

Democracy and Markets in a Partially Globalized World: Local and Global Financial Market Responses to Elections in Developing Countries

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Abstract: Global market responses to elections are at the core of debates about financial globalization in developing countries. While existing research focuses on the ability of global markets to reward and punish national governments, much less is known about the role of domestic finance. I argue that domestic financial markets (1) react more strongly to elections than global markets due to excessive exposure to political risk at home and (2) lead global market responses to elections where domestic investors have an information advantage. I find support for these hypotheses using price data on country funds for major emerging markets between 1988–2015, which affords a unique opportunity to compare the responses of local and international markets. The results show swifter and more dramatic reactions by domestic investors, which are transmitted to international markets. The findings underscore the underappreciated role of domestic investors in state-market relations under partial globalization.

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1 Introduction

Global financial market responses to national elections are at the heart of debates about financial globalization in the developing world. Elections represent critical junctures where the “confidence game” between financial markets and political actors often plays out in stark ways. Whether markets respond positively or negatively to elections, and how strongly, conveys investors’ assessments of candidates and their expected policies. Especially in developing countries, where political uncertainty is high and domestic conditions volatile, market reactions can be severe. Markets can punish electoral uncertainty and the risk of market-unfriendly policies with capital flight, higher interest rates, lower stock market valuations, and currency depreciation (Santiso 2013; Jensen and Schmith 2005; Hays, Freeman, and Nesseth 2003; Leblang 2002). Such market responses can affect the real economy, by raising the cost of capital for private agents, generating greater economic volatility, increasing the likelihood of currency and debt crises, and affecting governments’ access to credit. Critically, these negative reactions may prompt candidates and newly-elected governments to make dramatic policy reversals, whereas positive reactions may be taken as a stamp of approval (Barta and Johnston 2018; Campello 2015; Sattler 2013; Bechtel 2009; Bernhard and Leblang 2006).

As financial globalization has advanced, scholars have increasingly focused on *international* markets as the main audience whose confidence policymakers seek to earn. Research shows, for example, how global actors reward and punish countries’ policies and electoral choices—from global bondholders (Kaplan and Thomsson 2016; Mosley 2003) and fund managers (Santiso 2013) to multinational banks (Grittersová 2017; Santiso 2013) and credit rating agencies (Barta and Johnston 2018; Biglaiser and DeRouen 2007). This emphasis on international market actors has followed broader trends towards capital account liberalization around the world. As countries have reduced formal barriers to cross-border capital flows, our theories and empirical models have assumed a world of closely integrated financial markets, where global investors have a central role in disciplining governments. Yet, while existing research advances our understanding of global market discipline, less is known about the role of domestic finance.

There is good reason to further examine the role of domestic markets, for one thing. Despite

movements towards greater financial liberalization in the last few decades, developing countries are still not nearly as open as industrial economies. And despite many efforts to remove explicit barriers to capital flows, de facto financial integration has not kept pace with de jure liberalization (Bekaert et al. 2016). Numerous implicit barriers still limit integration, from information frictions to weak domestic institutions. These implicit barriers help explain why North-South capital flows have not materialized as predicted by standard economic models (Alfaro, Kalemli-Ozcan, and Volosovych 2008). In fact, financial flows remain concentrated among rich nations (Oatley et al. 2013), and investment in developing countries is still mostly financed through domestic savings (Aizenman, Pinto, and Radziwill 2007). Furthermore, investors' portfolios remain disproportionately weighted toward assets from their own home countries (Coeurdacier and Rey 2013). Such home bias, which is acute in developing countries as I show below, implies that investors have failed to take advantage of opportunities for global diversification, instead choosing to park their capital at home. By most available measures, developing countries' de facto integration into global markets remains limited.

Accordingly, this article identifies an important but overlooked role of domestic investors in government-market relations. I show that limited financial globalization puts domestic investors front and center in market responses to elections, in two main ways. First, domestic investors respond more strongly to elections because of their greater exposure to local political risk. A lack of global diversification, or home bias, leaves developing country investors overexposed to risks in their own home markets (Freeman and Quinn 2012; Coeurdacier and Rey 2013; Stulz 2005). As a result, national elections imply high stakes for domestic investors, whose interests are inextricably tied to domestic policy. In contrast, international investors typically have limited exposure to any single developing country market, and thus face lower stakes in any given election. Domestic markets therefore should be more responsive to domestic political conditions, and could even impose harsher punishment for political risk and uncertainty, all else being equal.

Second, domestic investors are also central in that they lead international market reactions to national elections. Despite major advances in information technology, global portfolio diversification still entails high information costs, often leaving international investors at a disadvantage

relative to local investors when assessing political risk in far-off countries (Ferreira et al. 2017; Teo 2009; Dvořák 2005). Local investors tend to have lower information costs, greater familiarity and knowledge of the political environment, denser professional and political ties in the country, and a greater ability to interpret new information in context. The responses of domestic markets to political events can therefore act as cues to international investors. Such form of information transmission from local to global markets should be particularly prevalent in low-information and volatile environments, two common characteristics of developing countries.

Empirically, I exploit price differentials for the same country stocks in two different markets—the developing country’s local stock market vs. a global financial center like New York—to compare the responses of local and foreign investors to elections. I do so by using price data for closed-end country funds, a class of exchange-traded investment funds focused on stocks from single countries. This strategy leverages existing research showing that the price of the country fund, which is traded in international markets, better captures the sentiment of international investors towards the country relative to local investors, while the price of the underlying stocks held by the fund, which are traded in the local stock market, better captures the relative sentiment of local investors. Because country fund behavior is strongly correlated with the broader stock market, country funds make for a useful microcosm of global markets where one can compare foreign and local investor reactions.

Using data for 13 major emerging markets between 1988–2015, I find that local investors have stronger reactions to elections than international investors, as revealed in the larger movements initiated by domestic markets during electoral periods. Moreover, the results show that domestic market responses are highly predictive of international market responses, but the reverse is not true. This supports the hypothesis that local investors lead the response of international investors to electoral shocks. Thus, while the “exit” of international capital may often be dramatic, such movements seem to result systematically from reactions to cues from domestic investors.

This study’s main contributions are twofold. First, the findings show that domestic investors matter more to the politics of market discipline than previously thought. In a partially globalized

world, domestic investors remain a key audience in the confidence game between policymakers and markets. This suggests that even in countries with relatively low levels of financial integration, domestic capital may still play a significant disciplining role towards governments. Second, the findings show that domestic markets matter not only directly through their reactions to political events, but also indirectly through their influence on international markets. While existing research studies domestic markets in isolation from debates about globalization and market discipline, this study bridges that gap by showing that global market reactions to domestic political events are often driven by local investors. Domestic markets thus provide a missing piece of the puzzle of market discipline in less than fully integrated economies.

The findings therefore connect the literature on the politics of capital mobility with the literature on the impact of political events on financial markets. Scholars have recently turned their attention to understanding the mechanisms through which political events affect the global financial system, including the impact of international politics on global markets ([Genovese 2021](#); [Wilf 2016](#); [Bechtel and Schneider 2010](#)) and the spillover effects of electoral shocks onto foreign currency markets and the global banking system ([Slaski 2021](#); [Cunha and Kern 2022](#)). The present results refine our understanding of these mechanisms by exploring the implications of persistent barriers to financial integration in developing countries. The findings are particularly relevant given the reduced impetus for further financial integration ever since the 2007-8 Global Financial Crisis.

2 Elections and Global Financial Markets

Understanding financial market responses to national elections gives us insight into the political preferences and behavior of an important class of capital owners. It also allows us to assess whether and how markets constrain domestic policy choices. Scholars have paid increasing attention to the behavior of financial markets in the context of global financial liberalization, as investors with interests spanning markets across the globe have brought greater scrutiny upon developing countries.

Investors care about elections to the extent that leadership turnover can produce policy changes that affect investment returns. Electoral turnover may lead, for example, to changes in corporate

taxation, fiscal and monetary stability, capital account regulation, among other policies that directly affect capital owners (Campello 2015; Wibbels and Arce 2003; Oatley 1999). For investors, elections are thus focal events that often concentrate uncertainty about potential policy shifts. As a result, election-induced uncertainty can deter investment and cause large reactions from market participants. Investors will demand a premium for holding risky assets during periods of heightened political uncertainty, or flee to safe assets such as developed country government bonds. Such uncertainty over future economic policy can thus produce financial volatility, capital flight, higher interest rates, depressed stock market valuations, and speculative attacks against the national currency around elections (Brooks, Cunha, and Mosley 2022; Santiso 2013; Jensen and Schmith 2005; Hays, Freeman, and Nesseseth 2003; Leblang 2002).

