

## Political Risk and Stock Returns in Indonesia

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### ABSTRACT

**Objective** – The research aims to find the relationship between the political risk with stock returns.

**Methodology/Technique** – Using the purposive sampling, secondary data on 30 companies listed in Indonesia Stock Exchange (BEI) of the year 2007-2015. Analysis technique used is weighted least square regression

**Findings** – The results of study Political risks significantly positively associated with stock returns. These results imply a change from the shock of political risk will affect cost of capital of the company increased, causing the company's stock price will go up which in the end impact on improving the company's stock returns obtained.

**Novelty** – The study implies Shock due to the change of political risk has a direct impact on the company's financial condition primarily of the cost of capital companies because it involves policy and investment decisions are made in Indonesia.

**Type of Paper:** Empirical

**Keywords:** BEI; Market Capitalization; Market Returns; Political Risk; Stock Returns.

**JEL Classification:** G30, G32.

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### 1. Introduction

Political risk is the uncertainty caused by the political events taking place in the country. Attention to political risk increased with increasing investment activity in a country. It can affect the development of capital markets, especially in developing countries.

Capital inflows from developing countries to countries - developing countries is an important issue, because the portfolio's cash flows to developing countries could increase market volatility and economic instability (Bilson, Brailsford & Hooper, 1999). Political risk is often defined as the risk of adverse originated from the political events in the country, as it can reduce the value of the company. Because of the political risks should be considered by the manager did give a positive or negative impact on the company.

The positive impact of the political risk will increase asset returns when variables used have a value greater than 0 ( $x > 0$ ), and otherwise reducing asset returns if the variable that is used has a smaller value of 0 ( $x < 0$ ) (Butler & Joaquin, 1998). Furthermore, Butler, et. al (1998) revealed the political risk to be responsible for systematic risk and cost of capital of multinational companies. This is evident from the interaction between

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markets, political risk with the market return. Implications of the political risks of the required rate of return depends on the expected return that result from changes in the political shock. Political risk will increase the cost of capital when the impact of the return of political shock has a positive relationship with the market portfolio return, otherwise the political risk would lower the cost of capital when the return of political shock has a negative correlation with the market portfolio return.

The impact of political risk is seen in developing countries compared to developed countries. In developing countries, the emergence of political risk looks economically as determinants of stock returns (Diamonte, Liew & Stevens, 1996). A change in the political map and a change of leadership power can cause a variety of reactions in the market, where investors are trying to make decisions related to investments and policies that will be used in the future and its impact on the company related to growth and cash flow (Kim, Pantzalis & Park, 2012).

Various studies have been conducted to see the relationship between political risk and stock returns in different countries, (Diamonte et al., 1996; Bilson et al., 2001; Suleman, 2013; Al-Mahmoud, 2014). Most of the results of the study found the impact of political risk on stock returns, particularly in developing countries.

The occurrence of political risk could also impact on the company's internal conditions. One of them has seen from the size of the company. Size can give an idea of the magnitude of wealth or assets owned by the company. The size of the company's assets will affect the company's ability to bear the risks that would occur in a variety of conditions facing the company.

Indonesia as a developing country must not be separated from conditions caused by the political changes that occurred. Various events related to the political situation in Indonesia such as the selection of candidates, the presidential election is an indicator of capital market players and used to make a profit in the future. Investors will wait to see the prospect of investing in the future, especially with regard to foreign direct investment (FDI). This condition can cause the Indonesian domestic political risk, so it becomes a matter of concern in both the short and long term.

Performance Indonesia Stock Exchange in 2015 decreased by 12.13% compared to 2014. The decline in performance is due to external factors related to the global economic slowdown. While the Indonesian political situation relatively stable throughout 2015. However, this condition can be changed if there is uncertainty caused by the political events that occurred in Indonesia. When these conditions occur then it will have an impact on the amount of investment in Indonesia, especially foreign investment. Based on these descriptions it is necessary to further study on the influence of political risk on stock returns in Indonesia.

## 2. Literature Review

Political risk is the risk that occurs in a country due to unexpected events as well as the change in the rules of the game of business activities in the country. This condition provides a major influence for multinational companies, so the impact on the value of the company. The visible impact of the future cash flow and required return investors (Butler et al., 1998).

