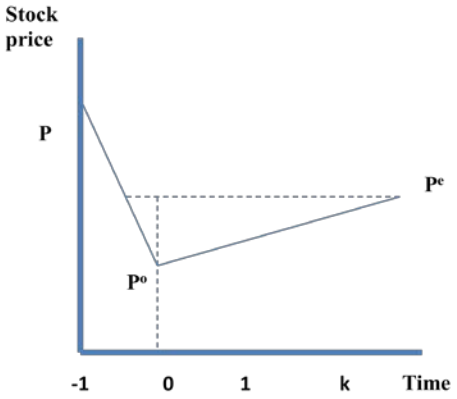
Figure 2.1 presents the diagram illustrations of stock price movement under EMH, OH UIH (Shachmurove, 2002) and Momentum Hypothesis (Lasfer et al., 2003; Spyrou et al., 2007):

Figure 2.1: Stock price changes as postulated by Efficient Market Hypothesis, Overreaction Hypothesis and Uncertain Information Hypothesis

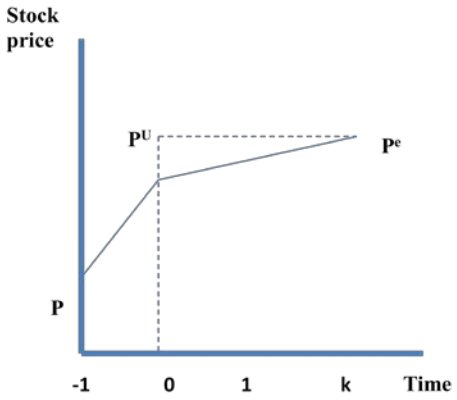


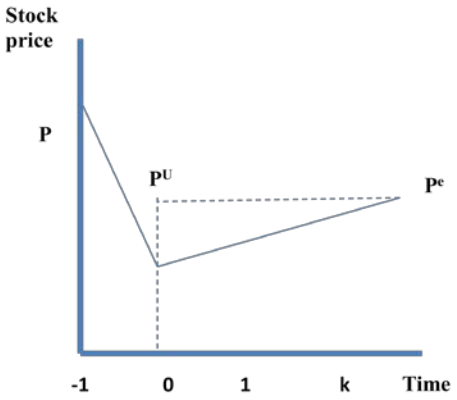
Overreaction Hypothesis (OH)



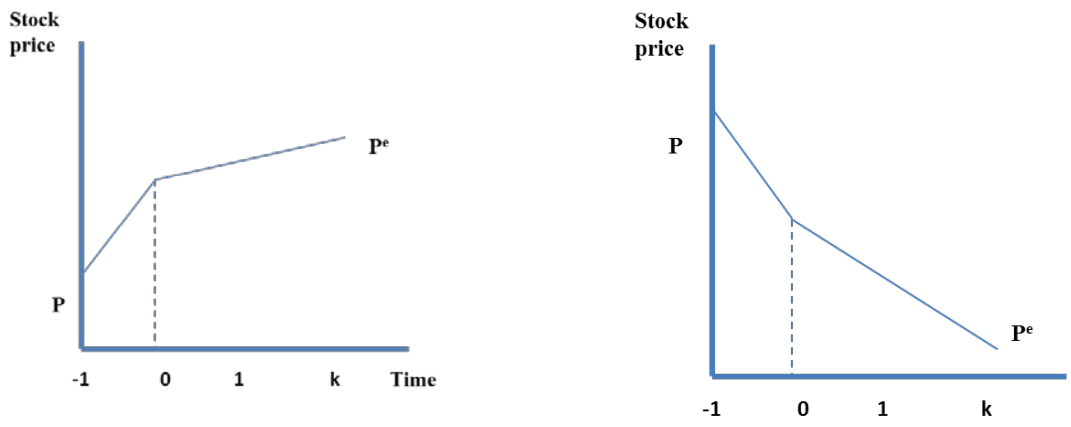


Uncertain Information Hypothesis (UIH)





Momentum Hypothesis



P^e = Equilibrium price
P^o = Overreaction price
P^U = Uncertain information price

2.6 Political economy literature

Political instability has been treated as a serious malaise which harms economic performance (Aisen and Veiga, 2011). According to the researchers, instable political landscape in a country is likely to shorten the policy maker's horizon which further leads to less efficient macroeconomic policies. What makes things even more detrimental is that instable politics always causes frequent switch of policies thus creating volatility which exacerbate the macroeconomic conditions.