These market responses to elections matter not only for their financial consequences, but also for their constraining effects on governments' policymaking autonomy. For one, such market reactions can affect the real economy by raising borrowing costs for consumers and firms, delaying investments, and creating inflationary pressure through currency depreciation. Voters and corporate actors may, as a result, demand more market-friendly policies from candidates in anticipation of such reactions. Furthermore, such market reactions can directly affect governments' fiscal space, by increasing debt servicing costs and affecting their ability to access new credit. How markets respond to elections therefore can affect candidates' and policymakers' incentives to pursue market-friendly policies, especially in countries that depend on foreign capital (Campello 2015; Brooks 2004; Wibbels and Arce 2003).

While research has focused on policy discipline imposed by global markets, in partially-globalized economies one should expect much of the market reaction to take place at home. Indeed, despite trends towards greater financial liberalization since the 1990s, developing countries are still not nearly as financially open as developed ones. Moreover, by some measures emerging markets have become less open since that first wave of liberalization (see Figure 1). Given this partial integration into global capital flows, one should expect domestic financial markets to be a key locus of market-government relations in developing countries.

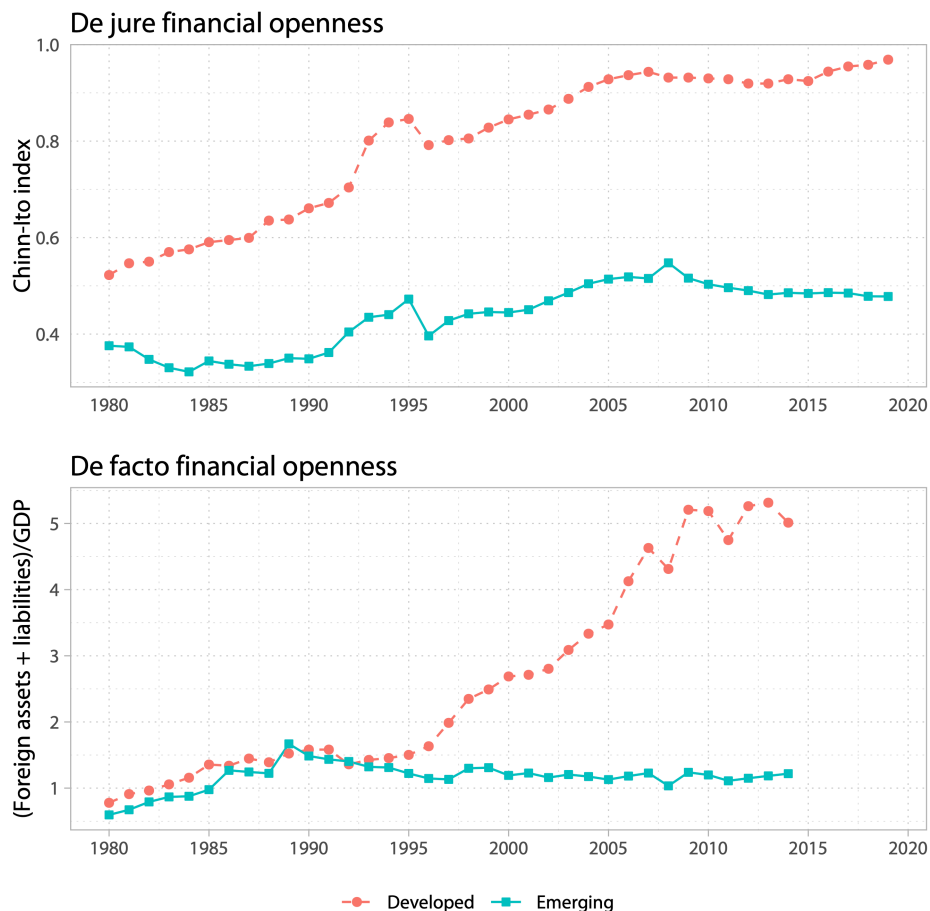


Figure 1. Average de jure and de facto financial openness in developed and emerging economies. Top panel shows the Chinn-Ito index of de jure financial openness; bottom panel shows the [Lane and Milesi-Ferretti \(2007\)](#) measure of de facto financial integration.

Like global markets, local market reactions to elections also affect the interests of governments, firms, and households. On the one hand, positive market responses may signal policy competence and serve as a stamp of approval for candidates. On the other hand, domestic market volatility can affect governments' financing costs and damage growth by raising the cost of capital, as well as delaying investment and hiring decisions as firms hedge against uncertainty. Domestic market reactions therefore can also affect policymakers' incentives by imposing costs on deviations from investors' preferred policies. Indeed, such form of "market defection" has long been identified as a source of structural power for domestic capital owners ([Lindblom 1977](#)). Given the relevance of domestic capital owners in less than fully integrated economies, in what follows I incorporate domestic investors into a model of global market responses to politics.

3 Local Investors, International Investors, and Political Risk

Limited financial integration implies a departure from standard models of financial market-government relations. I focus on two features of global markets—home bias in portfolio allocation and information frictions—and derive their implications for the interaction between democratic processes and markets. These two aspects of markets confer domestic investors a central role: first, home bias makes domestic investors more sensitive to election-induced risk than international investors; second, domestic investors will lead market reactions to elections where they hold an information advantage over foreign investors.

3.1 *Home Bias and the Electoral Stakes of Domestic Investors*

Market reactions to elections depend on how exposed investors are to the risks posed by electoral turnover. The more investors' returns depend on the direction of national economic policy, the greater the risk that elections may represent. Investors whose portfolios are entirely invested in domestic assets are more vulnerable to political risk than investors whose portfolios are globally diversified ([Freeman and Quinn 2012](#); [Stulz 2005](#)). This is especially true in developing countries, where elections are associated with significant policy volatility ([Fatás and Mihov 2013](#); [Nooruddin 2011](#)).

Existing work assumes, implicitly or explicitly, that domestic and foreign portfolio investors have similar exposure to local risks. However, in most countries local investors are disproportionately invested in their own home markets. This phenomenon, known as home bias, is well documented and refers to investors' tendency to allocate a disproportionately large share of their portfolios in domestic assets, thus underinvesting in foreign assets despite the available gains from international diversification ([Coeurdacier and Rey 2013](#); [Obstfeld and Rogoff 2001](#); [Lewis 1999](#)).

Standard portfolio theory dictates that investors should have diversified international portfolios. The reason is that the total risk of a portfolio is determined by how correlated the different assets in the portfolio are. The higher the correlation, the higher the risk. Thus, portfolios that concentrate on

assets from the same country, where all assets are susceptible to the same domestic policy shocks, will be riskier than internationally-diversified portfolios. Indeed, the workhorse model of global portfolio allocation—the international capital asset pricing model (ICAPM)—says that investors should hold stocks from different countries in proportion to those countries’ share of global stock markets (Coeurdacier and Rey 2013; Lewis 1999).

However, despite the growth of global capital markets in the last decades, investors have yet to take full advantage of diversification opportunities. In most countries, foreign stocks make up only a small share of investors’ portfolios. US investors, for example, still invest less than 20% of their portfolios abroad, even though non-US stocks represent approximately 60% of the world’s investable portfolio (Figure A1 in the Supplementary Information). Although this home bias has decreased over time in OECD economies, it still remains large (Coeurdacier and Rey 2013; Cooper, Sercu, and Vanpée 2013). In developing economies, home bias is even more acute (Figure 2). Moreover, it has not shown signs of declining over time, consistent with these countries’ low level of integration into global markets (Mishra 2015; Cooper, Sercu, and Vanpée 2013). In this regard, developing country markets have stayed on the sidelines of globalization, as local investors remain tethered to their home markets.