Research conducted Diamonte et al. (1996) revealed that political risks have an impact on the return of companies in developing countries, where the political risk is greater in developing countries than in developed countries. Therefore, the political risk is one factor predictor of stock returns. Similar results were shown by studies conducted by Bilson et. Al (1999). According to them the political risk may increase investor concern in making decisions related to the allocation of international portfolios.

While Beaulieu, Cosset and Essaddam (2005) in their research results explain that the political uncertainty caused by; (1) the probability of conditions that occur in a country; (2) rating the risk occurring; (3) capital flight. Besides the impact of political risk for the continuation of foreign direct investment were affected by the investment climate, stable political conditions as a decisive factor in investment decisions. Their results reveal that the political risk of contributing to the volatility of stock returns, where the political risk associated with the bad news over a significant impact on the volatility of stock returns than the political risk associated with the good news.

Harvey (2005) examined the relationship between country risk, cost of capital on stock returns in emerging markets. The research results reveal that the strong links between country risk and capital costs by using stock returns. Similar results were found in studies conducted by İkizlerli and Ulku (2010). In their study found that there is a rapid response from multinational companies in the stock market as a result of their political risk. The response of foreign investors in trading activity in the stock market will decline if increased political risk investor response otherwise would go up if the political risk has decreased.

Suleman (2013) examined the stock market changes in response to changes in political risk in developing countries and developed countries. Indicators used to measure political risk by using the International Country Risk Guide (ICRG). Suleman and Randal (2016) found that the average political risk rating is better than the developed countries in developing countries. Al-Mahmoud (2014) also found similar results where the political risk significant effect on stock returns. Stable political conditions make some policies can be done well.

Based on the literature review of political risk and stock returns in the context of the research hypotheses of this study are, as follows:

- H<sub>1</sub>: Market Return has a positive influence on stocks return
- H<sub>2</sub>: Political Return has a negative influence on stocks return
- H<sub>3</sub>: Market Capitalization has a positive influence on stocks return

### 3. Data and Method

The object of this research is the political risk, market returns, market capitalization and stock returns. The method used is explanatory method. Source of research data derived from secondary data, including monthly data in the Indonesia Stock Exchange monthly period from January 2007 - December 2015 were obtained from the Indonesian Capital Market Directory (ICMD). While the Indonesian political risk data obtained from the International Country Risk Guide (ICRG). Collecting data using time series data and cross-section of individual company shares in the period January 2007 - December 2015.

The sample in this study conducted by purposive sampling. Thus, companies that meet the criteria for the determination of the samples in this study were as many as 30 companies listed in Indonesia Stock Exchange.

Table 1. Variables Used in Analysis

Variable	Indicator	Measure	Scale
Market Return	IHSG	$\frac{IHSG_t - IHSG_{t-1}}{IHSG_{t-1}}$	Ratio
Political Risks	Composite political risk, economic risk & finance risk	$\frac{PR_t - PR_{t-1}}{P_{t-1}}$	Ratio
Market Capitalization	The market value of the share issued ( <i>Outstanding Share</i> )		Ratio
Stocks Return	Stock Price	$\frac{P_t - P_{t-1}}{P_{t-1}}$	Ratio

Analytical techniques used in the study conducted by regression analysis of cross section to return stock to determine the risk premium of the market return variable and political risk. The model of the regression equation as follows:

$$R_{it} = \beta_{0i} + \beta_{1i}MR_{it} + \beta_{2i}PR_{it} + \beta_{3i}MC_t + \beta_{4i}PR * MC_t + \varepsilon_t \quad (1)$$

Where:

$R_{it}$	: Excess Return Asset
$\beta_{0i}$	: Constant
$\beta_{1i}MR$	: Market Return
$\beta_{2i}PR_t$	: Political Risks
$\beta_{3i}MC_t$	: Market Capitalization
$\beta_{4i}PR*MC_t$	: Moderating Variable
$\varepsilon_t$	: Error

#### 4. Result and Discussion

Stationary test data is done to determine whether the data used can be used to perform further analysis. The result of the data shown in Table 2, as follows:

Table 2. Unit Root Test

Variable	Uji Akar Unit						Stationer
	ADF	Critical Value at 5% of sig.level	PROB	ADF	Critical Value at 5% of sig.level	PROB	
Market Return	-2.88867	-7.824409	0.0000				Level
Political Risks	-2.88975	-2.841880	0.0560	-2.89155	-5.57284	0.0000	1 <sup>st</sup> Difference

Source: Result Analysis, 2017

From table 1 shows that the value of critical value market return is greater than the critical value of 5% ADF (-2.88) is (-7.82) thus the market return data already stationary at the current level. While the value of the critical value of political risk is smaller than 5% ADF critical value at a rate that is necessary to test the level at the 1st level difference. The test results on the 1st level difference values obtained critical value of political risk is greater than 5% ADF critical value (-2.89) is (-5.57). Thus the political risk data have been already stationary at the 1st level difference. Based on these results it has been stationary all variably so it can do further analysis. The results of a cross-sectional regression analysis using WLS method are as follows shown in:

Table 3: Regression Cross Section

Variable	Coef.	Prob.
C	0.0078	0.0027
Market Return	0.0029	0.3969
Political Risks	0.0109	0.0010
Market Capitalization	-0.0084	0.7094
Political Risks*Market Capitalization	0.0707	0.0006
R-Squared	0.6568	
Adj R-squared	0.5914	
Prob (F-Stat)	0.0001	

Note: \*\*\*,\*\* Significant Level at 1%, 5%

So that, when administered in the form of the general equation is as follows:

$$R_{it} = 0.0078 + 0.0029 MR_{it} + 0.0109 PR_{it} - 0.0084 MC_{it} + 0.0707 PR * MC_{it} + \varepsilon_{it}$$

Table 3 shows that the market returns are not significantly positively associated with stock returns is 0.0078, meaning that if the market returns rose by 1%, then the stock return will increase by 0.0078. Theoretically market returns and stock returns have a linear relationship. This is caused by the condition of the Indonesia Stock Exchange fluctuated from stock so the impact on the value of return generated by shares in the Indonesian Stock Exchange. The global crisis that occurred in 2013-2014 that originated from China's economic slowdown had an impact on global economic conditions Indonesia is no exception.

Political risks significantly positively associated with stock returns is 0.0190, meaning that if the political risk rose by 1%, it will increase the stock return of 0.0190. These results imply a change from the shock of political risk will affect cost of capital of the company increased, causing the company's stock price will go up which in the end impact on improving the company's stock returns obtained. Additionally, sample of companies used in the study is a company that has an asset value of medium and large, so that when there is a change of political risk shock is not very negative impact on the rate of return generated.

The market capitalization does not significantly negatively associate with stock returns is -0.0084, which means that if the market capitalization fell by 1%, it will return a stock will fall by -0.0084. In theory should have a market capitalization of positive relationship with stock returns, but the results of this study found a market capitalization negatively related to stock returns. This condition occurs due to declining performance of the Indonesia Stock Exchange, in addition to the characteristics of the Indonesian capital market is still in a weakened form so that when there is a change at the macro level, it can directly impact on activity in the Indonesia Stock Exchange.

While Political Risks\*Market Capitalization has a significant positive correlation with stock returns is 0.0707, meaning that if there is an increase of 1% Political Return\*Market Capitalization then return stock will increase by 0.0707. This indicates that the moderation of political risk variables on market capitalization will strengthen the influence of political risk on stock returns. Shock due to the change of political risk has a direct impact on the company's financial condition primarily of the cost of capital companies because it involves policy and investment decisions are made in Indonesia. Additionally, medium and large companies tend to have resistance to the change of the political risks that occur due to having a larger capital cost compared to small companies that tend to be susceptible to changes caused by political risks.

## 5. Conclusion

Market returns have no significant positive correlation to stock return. Political risk has a significant positive correlation to stock return. The market capitalization has a negative correlation with stock returns and Political Return\*Market Capitalization has a significant positive correlation with stock returns. The political risk of a positive impact on companies that have a market capitalization of medium and large due to increasing cost of capital. The rising cost of capital will increase so that the stock price will increase the level of stock returns.

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