An ample of literature documents the negative impact of instable politics on various macroeconomic variables. Alesina and Perotti (1992) did a survey on recent literature regarding political instability and economic growth. They found that political instability can be defined in two ways. The first way uses a sociopolitical unrest index (SPI) that

comprises various political riots and social violence. The second way uses the executive turnover, namely the frequency of government collapse, as the indicator of political instability. By using the first measure of political instability, Hibbs (1973) concludes that there is no relationship between political instability and economic growth. Using the method of principal components to construct the SPI, Venieris and Gupta (1986) discovered a negative relationship between political instability and national saving rates. On the other hand, Barro (1991) add the frequency of coup d'état and the number of political assassination into his growth regression model and found that these two variables negatively affect economic growth and investment. The ultimate theme of this research is to show that political instability may lead to market uncertainty and in turn causes a reduction in investment incentives.

Alesina et al. (1996) shows that GDP growth is significantly lower in countries that experience higher frequency of government collapse. Aisen and Veiga (2011) found similar results and on top of that they examine the channel of transmission between the political instability and lower GDP per capital. Their study identifies that political instability affect economic growth mainly through its adverse effect on total factor productivity (TFP) rate. Besides, physical capital accumulation and growth of human capital are another two channels which instable politics transmit its negative effect to economic growth.

Using the results of national elections in 48 countries between 1980 and 2005, Julio and Yook (2012) attempts to compare the difference in corporate investment behavior due to

fluctuations in political uncertainty in the year of election and non-election. Their empirical results basically support the political uncertainty hypothesis and conclude that the political uncertainty during national elections period creates cycles in corporate investment. On average, the investment expenditure was reduced by 4.8% in the period leading up to election.

Besides the theory of political uncertainty, value of political connections literature provides another perspective of explaining the phenomena of election-induced cycles in investment. According to Julio and Yook (2012), investors tend to change their investment decision or behavior to ensure that their political cronies remain in control of the political regime through the election cycle. Betrand et al. (2006) examine the behavior of well-connected firms in France during the municipal elections and discover that CEOs who are politically connected will normally boost the investment of the firms during election years, probably because they attempt to help their political cronies get re-elected.

2.6.1 Political announcements and stock market reaction

Aktas and Oncu (2006) examine the pricing behavior of the Turkish stock market with response to a single major political event—the rejection of Turkey Parliament on a bill to allow deployment of US troops in Turkey on 3 March 2002, which created significant economic implication for market participants. To examine whether the Turkey market efficiently assessed the impact of this announcement, 50 stocks were obtained each from ISE-National 50 index and ISE-National 100 index to form two portfolios from 20

February 2002 to 7 March 2002. Results show that the test statistics for Abnormal Return for both portfolios on the announcement day and four days after are all insignificant thus suggests that there is no sign of overreaction and underreaction that violates the EMH.

In the Baltic States, Soultanaeva (2008) studies the relationship between political news releases, and the returns and volatility of stock markets in Riga, Tallinn and Vilnius. Political news which is related to Russia and the Baltic states, as well as news which is related to each Baltic States country (domestic news) were selected between October 16, 2001 and Oct 1, 2007. Daily stock price indices were obtained from stock exchange of Estonia, Lithuania and Latvia as well as Russia for the same period of time. To model the relationship between stock market return and volatility and arrival of news, an expanded VARMA-GARCH model was developed to capture the effect of news. Results show, for the first half of the study period, stock return in Latvia react negatively to domestic and foreign news. This implies that these news releases are perhaps treated as unfavorable by the Latvian market participants. Besides, the stock markets of Tallinn and Vilnius do not react significantly to political news from Russia and other countries. However, the researcher explains that this insignificant result observation is probably due to no attempt in separating good and bad political news during the testing process. As for the second part of the study period, negative weekend-effect on returns in the stock markets of Riga and Tallinn were noticed. Stock return in Riga, again, reacts negatively to Moscow related news but this time the effect is smaller than the previous period of study. Stock markets of Tallinn and Vilnius, however, do not react to any of the political

news. From the study of conditional volatility, results show that the arrival of political news actually reduces the risks in the stock market of Riga and Tallinn because there is a reduction in investors' uncertainty when receiving the news. This is in accordance with the theoretical model suggested by Äijö, 2008, which contends that if there is uncertainty before a news release, the arrival of the news will resolve the uncertainty and therefore the volatility of stock is reduced.