For domestic investors, whose assets are overwhelmingly tied to the performance of the national economy, elections can be a significant source of investment risk and uncertainty. In particular, leadership turnover may result in adverse policy changes, including higher taxation, stricter regulation, and greater tolerance towards deficit spending and inflation. Moreover, such uncertainty is especially high in the context of developing country politics (Brooks, Cunha, and Mosley 2022; Freeman and Quinn 2012). For one, these countries typically have weakly institutionalized party systems, characterized by personalistic representation and uninformative party labels. This heightens uncertainty to the extent that the identity of the governing party is not always a good predictor of policy content (Mainwaring and Torcal 2006). Weakly institutionalized systems also produce high electoral volatility. When coupled with ample policy discretion, electoral volatility can lead to wide swings in economic policy (Cohen, Salles Kobilanski, and Zechmeister 2018; Fatás and Mihov

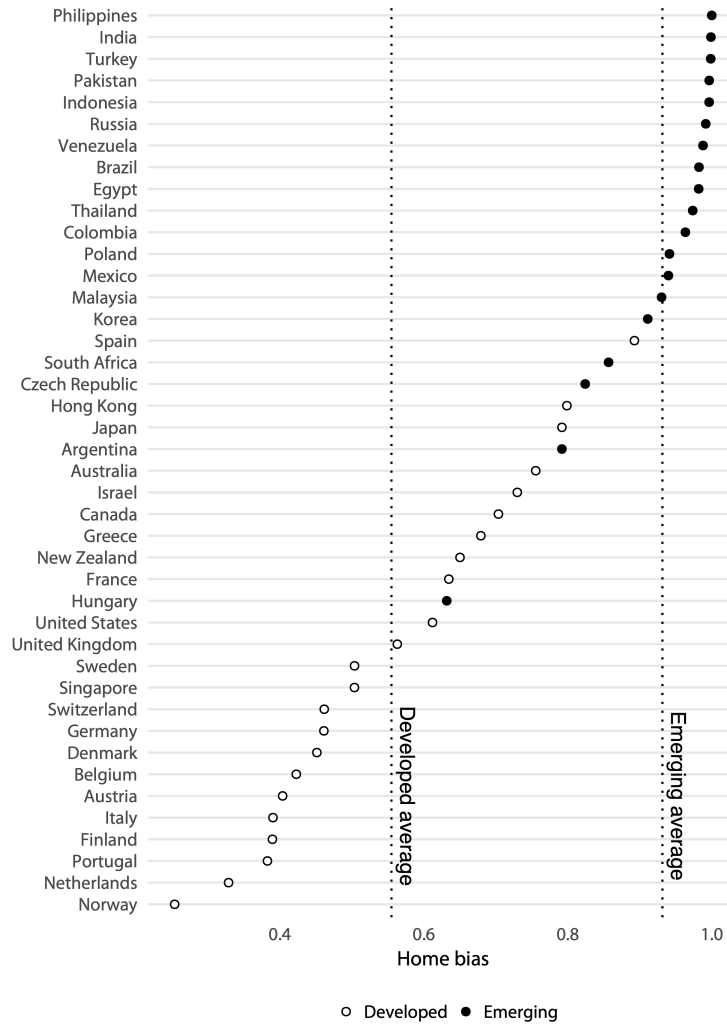


Figure 2. Home bias in emerging and developed markets. Measure ranges from zero (when investors hold stocks from home country in proportion to the country's share of the world portfolio) to one (when investors exclusively hold stocks from home country). Source: [Mishra \(2015\)](#).

2013). Of particular concern for investors is distributive conflict in unequal societies, which increases demand for redistributive policies at the ballot. As a result, electoral turnover in developing democracies comes with considerable investor uncertainty.

With portfolios heavily concentrated in home assets, domestic investors are overexposed to political risk and therefore should be highly sensitive to election-induced uncertainty. Relative to foreign investors with more diversified portfolios, elections will disproportionately affect the interests of domestic investors. We thus should observe sharp movements in local asset prices, as local investors shift their portfolios into and out of risky assets in response to perceived changes

in electoral risk. Domestic investors hedging against political risk will shift away from risky assets such as equity and local currency into safer assets such as fixed income or global reserve assets like hard currency and gold. Conversely, investors will move into riskier local assets when a favorable election outcome is expected.

Compared to domestic investors, we should expect more muted responses from international investors. Local investors' overexposure to the home market means that their economic fate is tied to domestic policy cycles. In contrast, elections should have a more limited effect on foreign investors, as the latter will typically have only a small share of their assets invested in any given foreign country. Indeed, the very purpose of diversifying towards emerging markets is to take advantage of return opportunities while reducing overall risk. International investors therefore will be less affected by any single developing country election, given that these account for a small share of their total portfolio risk. We should therefore expect larger reactions from domestic investors than from international investors.

3.2 Information Asymmetries and the Domestic Investor Lead

Domestic markets should matter not only because of their high responsiveness to political risk, but also because of their impact on international markets. Where local investors hold an information advantage relative to foreign ones, the former should lead the latter's response to elections.

Despite claims that progress in information technology have erased distances and eliminated information costs for cross-border investing, research in international finance shows that information costs and the advantages of location still matter for portfolio investing. Proximity affords domestic investors an advantage in terms of access, cost, and ability to process information in context. This information advantage typically translates into better investment performance for domestic investors in their home markets relative to foreign investors. In developed and developing markets alike, the trading patterns of local investors are consistent with the existence of an information advantage (Ferreira et al. 2017); local investors normally obtain higher returns than foreign investors (Teo 2009; Choe, Kho, and Stulz 2005; Dvořák 2005) and the investment recommendations of local

analysts tend to outperform those of foreign analysts ([Chang 2010](#); [Bae, Stulz, and Tan 2008](#)).

These information asymmetries should matter for financial markets' reactions to politics. Existing models underscore the centrality of informed investors in asset price formation ([Mele and Sangiorgi 2015](#); [Calvo and Mendoza 2000](#)). These models emphasize the role of market prices as an information transmission mechanism. Where investors face different information costs, those with lower costs will have an incentive to invest in information acquisition. New information will then be incorporated into market prices through their informed trading. Investors with higher costs will have fewer incentives to pay information costs, as they can infer changes in asset values from market prices.² Differential incentives for information acquisition can therefore result in dynamics of information transmission from informed to uninformed traders.

While such information asymmetries are common in financial markets, they are especially pronounced when it comes to global investing. Maintaining a global portfolio entails high information costs. Investing in foreign markets requires the routine collection and processing of detailed information about target countries, from macro- and microeconomic data to political indicators ([Mosley 2003](#); [Bernhard and Leblang 2006](#); [Leblang 2002](#)). Estimating outcome probabilities for political processes and the implications of political events for investors' portfolios is complex. Investors must take into account the institutional environment and the strategies of multiple political actors. Assessing political risk is especially challenging in developing countries, where weak institutions and volatile conditions sharply raise information costs ([Ferreira et al. 2017](#)).

Under these conditions, local investors can have access to more precise signals about political risk than foreign investors. Cross-border monitoring is more difficult than in a domestic context, and unfamiliarity with the political and regulatory environment adds significant costs for investors wishing to diversify towards developing markets. Proximity to and familiarity with local politics afford local investors easier access to information, and international investors may only be able to obtain the same information at a higher cost ([Frankel and Schmukler 2000](#)). Domestic investors

²A strong version of this argument assumes that prices incorporate all public and private information (efficient markets), but the informational value of market prices holds under weaker assumptions, as long as prices largely reflect available information. In fact, some inefficiency may be required for investors to recover their investment in information ([Grossman and Stiglitz 1980](#)).

can exploit political connections that afford them access to privileged information (Braun and Radatz 2010). Dense professional and political networks also afford domestic investors prompt access to local knowledge (Ozsoylev et al. 2014). Moreover, knowledge of local politics puts domestic investors in a favorable position to interpret information in context and form timely and accurate risk assessments.

This informational model predicts that foreign investors will take advantage of price signals in local markets. Indeed, taking cues from local markets can be efficient. Research shows that investors systematically use informational shortcuts to assess country risks (Gray 2013; Brooks, Cunha, and Mosley 2015). Professional incentives may reinforce the appeal of this strategy, since investment professionals face performance reviews relative to their peers or market benchmarks. Investors concerned with their reputations within the industry may follow other investors to avoid being outperformed (Mosley 2003; Linsi and Schaffner 2019). For international investors, this may include foregoing the costly acquisition of local information and drawing on cues from local markets, since investing in complex and uncertain environments “requires a degree of due diligence that many [foreign investors] are unwilling to commit.”³ Combining their own information with information drawn from the trading activity of local investors allows foreign investors to work around information constraints when assessing political risk.

We should therefore expect to observe dynamics of information transmission, or contagion, from local to international markets, whereby political shocks in developing countries propagate from local to global capital markets. Investors from developing countries should play a key role in acquiring and processing timely information on country risks. Price movements resulting from their trading activity will signal changes in fundamentals to international investors. Observationally, this implies that local responses to elections should be predictive of international responses.

Taken together, home bias and information asymmetry lead to two testable hypotheses: (1) domestic markets will react more frequently and strongly to elections than international markets, and (2) domestic markets will lead international markets in responding to election-related risk.

³“Investors will shun chaotic Brazil until signs of progress.” *Financial Times*, June 19, 2019.

