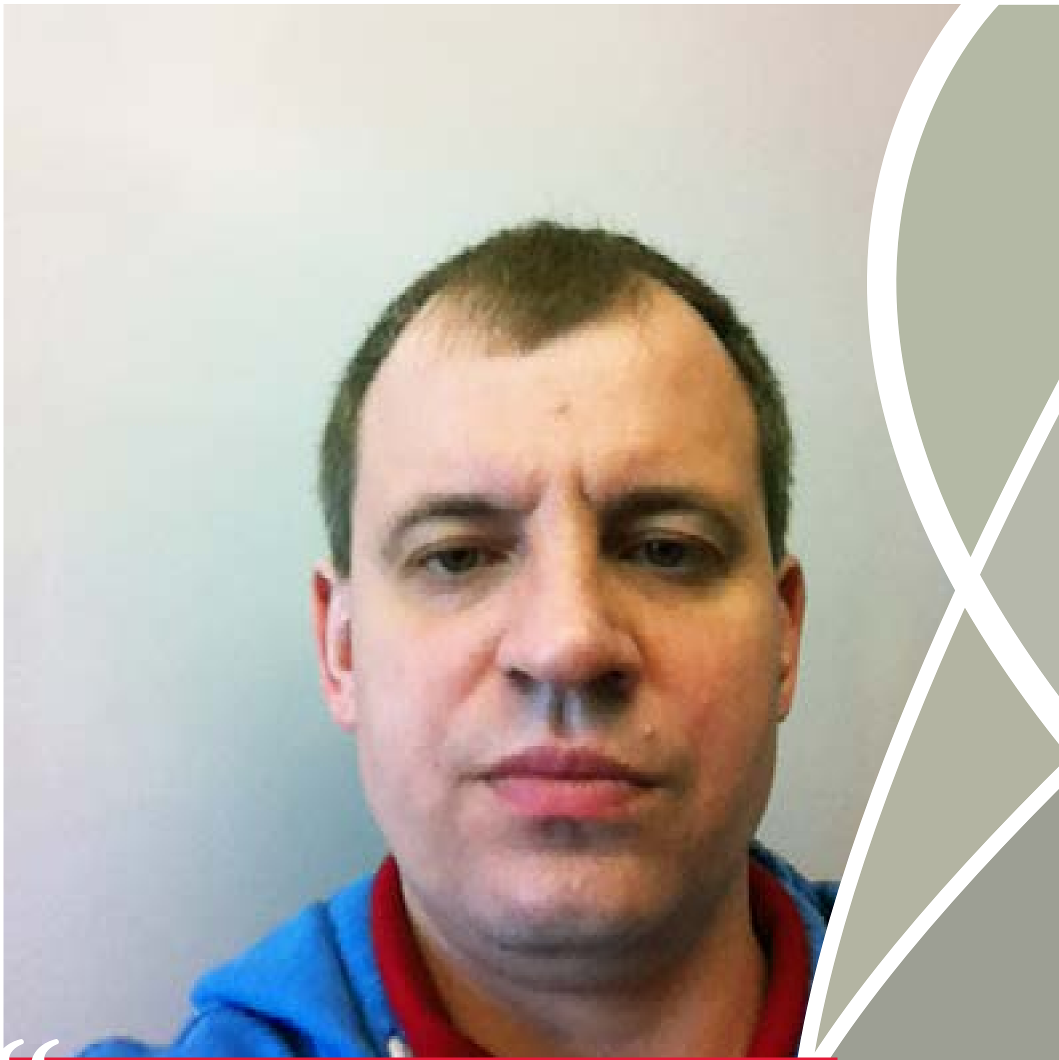
ART DURNEV

PRECARIOUS POLITICS & RETURN VOLATILITY

Elections are great for democracies, but my new study finds they may not be so good for business. My co-authors and I find that countries with national elections have more volatile economies because businesses don't like political uncertainty. The study also found economic volatility increases during political campaigns. Autocracies, however, demonstrate no such volatility, as they have less political risk and so investors are more easily able to make business decisions in those countries. The study measured volatility as the returns on stocks for companies based in each country, or companies based elsewhere that do significant business in a country. We looked at 50 countries, both developed and developing, and observed stock market volatility during the six months leading up to an election and for the year after the election.