Political conflicts, including war events, can also affect a country's economy, (Schneider & Troeger, 2006; Guidolin & La Ferrara, 2010). Schneider & Troeger (2006) analyze the impact of three war conflicts—the Israel-Palestinians conflicts, the US invasion to Iraq, and the war fought in Ex-Yugoslavia—on the global financial markets, represented by CAC, Dow Jones and FTSE. The time series analysis confirms that the stock markets mostly react negatively to international crisis and the stock market volatility is strongly affected by these conflicting events. Guidolin & La Ferrara (2010), on the other hand, found contrasting results which suggest that stock markets are more likely to react positively than negatively to political conflicts. By adopting event study methodology, the authors select a number of internal and inter-state conflicts between 1974 and 2004, and discover that international conflicts have higher significant impact on stock markets. Move forward, their articles report that positive abnormal return opportunities are possible for investors who systematically exploiting the conflict onsets and applying some conflict-driven strategies. From another perspective, Kollias et al. (2011) investigated the impact of terrorist attacks on economy. Their research intends to seek for answer for the three questions: whether the market reaction to terrorism has changed

overtime, whether the size and maturity of the market determine the reactions, and whether the market reactions depend either on the perpetrator or the type of targets. In order to test the effect, the London Stock Exchange (LSE) and Athens Stock Exchange (ASE), each represents the large and the small equity market respectively, had been chosen for the investigation. Event study methodology, combined with the GARCH model, has been adopted to test the impact of stock market as well its volatility. Results shows that there is no significant evidence to prove that market reaction to terrorist attack has changed overtime for both market. However, the size and maturity of the market did response to terrorism differently and stock volatility behaves differently across the size of the market. The authors explain that it is because the larger LSE is more efficient in institutional arrangement and internal checking which could absorb unexpected shock in a more efficient manner.

A growing body of literature also addresses the issues of stock volatility and political events. Beaulieu et al. (2005) examines the link between political risk and stock market movement in Canada. Their research delves into the issue of separation of Quebac from Canada and intends to investigate the impact of this political risk on the stock volatility. To assess the response of the stock market, the bivariate-modified GARCH model is used in this case. The findings show that although the political news did affect the conditional volatility of the stock return, it does not affect the mean returns itself, thus suggesting that the political risk can actually be diversified away and hence, the require return by the investors is not affected. In Asia, Fong and Koh (2002) investigate whether political risk causes a change in stock volatility in Hong Kong. By plotting the return of Hang Seng

Index over the period from January 1079 to April 1998, they found that although the mean return is relatively constant, the volatility varies across time. In addition to that, results from GARCH model confirm a regime shift in volatility with respect to different political risks. High volatility regime is associated with bad news and vice versa.

In Malaysia, study on the relationship between stock market reaction and political announcement is extremely scarce. Part of the study conducted by Ali et al. (2010) discusses the evidence of long term overreaction of stock market in Malaysia with respect to the arrival of extraordinary political events. In order to test the significance of the events, six political announcements have been selected which include the announcements of the four General Elections in 1990, 1995, 1999, and 2004, as well as the announcement of removal of Anwar Ibrahim as the Deputy Prime Minister and the resignation of Mahathir Mohamad, the then Prime Minister. All firms in Bursa Malaysia have been identified and cumulative abnormal return (CAR) of each firm is recorded at the end of each formation period. Winner and loser portfolio are formed by ranking the CAR. Later at the end of the testing period, the winner CAR and the loser CAR is compared to determine if the loser portfolio outperform the winner. Results show that in the long term, significant overreaction behavior is observed in the Malaysian stock market upon the arrival of announcement of removal of Anwar Ibrahim and the resignation of Mahathir Mohamad. However, results show that the market tends to underreact on the election announcements in the long term.