4 Data and Methods

The main challenge in analyzing domestic and international investor reactions to elections is teasing out their respective responses. Conventional data, such as stock and bond market indices, are of limited use, since they aggregate the market activity of domestic and foreign participants. Instead, I exploit price differentials for the same country assets across different markets to capture differences in the market sentiment of domestic and foreign investors towards a country. The strategy compares the price of a portfolio of country stocks, as determined in the country's local stock market, against the price of the same portfolio of stocks as determined in international markets.

I examine these price differentials using data on closed-end country funds. Country funds are actively-managed investment funds that focus on stocks from a single country. Like other international funds, country funds allow investors to diversify toward foreign markets without requiring knowledge of specific firms or industries in the country ([Fletcher 2021](#); [Cohen and Remolona 2008](#)). Unlike conventional mutual funds, country funds consist of a fixed number of shares that are publicly traded in exchanges like regular stocks. Once a closed-end fund is established, new shares cannot be issued and existing shares cannot be redeemed. Instead, investors must trade fund shares in secondary markets. As such, country funds allow investors to trade a whole country portfolio in a single transaction.

Empirically, a useful feature of country funds is the premium (or discount) at which they trade relative to the value of their constituent stocks ([Cohen and Remolona 2008](#); [Frankel and Schmukler 2000](#); [Levy-Yeyati and Ubide 2000](#)). The fund premium is the difference between the fund price and the value of the underlying equities held by the fund, known as the fund's net asset value (NAV). In the New York Stock Exchange, for example, country funds trade at their US dollar price, and their price reflects the demand for stocks from a particular country among Wall Street investors. The fund's net asset value is the dollar value of the stocks held by the fund, which reflects demand for the country's stocks in the country's own stock market.

The country fund premium provides a measure of the differential market sentiment of foreign and domestic investors towards the target country. While the fund price is determined in global

financial centers, the net asset value is determined in local stock markets. As such, the premium reflects how much fund holders value the fund relative to holders of the country stocks (Cohen and Remolona 2008; Levy-Yeyati and Ubide 2000; Frankel and Schmukler 2000). Indeed, research in international finance shows that the fund price reflects relatively better the information and market sentiment of international investors, while the NAV better reflects the sentiment of local stock investors (Cohen and Remolona 2008; Frankel and Schmukler 2000).

I compile a dataset of single-country funds whose target country is considered an emerging or developing market by the main index providers (MSCI and FTSE) and has held general elections in the period under analysis. The sample excludes funds with a multi-country focus and funds whose target country does not hold regular general elections. The 21 funds in the sample invest primarily in stocks; most of the funds are mandated to hold at least 80% of their assets in equities from the target country. The fund sample has wide geographic coverage, including 13 countries from Africa, Asia, and Latin America. Weekly pricing data is available for the 1988–2015 period, while daily data covers 1992–2015.⁴

Table 1 shows summary statistics for the weekly return on country funds and their net asset values, as well as for the fund premium. There is wide cross-country variation in fund premia; most funds trade at a discount on average, but some even show a large premium. Furthermore, the standard deviation of the fund premia shows significant variation within countries over time. Overall, variation in fund premia seems to reflect both country-specific factors and common external shocks (Figure A3). Importantly, country fund markets can be used as a microcosm of global stock markets where one can observe global-local investor interactions. Movements in the value of country fund holdings are strongly correlated with national stock markets; the median correlation between the NAV and a broad-based country index is 0.82 and 0.79 for daily and weekly returns, respectively (Table A4). This suggests that country fund behavior is likely representative of the broader stock market. Therefore, country fund data can offer insights into the interaction between markets and politics beyond fund markets.

⁴Details about the sample and fund mandates appear in the SI. The data was collected from Bloomberg and Lipper/Thomson Reuters, and because they are proprietary, coverage is only available to the author until 2015.

Table 1. Summary statistics for emerging market country funds

<i>Fund Name</i>	<i>Symbol</i>	<i>Fund</i>		<i>Net Asset Value</i>		<i>Premium</i>	
		<i>Mean</i>	<i>SD</i>	<i>Mean</i>	<i>SD</i>	<i>Mean</i>	<i>SD</i>
Argentina Fund	AF	−0.11	4.70	−0.05	3.51	−6.73	15.62
Brazilian Equity Fund	BZL	−0.05	5.93	−0.03	5.76	−9.45	11.89
Brazil Fund	BZF	0.18	5.73	0.18	5.87	−11.12	14.60
JPMorgan Brazil Inv. Trust	JPB	−0.24	3.35	−0.21	3.36	−3.40	4.80
Chile Fund	CH	0.00	4.60	0.03	3.32	−7.79	11.46
First Philippine Fund	FPF	−0.22	4.81	−0.19	3.53	−15.71	9.02
India Fund	IFN	0.06	5.08	0.07	4.01	−8.75	12.35
India Growth Fund	IGF	−0.01	4.79	−0.00	4.05	−6.70	18.43
Indonesia Fund	IF	−0.04	6.66	−0.03	4.89	7.24	22.77
Jakarta Growth Fund	JGF	−0.41	7.07	−0.41	4.71	7.44	19.51
Korea Equity Fund	KEF	−0.01	4.81	0.01	4.68	−8.58	10.13
Korea Fund	KF	−0.11	6.15	−0.09	5.80	−1.36	16.98
Malaysia Fund	MF	0.03	5.03	0.02	3.63	−2.76	18.74
Mexico Equity & Income Fund	MXE	0.03	5.31	0.03	4.55	−10.06	8.74
Mexico Fund	MXF	0.13	4.78	0.11	4.22	−12.02	9.04
New South Africa Fund	SOA	−0.14	4.14	−0.14	3.94	−17.13	5.46
Taiwan Equity Fund	TYW	0.10	4.57	0.13	4.06	−11.88	10.91
Taiwan Fund	TWN	−0.03	4.91	0.01	4.13	−3.39	17.93
Thai Capital Fund	TC	−0.06	5.69	−0.05	3.96	0.85	22.18
Thai Fund	TTF	−0.04	5.69	0.02	4.46	9.32	28.41
Turkish Investment Fund	TKF	−0.00	6.36	0.00	6.60	−1.90	15.89

Table shows descriptive statistics for the weekly fund return, net asset value return, and fund premium (in percentages). Fund and NAV returns calculated as: $Return_t = \ln(Price_t/Price_{t-1}) \times 100$. Fund premia calculated as: $Premium_t = [(Price_t/NAV_t) - 1] \times 100$.

The empirical strategy does *not* assume that local stock prices are driven solely by domestic investors. The critical assumption is that the two investor populations—those active in global centers and those active in local markets—are distinct, and that the influence of international and domestic investors in determining fund prices and NAVs is proportional to their participation in each market (Cohen and Remolona 2008). This strategy would be problematic if foreign investor sentiment had a disproportional impact on local asset prices. Nonetheless, existing research finds no consistent evidence that foreign investors “punch above their weight” (Bekaert et al. 2016; Karolyi and Stulz 2003). Moreover, on average foreign investors account for only 15% of the number of trades and 31% of the value of trades in emerging markets (World Federation of Exchanges 2018, 21). To the extent that investor populations in local and global markets overlap, the analysis is likely to yield conservative estimates of the differential reactions of local and foreign investors.

4.1 *Estimating Market Responses to Elections*

Given home bias in investors' portfolios and the limits to financial integration in emerging markets, risks arising from elections should be mostly reflected in changes in local asset prices. That is, a country fund's net asset value should be more sensitive to elections than the fund's international price. I combine multiple strategies to test this first hypothesis.

First, I assess abnormal market behavior during elections using an event study design. Event studies are widely used to estimate the effect of political events on asset prices. I estimate the abnormal return on country funds and their net asset values during electoral periods to gauge domestic and international responses to elections. The main quantity of interest—the cumulative abnormal return—is the observed return over the election window net of the normal, or expected, return that would have obtained had the election not occurred. Using a regression model of country fund returns, one can estimate the electoral abnormal returns by adding dummy variables for each day of the election window. I thus add the following term to the regression specification (see more details about model specification below): $\sum_{\tau=T_1}^{T_2} \beta_{\tau} D_{\tau,t}$, where $D_{\tau,t}$ are dummy variables coded one for day $t = \tau$ in the election window and zero otherwise, for $\tau = T_1, T_1 + 1, \dots, T_2$. The election window is $T_1 \leq \tau \leq T_2$. Estimates of β_{τ} give daily abnormal market returns throughout the election period. I obtain the cumulative abnormal return (CAR), i.e. the total impact of the election on markets, by summing the daily abnormal returns, $\hat{\beta}_{\tau}$, over the event window. If political risk is priced locally, one should observe significant local market reactions as captured by the net asset value CAR, while the country fund CAR should not be significant.