The study found that in general, more mature democracies saw increased market volatility in the six months prior to an election. The markets in autocracies did not exhibit that volatility. This doesn't mean that autocracies face no market uncertainty. Dictatorships often experience revolutions, destabilizing the economy by throwing out the dictator, and increasing market volatility. The death of a dictator while still in office also causes increased market volatility because investors are unsure how the country's citizens will react and new leadership will govern.

But the volatility in democracies was more frequent and clearly tied to the election. The study did not quantify each country's market volatility because that level depended on factors unique to each country and each election. For instance, Russian markets might



"ELECTIONS ARE GREAT FOR DEMOCRACIES, BUT MY NEW STUDY FINDS THEY MAY NOT BE SO GOOD FOR BUSINESS."

experience little volatility in the run-up to the presidential elections there if the markets expect that Vladimir Putin will win re-election to a third tenure in office. However, Egypt's already destabilized economy will likely become even more so because nobody knows who will win the coming elections.

But the study found that markets don't necessarily settle down in the year after an election. Sometimes the election brings political stability that leads to economic stability. But sometimes, the election only creates more instability, increasing political risk and doing nothing to smooth a country's economy.

The study found that export-oriented industries, industries dependent on contract enforcement, and labor-intensive industries exhibit higher volatility when political risks are higher. Labor-intensive industries also display higher volatility when governments from the political left lead a country or when labor laws are stricter. Autocratic regimes, on the other hand, reduce volatility, especially in industries that are more dependent on trade or contract enforcement.

The study sheds light on what's happening in the U.S. economy right now. Political uncertainty is high and so businesses respond by putting off expansions, investments, and new hires, slowing the economic recovery. I expect businesses to continue sitting on their cash until after the next election, when they have a clearer idea of who our new leaders will be. But even then they may hold back because the perceived polarized nature of American politics will create an ongoing uncertainty no matter who wins.

The results of the study have several theoretical and practical implications. For example, this paper has implications for corporate financial decision-making, as we show that choices to engage in trade with international partners or invest in lines of business with greater input or labor dependence can increase volatility and, thereby, can affect the cost of capital.

"Precarious Politics & Return Volatility," is a paper co-authored with:

Maria Boutchkova, University of Leicester
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It is forthcoming in the Review of *Financial Studies.*

BIOGRAPHY

DR. ART DURNEV is Assistant Professor of Finance at the Henry B. Tippie College of Business at the University of Iowa. He joined Iowa in 2011 after spending six years at the Desautels Faculty of Management at McGill University in Montreal, Canada. Art Durnev earned his Ph.D. in Finance from the University of Michigan Business School. He is a Canadian and Russian citizen.

Art Durnev's research interests are primarily focused on corporate finance, political cycles, governance, and financial markets development. His work involves empirical investigations of how political cycles affect corporate policies, firm governance structures, disclosure policies, insider trading regulation and idiosyncratic volatility. He has published this work in top academic and practitioner journals, such as the Journal of Finance, Review of Financial Studies, Journal of Accounting Research, Journal of Applied Corporate Finance, Journal of International Business Studies, Michigan Law Review, and Economics of Transition. Two of his Journal of Finance articles were nominated for the Brattle Prize (awarded to the best corporate finance articles).

TESTIMONIAL

THE STUDY WOULD NOT BE POSSIBLE WITHOUT A GENEROUS AWARD FROM THE CSIRF. To complete the study, I had to hand-collect data on elections around the world. The award helped me recruit a team of qualified students who, under my guidance, collected the necessary data. To get necessary feedback from academic experts, I presented this study at several conferences around the world. The CSIRF award financed my travel costs. This project resulted in a paper that got accepted in a top finance academic journal, Review of Financial Studies.