2.7 Theory of political business cycle

The idea that politicians might manipulate policies before election was first developed by Kalecki (1943) and later became the ground of the development of the political business cycle (PBC) literature. There are two approaches of explaining the economic fluctuation around election using the PBC theory. The *opportunistic cycle* discussed by Nordhaus (1975) basically deals with the issue of whether government will use fiscal and monetary policy in order to manipulate the level of economic activity before an election in the hope to increase the probability of winning the forthcoming election. The opportunistic model predicts that on average the economics activities before the election should be higher and the actions used by the incumbents to stimulate economy will have a crowding out effect on private investment. The second approach—*partisan theory*—contends that political parties set their policies differently because they have different ideologies and serve the interests of different social groups in the society (Swank, 1993). As a consequence, economic fluctuations only arise if the regime after elections falls to the alternate political party which will possibly set policies different from the previous incumbent party.

In the United States, the major studies on presidential election and stock market returns on a long term basis were conducted by Huang (1985), Santa-Clara and Valkanov (2003) and Nickles (2004). Huang (1985) examines whether there exists a pattern of stock market return during the four year presidential cycle and whether the stock market return is affected by the different party administration. His results show that on average the stock market gains in the third and fourth year of the cycle and losses during the second year. In addition, although the market favors the Republican administrations, historical

results show that higher average returns were obtained during the Democratic administrations (Huang, 1985; Santa-Clara & Valkonov, 2003). On top of that, Santa-Clara & Valkonov (2003) also found that the pattern of these return during the presidential cycle is not correlated to business cycle and there is no large excess return found around the election dates. Nickles (2004) identified potential investment strategies based on the US presidential election cycles. He found that full cycle occurs every four years, where market is bullish for about three years and bearish for less than a year. Thus, his analyses suggest potential investment strategies can be formed by observing the market movement of the cycle and conclude that investing 27 months before the Election Day can be more profitable than investing after the election.

In Germany, Döpke and Pierdzioch (2006) analyze the relationship between stock market movements and politics. In their paper, they use German stock data to test the economic theory of Political Business Cycle (PBC) which predicts that the popularity of government relies on the state of economy. In this case, stock market movement is being used as a proxy of the state of economy. In order to study the impact of stock market on political process, the authors estimated the popularity function, where the government popularity is treated as dependent variables and stock market movement as independent variables. In addition to that, a vector autoregressive (VAR) model is also formed in order to capture a more complex link between government popularity and stock market movements. The findings suggest that stock market return performance do significantly influence the popularity of government. However, when looking at whether the inverse relationship exists, the results show that political process in Germany does not

significantly affect the stock market return, i.e. there is no difference on stock market return between left-wing government regime and right-wing government regime—a result which is obviously inconsistent with the US scenario. Moreover, there is also no strong evidence that shows political or election cycles in German Stock market.

Turning the focus to emerging markets, Jensen and Schmith (2005) examine the impact of the 2002 Brazilian Presidential election on the stock market response. By using time series regression models, they intend to find the impact of the four president candidates (Lula, Serra, Ciro Gomes and Garotinho) on the mean and variance of the stock market returns. His results find no strong evidence that the newly rise president, Lula, leads to downfall of Brazilian stock market. As explained by Jensen and Schmith, the plummeting of the Brazilian stock market might be due the slumping world economy. However, while no evidence was found on the relationship of mean return and the rise of Lula, there is significant impact of this event on the stock market volatility, which conforms to the Candidate Uncertainty Hypothesis. The author further explain that this uncertainty is not deal with the uncertainty of the election results, but rather the uncertainty of Lula's policies.

2.8 Stock market reaction to macroeconomic factors

Nikkinen et al. (2006) investigate how global stock market reactions are influenced by US macroeconomic announcements. To examine the relationship, the author analyzes the GARCH volatilities around ten United States' macroeconomic news for 35 local stock markets. Reports show that for G7 region the coefficients for consumer price index

(CPI), Employment Cost Index (ECI), Employment Situation (ES) and National Association of Purchasing Management (NAPM) are significantly positive which suggest that the release of news related to those factors will increase uncertainty and thus affect the volatility of stock. In the European countries, the results are similar with respect to those G7 countries except for CPI, which is not a significant macroeconomic factor that affects the volatility of the stock market. In general, the overall results support previous studies that look into the reaction of stock market from other regional market to US macroeconomic news.