For this analysis, the election window covers the period from 30 days before an election until the day after the election.⁵ This ensures that the abnormal return estimates will pick up both the effect of ex ante electoral uncertainty on markets as well as any anticipatory effects. For one, financial markets will instantaneously incorporate information about the likelihood of alternative outcomes and the future course of economic policy as new information—such as changes in polling numbers

⁵The typical campaign period is 30-60 days (Bernhard and Leblang 2006). Robustness checks reported in the SI show that the results hold for a longer event window of 60 days.

and candidates' policy announcements—is revealed throughout the campaign. This information should affect asset prices ahead of the election day, especially when the outcome is seen as relatively predictable (Bernhard and Leblang 2006). When the outcome is less predictable, ex ante uncertainty will also impact market prices before the election takes place, as investors will demand a larger premium to hold risky assets during the campaign (Pantzalis, Stangeland, and Turtle 2000; Bechtel 2009). In most cases, therefore, asset prices will adjust before the election even happens. Still, this specification of the election window also captures any surprises that may arise as the election results are revealed, which should be reflected in asset prices around the election day (Sattler 2013).

The second strategy compares the median abnormal return during the election to a distribution of median returns obtained from non-electoral periods. This test has two advantages: it is robust to outliers and fat-tailed return distributions, and it complements a traditional event study, which tends to have low power for multi-day event windows. For each country fund, I randomly select a non-electoral period, defined as a sequence of 250 consecutive trading days (~ 1 calendar year) that do not fall within six months prior to or after an election. For each sampled non-electoral period, I estimate a model for the fund price and for the net asset value, obtain the abnormal returns for the price and NAV, and identify the median abnormal return in the period. I repeat this procedure 5,000 times for each fund to obtain an empirical distribution of median abnormal returns in non-electoral periods, from which I calculate 95% confidence intervals (Bernhard and Leblang 2006). I then calculate the median abnormal return for each electoral period in the sample (the period of 30 days before an election, election day included), and compare it against the distribution of non-electoral returns to assess the extent to which elections cause abnormal movements in domestic and international prices.

Third, I test how local and international markets respond to ex ante electoral uncertainty by incorporating daily data on presidential polling, which is available for 14 elections in 5 of the sampled countries. I measure changes in uncertainty over the election outcome using the formula: $Entropy_t = 1 - 4[(p_t - 0.5)^2]$, where p_t is the frontrunner's share of the two-party vote (Bechtel 2009; Freeman, Hays, and Stix 2000). The entropy variable takes higher values when the two lead-

ing candidates have equal chances of winning (when p is close to .5) and lower values when one candidate is certain to win (when p is closer to 1). I estimate the effect of electoral uncertainty using the model specification described in the next section, adding entropy as an exogenous term to the regression model. The coefficient $\beta_{Entropy}$ captures the responsiveness of local and global markets to uncertainty shocks in the run-up to elections.

Finally, because market reactions also depend on the ideological make-up of the incoming government (Brooks, Cunha, and Mosley 2022; Leblang 2002), I incorporate heterogeneity across partisan lines. Using data from Herre (Forthcoming), I add a term to the regression, $(Election_t \times LeftElected_t)$, that interacts an election period dummy with a government ideology dummy coded one if a left government is elected; zero for a right or center government. Beyond the expected ideology of the new government, markets may react more strongly to elections that result in a partisan switch. Therefore, I alternately include the terms $(Election_t \times LeftSwitch_t)$ and $(Election_t \times RightSwitch_t)$, where $LeftSwitch_t$ and $RightSwitch_t$ are coded one if the election results in a partisan change from right/center to left and from left to right/center, respectively; zero otherwise.

4.2 A Vector Error Correction Model of Cross-Border Contagion

In this section, I specify the vector error correction model that will be used to test the domestic investor lead hypothesis. This model is also used to estimate the frequency and size of market responses to elections as described in the previous section. Critical to testing the domestic investor information lead is being able to determine the direction of contagion between domestic and international markets.

A vector error correction model (VECM) is a natural modeling choice for testing dynamics of information transmission between local and international markets, as it incorporates both short- and long-run relationships between international and local markets. Where local investors have an information advantage, local asset prices should closely track domestic risks. Less well-informed foreign investors will take advantage of the information contained in local stock prices to inform their responses. In this process, short-run changes in the net asset value (NAV), which better reflect

changes in local investor sentiment, should help predict changes in international fund prices, which reflect global investor sentiment. In the context of a VECM, short-run changes in local stock prices are a function of past short-run changes in international prices, and vice-versa.

More importantly, VECMs also capture the long-run relationship between local and international markets. A central implication of the information asymmetry model is that domestic and international markets should be in a long-run equilibrium relationship. If fund prices and NAVs represent two market prices for the same portfolio of country stocks, in the long run both should reflect the fundamental value of that portfolio. In the short run, however, shocks can send the two series away from their equilibrium value. As new information emerges, domestic investors respond swiftly, moving the NAV away from the fund price. Then, as foreign investors observe price changes in the local market, they adjust their portfolios accordingly and bring the fund price closer to the NAV, thus reestablishing the equilibrium. Therefore, we should expect country fund prices to respond to deviations from the equilibrium (but not the net asset value).

I model these contagion dynamics using a fractional error correction model. Compared to a conventional ECM, a fractional ECM is more general, as it does not require strong assumptions about cointegration. In conventional ECMs, researchers must first determine that the long-run equilibrium is perfectly stationary, that is, that any deviations from equilibrium are immediately corrected. In contrast, fractional cointegration allows deviations from equilibrium to persist in the short-run and dissipate over longer horizons, thus better capturing price dynamics in a world of information frictions as well as implicit and explicit barriers to cross-border arbitrage.⁶ Indeed, existing work highlights the importance of allowing for fractional cointegration when modeling financial market dynamics ([Bollerslev et al. 2013](#); [Baillie and Bollerslev 1994](#)).

For the country fund price and net asset value, the fractional error correction model can be

⁶Formally, traditional cointegration assumes that a linear combination of the parent series has order of integration zero, $I(0)$. Fractional cointegration relaxes this requirement, allowing the order of integration to be $I(d)$, with $0 < d < 1$. Two series are cointegrated if they have the same order of integration, d , and if the order of the cointegrating residuals, d' , is less than that of the parent series ($d' < d$).

written as:

$$\begin{aligned}\Delta p_t &= \phi_1 + \alpha_1[(1-L)^d - (1-L)]z_t + \gamma_{1i}\Delta n_{t-i} + \omega_{1i}\Delta p_{t-i} + \beta_1 X_t + v_{1t} \\ \Delta n_t &= \phi_2 + \alpha_2[(1-L)^d - (1-L)]z_t + \gamma_{2i}\Delta p_{t-i} + \omega_{2i}\Delta n_{t-i} + \beta_2 X_t + v_{2t}\end{aligned}\tag{1}$$

where p_t is the log of the fund price, n_t is the log of the fund's net asset value, ϕ_1 and ϕ_2 are intercept terms, γ_i are the coefficients on the lagged changes in the other series, ω_i are the coefficients on the lagged changes in the series themselves, X_t is a vector of controls, and v_{1t} and v_{2t} are disturbance terms. The (fractionally integrated) error correction term is $\alpha[(1-L)^d - (1-L)]z_t$, where L is the lag operator, d is the fractional differencing parameter, and z_t captures deviations from the long-run equilibrium relationship between the fund price and the net asset value. The equilibrium errors, z_t , are obtained from the residuals of the cointegrating equation, $p_t = \delta_0 + \delta_1 n_t + z_t$. I estimate the model using the Engle-Granger two-step procedure (described in the SI). To ensure that the results capture country-specific risks net of global market movements, the vector of controls, X_t , consists of common external factors that account for variation in international and local prices, including stock indexes for developed markets (MSCI World), emerging markets (MSCI Emerging Markets), large US stocks (S&P 500), and small-capitalization US stocks (Russell 2000).

The main coefficients of interest for testing the information asymmetry hypothesis are α_1 and α_2 , known as the error correction parameters. They capture the speed with which the fund price and NAV return to equilibrium after a shock moves them away from each other. For example, if domestic markets react swiftly to new developments in the election campaign, α_1 will tell us how long international markets will take to incorporate the new information contained in domestic market prices. In other words, the error correction parameters tell us how responsive international prices are to changes in local prices, and vice-versa. High values of α_1 indicate that the fund price is highly responsive to deviations from local prices, whereas high values of α_2 would mean that domestic prices are sensitive to international fund prices. If international investors follow local markets as predicted by the information asymmetry hypothesis, then α_1 , the adjustment rate of the fund price, should be large. Likewise, α_2 will be small if domestic investors lead the response to domestic shocks

instead of lagging international markets.

One can further test the implications of the information asymmetry model using a Granger causality test of the joint null that the error correction parameter and the short-run parameters, γ_i , equal zero. If as expected domestic prices are predictive of international prices, one would reject the joint null hypothesis that α_1 and all γ_{1i} equal zero. Accordingly, if international prices have little predictive value over domestic prices, we should fail to reject the joint null that α_2 and all γ_{2i} equal zero.

5 Results

5.1 *Are local markets more responsive to elections than global markets?*

I start by evaluating the evidence for the hypothesis that domestic markets are more responsive to national elections. The first test involves calculating the cumulative abnormal return of the country fund and the NAV in the thirty days leading up to the election (election day included). For the sake of space, I report the results in the SI (Table A19). The cumulative abnormal return provides a measure of the total impact of elections on markets. The results show a discernible response of domestic prices (NAVs) to upcoming elections in 5 out of 32 cases, while international (country fund) prices show a discernible reaction in only one case. The results are similar when using an election window of 60 days, as shown in the SI. However, event studies of this type can be underpowered for multi-day event windows, with power decreasing with the size of the event window, which likely explains why market reactions can only be accurately detected in some cases.

To complement this analysis, an analysis of median abnormal returns during electoral periods confirms the greater responsiveness of local markets to elections. Figure 3 shows the median abnormal return during electoral periods for each fund and election pair, as well as the empirical 95% confidence interval for non-electoral periods. The sample includes 84 fund-election pairs that cover 60 elections in 13 countries. Solid black points represent median abnormal returns in electoral periods that can be distinguished from non-electoral median returns with 95% confidence. For local

markets, as captured by the fund’s net asset value, the median abnormal return in electoral periods is statistically significant in 53 of the 84 cases (63%), while for international markets, as captured by the country fund price, the median abnormal return is significant in only 36 cases (43%). These results confirm that local markets react abnormally to elections more often than not, while international markets react much less frequently. Moreover, for those cases where any measurable market response to the election is detected, a Wilcoxon signed rank test provides supporting evidence for the hypothesis that domestic markets show more extreme electoral returns (in absolute value) than international markets ($p = 0.054$, $n = 53$), though the small cross-section of elections suggests caution in interpreting the test.

Estimated market responses to pre-election polls reinforces these findings. Figure 4 shows estimates of the effect of electoral uncertainty on country fund prices and net asset values, where electoral uncertainty is measured by the entropy variable. The figure only shows the coefficients for entropy; full model results appear in the SI. Figure 4 shows a disparity in how domestic and international markets respond to electoral uncertainty. In panel (a), estimates using pooled country fund data show that domestic markets are highly responsive to electoral uncertainty, as indicated by the large and statistically significant $\hat{\beta}_{Entropy}$ for the NAV, while there is no clear evidence of an international market response. Panel (b) reports separate estimates by fund-election pair, showing evidence of a domestic market response to electoral uncertainty in 5 out of 14 cases with 90% confidence and 3 cases with 95% confidence. In none of the cases are international markets discernibly sensitive to electoral uncertainty.

Local equity markets seem particularly sensitive to Brazilian elections. In the institutional literature, Brazil is described as having a weakly institutionalized party system, high electoral volatility, and high fiscal policy volatility. Weak institutionalization and high electoral volatility contribute to political opaqueness and uncertainty, while high fiscal policy discretion means that elections pose high stakes for investors, as executive turnover can cause wide swings in economic policy. These factors likely explain markets’ heightened sensitivity to electoral uncertainty in the country. These results are also in line with [Hardie \(2006\)](#)’s findings regarding Brazil’s 2002 presidential election,

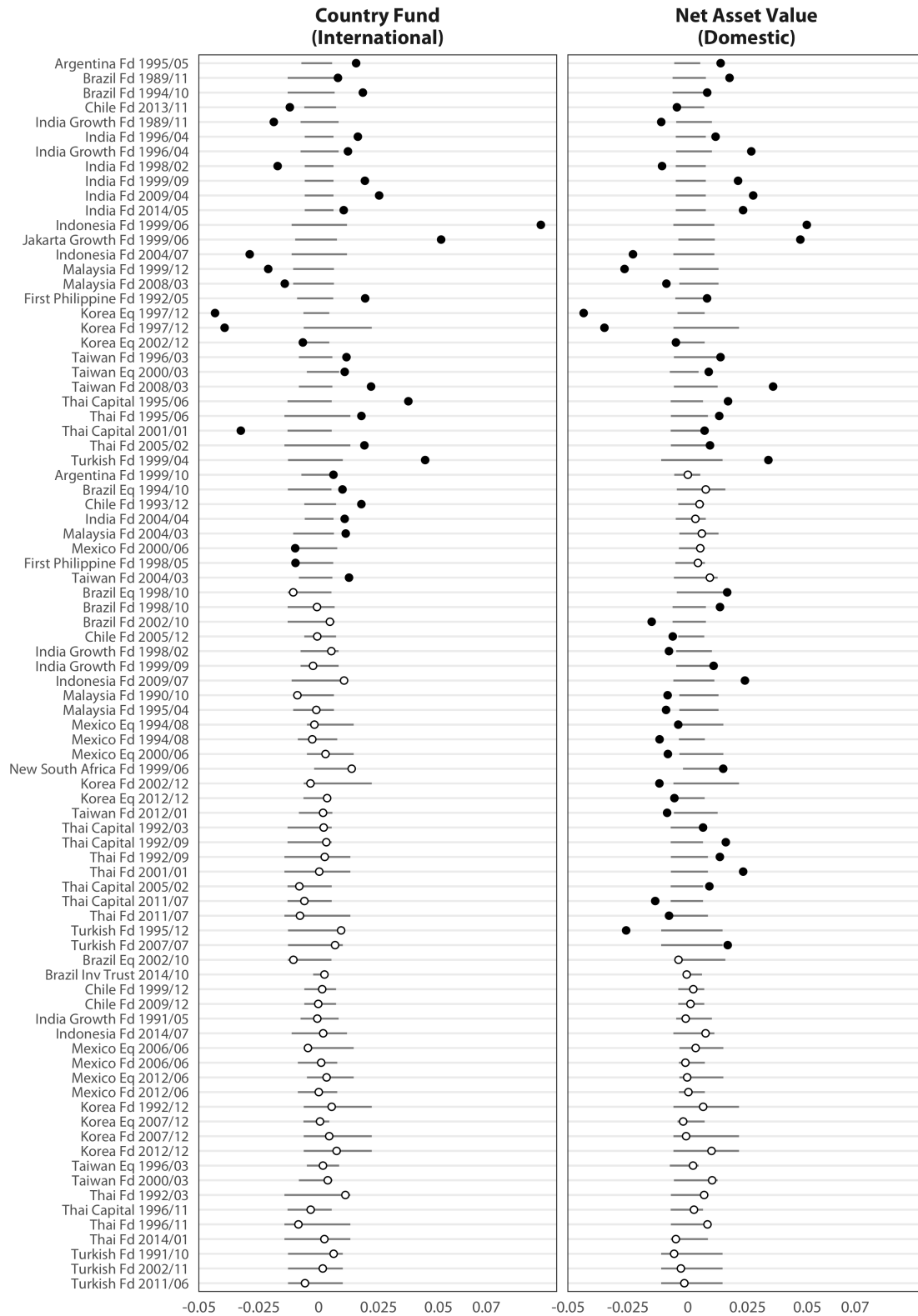


Figure 3. Median abnormal return of domestic and international assets in the run-up to elections. Points show median abnormal return in the thirty days before the election, election day included. Bars are 95% CIs from a bootstrapped distribution of median abnormal returns in non-electoral periods. Black points show electoral estimates that are statistically distinguishable from non-electoral periods. Sample includes 84 fund-election pairs spanning 60 elections in 13 countries.