Turning to Asian markets, Gunasekarage et al. (2004) study the effect of macroeconomic variables on stock exchange in Sri Lanka. Four macroeconomic factors—money supply, Treasury bill rate, CPI and the exchange rate—are selected to test the market reaction on long run and short run basis. The results from vector error correction model (VECM) indicate that the lagged values of the four macroeconomic variables do significantly influence the stock market. And of all macroeconomic factors, the Treasury bill factor has the strongest effect on the price change. In Singapore, Maysami et al. (2004) examine the relationship between selected macroeconomic variables and Singapore stock market index (STI) as well as other sectorial index on a long term basis. The results show that the Singapore market return is positively related to inflation, which is contrary with previous studies. A possible explanation of this is supported by "Fisher effect" which states that the risk of inflation can be hedged by holding stocks, thus creating a positive relationship between inflation and stock return. Besides, stock returns also show significant positive relationship with the real economic activities, which is reflected by

the industrial production index. In terms of interest rates, the stock market shows a positive relationship with short term interest rate, while negatively correlate with long term interest rates. As for money supply changes and exchange rate, both factors positively influence the stock return movement. While the Singapore stock market and the property index show significant relationship with all macroeconomic index, other sectorial index only show significant relationship on selected variables.

Chay and Marsden (1996) examine whether the announcement of a new foreign investor tax credit regime will have any significant impact on the local stock market. The new system basically allows those foreign investors who hold less than 10% stake in a New Zealand company to receive additional dividends. Using the event study methodology, the authors show that in general, their evidence support the hypothesis which states that tax policy does significantly affect stock price behavior. Arin et al. (2009) investigate the impact of tax policy innovation on stock market reaction. The overall results suggests that stock market return is significantly related to the government choice of tax instruments but not all components of a tax policy concern the stock market returns. Empirical results show that while both labor and indirect taxes negatively affect stock returns, corporate tax has no significant influence. Corporate tax innovation is irrelevant in this case because the firms are free to choose its capital structure. If tax rate increases, they can always shift from equity financing to bond financing at their own discretion to achieve the best cost of capital (Arin et al, 2009). In search of the relationship between stock market reactions and capital gain tax, Lin (2005) seeks evidence from the 1985 government announcement of cumulative tax exemption for capital gain in, which

basically supports the significant relationship between stock market reactions and capital gain tax. Using the daily stock return and trading volume of Canadian stock exchange, Lin found that the share prices decreased three days before the announcement whereas trading volume increased two and four days before announcement as well as three days after announcement.

The impact of federal budget deficits on stock market movement in Australia and France has been examined by Ewing (1998). From the results of Granger-causality test, the author concludes that past budget deficit announcement does affect the stock movement and further on suggests that the stock market is inefficient in reflecting past budget deficit announcement.

2.8.1 The 1997 Asian Financial Crisis and Capital Control Policy in Malaysia

The 1997 Asian Financial Crisis, which began with the collapse of the value of Thai Baht, rapidly spread to other countries in the region and caused devaluation of currency and slumping of stock market especially in South Korea, Indonesia, Thailand and Malaysia (Jang & Sul, 2002). While South Korea, Indonesia and Thailand applied for the IMF bailout packages, Malaysia imposed capital control, without the help of IMF, to correct its financial imperfections (Sharma, 2003). As a start, tight fiscal and monetary policies were adopted where government spending was drastically reduced by 18% in December 1997 and interest rates were increased sharply from 6% in June 1997 to 35% one month later (Sharma, 2003). Current account deficit was targeted to be reduced from 5% to 3% of GDP in 1998. However, these comprehensive bailout facilities did not

deliver the expected results. The economy position was worsened and soon the crisis effect spread to the whole nation (Yusof et al., 2000). Apart from that, the announcement of expansionary budget 1998 further exacerbate the sentiment of the market participants as they view this as the government denial of the seriousness of the financial disaster.

As a result, the Malaysian government imposed capital control on 1 September 1998 and pegged the Ringgit at 3.80 to the dollar. Capital control thus allows the government to loosen fiscal policy which consequently allowed the government to announce a high budget deficit for 1999 (Sikorski, 1999).