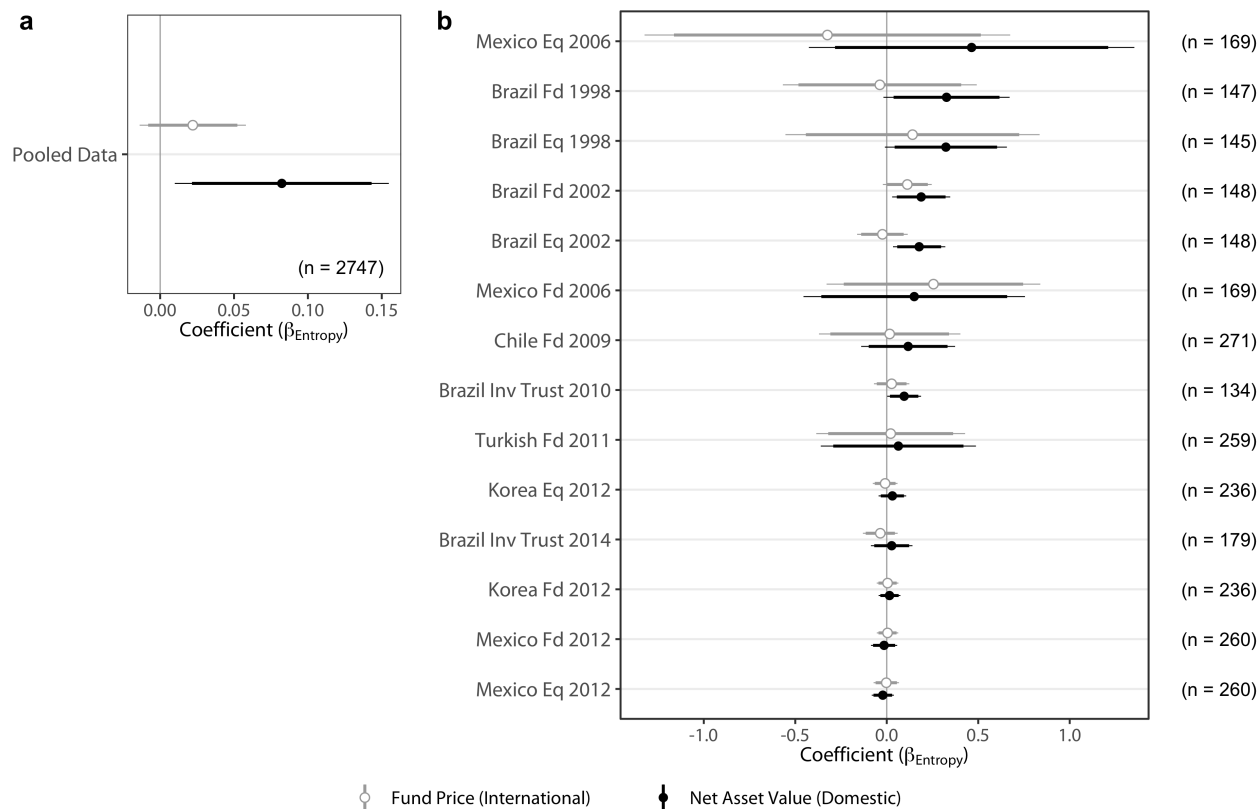


Figure 4. Electoral entropy, local markets, and international markets. Plot shows coefficients for the electoral uncertainty (entropy) variable, $\beta_{Entropy}$. Bars are 90% and 95% CIs. Panel (a) shows estimates from a time-series cross-sectional model of pooled fund data with country fixed effects and standard errors clustered by country; panel (b) shows separate models by fund-election pair. Sample includes 14 cases covering 9 elections in 5 countries.

according to which foreign bondholders were not very sensitive to the unprecedented rise of the left-wing Workers' Party to power.

Finally, Tables A17 and A18 assess market responses based on the expected ideology of the incoming government. The results in Table A17 confirm that domestic markets are more sensitive to elections than foreign markets, especially when left governments are elected. Furthermore, domestic markets react to partisan switches in government more than international markets, as shown in Table A18. This is the case both for shifts from right/center to left and from left to right/center. Taken together, these findings underscore that domestic investors are major drivers of responses to elections.

5.2 *Do local markets lead global markets?*

The information asymmetry hypothesis predicts that local markets should lead the response of global markets to domestic political risk. An examination of the dynamic properties of the country fund data provides initial support for this prediction. Unit root and cointegration tests, reported in the SI, provide evidence of a long-run equilibrium relationship between international and domestic prices. Specifically, I find strong evidence of fractional cointegration, which indicates that international and domestic prices share an equilibrium relationship characterized by shocks that are persistent over time but mean-reverting. In other words, when a shock sends the two price series apart, they eventually return to their shared trajectory.

The error correction analysis examines the direction of contagion between international and domestic markets. The information asymmetry hypothesis predicts that international investors should respond to deviations from equilibrium as they take cues from local markets and adjust accordingly. Estimates of the error correction parameter, α , are of special interest, as they tell us how responsive international markets are to equilibrium deviations. Figure 5 shows error correction rates, α (in absolute value), using weekly data to maximize the sample coverage (full model results are shown in Table A14). The results show strong evidence of contagion from domestic to international markets. Estimates of α_1 , which capture the responsiveness of country fund prices to the NAV, are statistically significant for 19 of 21 funds, indicating that international markets systematically adjust to deviations from domestic prices. In contrast, error correction rates for the net asset value, α_2 , are statistically significant in only 4 out of 21 funds, which indicates that local markets seldom follow international markets.

When it comes to differences in the size of the error correction rates, Figure 5 shows that the estimates are systematically larger for country funds than for their respective NAVs. With the exception of two funds, the error correction rates of country funds are larger than those of NAVs, and the difference is statistically significant in two-thirds of the cases. The top row in Figure 5 summarizes these findings by pooling the country fund data. The results show that international markets often respond to the price signals of domestic markets, but the reverse is rarely the case.

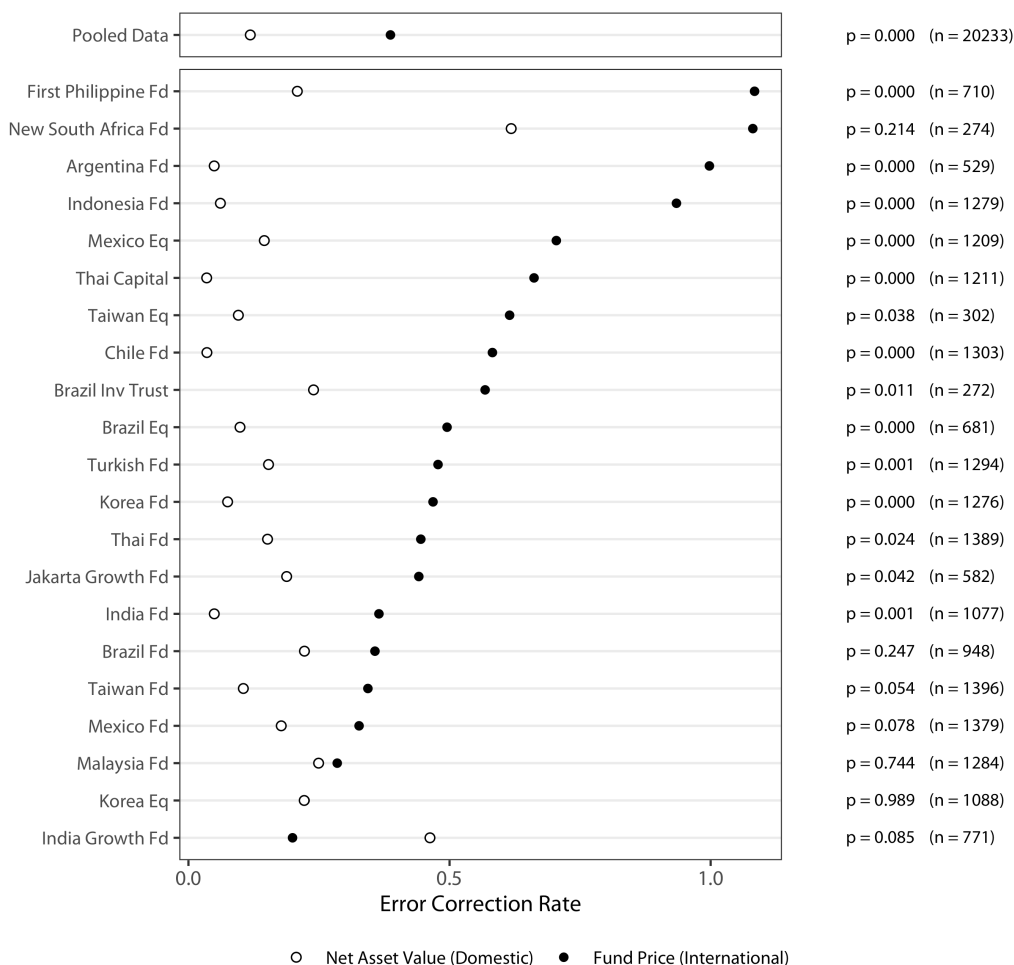


Figure 5. Do international markets follow domestic markets? Graph shows error correction rates for weekly fund and NAV returns (α_1 and α_2 in Eq. 1, respectively; in absolute value). Top row estimates obtained from a time-series cross-sectional model pooling all funds (with country fixed effects and standard errors clustered by country). p -values are for a two-sided test of the null that the two rates are equal.

The analysis of daily data further strengthens these conclusions. Daily data allows for a more accurate estimation of the dynamics of information transmission. It is also suitable for examining domestic-to-foreign contagion in individual elections, thus allowing for possible heterogeneity across cases, as enough observations are available within election years. Figure 6 compares error correction rates of country fund prices and NAVs for each fund and election in the sample (Table A19 reports full model results for the daily analysis). The daily data reveals the same contagion pattern as the weekly data. With few exceptions, error correction rates are higher for country funds than for NAVs. The difference in rates is statistically significant in 24 out of 32 cases. In 27 out

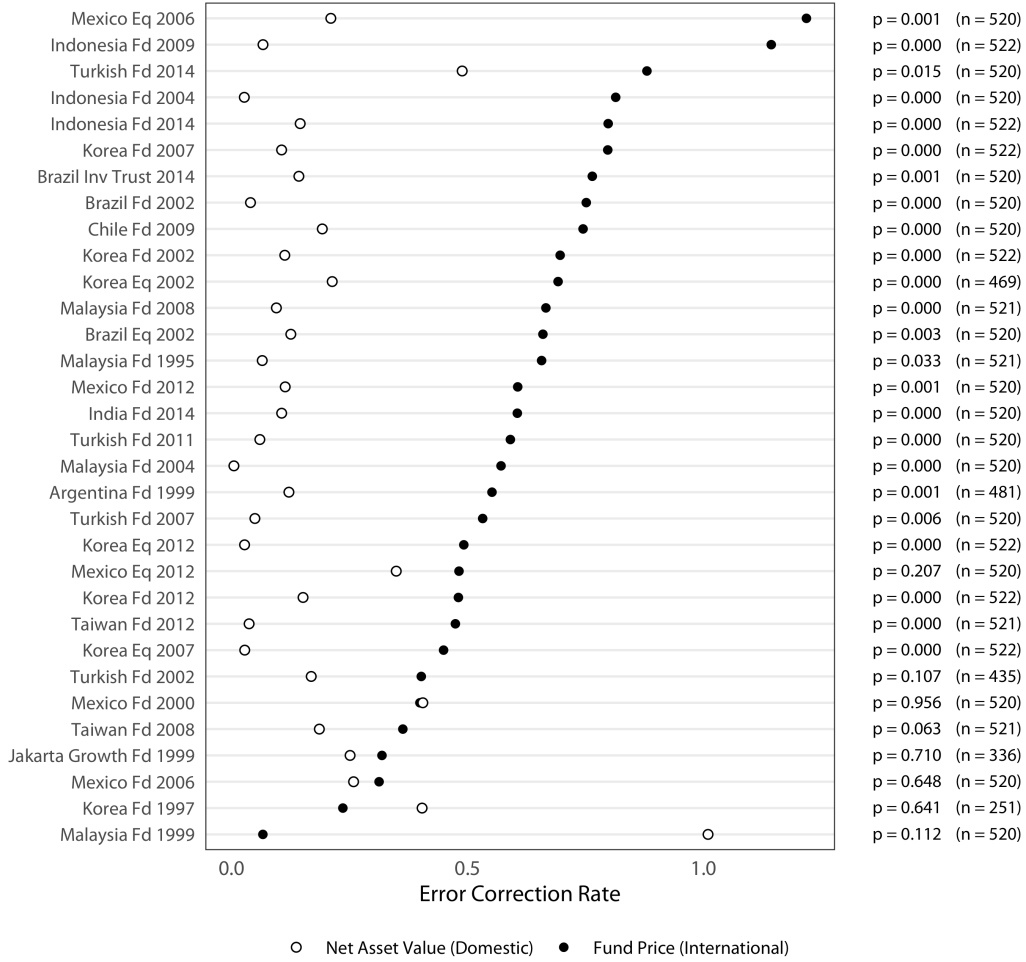


Figure 6. Do international markets follow domestic markets in election years? Error correction rates for daily fund and NAV returns around national elections (α_1 and α_2 , respectively; in absolute value). p -values are for a two-sided test of the null that the two rates are equal.

of 32 cases, the error correction rate of fund prices, α_1 , is statistically significant, indicating that international markets systematically adjust to deviations from domestic prices. For the NAV (α_2), the coefficients are significant in 13 out of 32 cases. These results provide further evidence that international markets follow domestic markets, but not vice-versa.

Finally, we can assess how predictive domestic market responses are of international market responses using Granger causality tests. In the context of error correction models, testing whether domestic markets Granger cause international markets means testing the joint hypotheses that $\alpha_1 = 0$ and all $\gamma_{1i} = 0$. Table 2 shows Granger causality results for election years using daily country fund data. The results show that domestic markets have predictive power over international markets for

Table 2. Granger causality tests using daily country fund data in election years

Country Fund	Election	NAV \rightarrow Fund Price		Fund Price \rightarrow NAV		N
		F Statistic	p-value	F Statistic	p-value	
Argentina Fd	1999	28.158	0.000	2.336	0.098	481
Brazil Eq	2002	32.707	0.000	0.828	0.479	520
Brazil Fd	2002	26.772	0.000	0.533	0.660	520
Brazil Inv Trust	2014	36.822	0.000	0.562	0.640	520
Chile Fd	2009	26.073	0.000	2.781	0.063	520
India Fd	2014	38.131	0.000	0.822	0.440	520
Indonesia Fd	2004	14.663	0.000	0.408	0.665	520
Indonesia Fd	2009	20.934	0.000	5.999	0.001	522
Indonesia Fd	2014	36.409	0.000	0.524	0.593	522
Jakarta Growth Fd	1999	1.819	0.164	3.424	0.034	336
Korea Eq	2002	59.089	0.000	14.592	0.000	469
Korea Eq	2007	16.087	0.000	0.614	0.542	522
Korea Eq	2012	83.165	0.000	0.334	0.716	522
Korea Fd	1997	0.574	0.564	4.277	0.015	251
Korea Fd	2002	31.539	0.000	2.180	0.114	522
Korea Fd	2007	17.118	0.000	3.370	0.035	522
Korea Fd	2012	38.052	0.000	5.196	0.006	522
Malaysia Fd	1995	3.316	0.037	0.402	0.669	521
Malaysia Fd	1999	0.155	0.857	4.137	0.017	520
Malaysia Fd	2004	19.831	0.000	0.636	0.530	520
Malaysia Fd	2008	22.561	0.000	5.198	0.006	521
Mexico Eq	2006	5.468	0.001	0.931	0.425	520
Mexico Eq	2012	23.238	0.000	7.456	0.001	520
Mexico Fd	2000	15.867	0.000	15.287	0.000	520
Mexico Fd	2006	7.899	0.000	10.244	0.000	520
Mexico Fd	2012	17.471	0.000	1.974	0.117	520
Taiwan Fd	2008	14.944	0.000	2.565	0.078	521
Taiwan Fd	2012	57.890	0.000	0.804	0.448	521
Turkish Fd	2002	23.024	0.000	3.259	0.039	435
Turkish Fd	2007	10.407	0.000	1.554	0.212	520
Turkish Fd	2011	20.580	0.000	0.172	0.842	520
Turkish Fd	2014	17.080	0.000	2.628	0.073	520

The NAV \rightarrow Fund Price column tests if local prices help predict international prices (joint null: $\alpha_1 = 0$ and all $\gamma_{1i} = 0$); the Fund Price \rightarrow NAV column tests if international prices help predict local prices (joint null: $\alpha_2 = 0$ and all $\gamma_{2i} = 0$). Table cells shaded in dark grey indicate statistical significance at the 1% level, and cells shaded in light grey at the 5% level. Tests are for models in Table A19.

most fund-election pairs in the sample. There is also some evidence, albeit weaker, that international markets can be predictive of local markets in some cases. Similar findings using weekly data are reported in the SI. These tests strongly support the hypothesis that domestic asset prices contain more information about local risks than international fund prices, and that the information flows

from the former to the latter.

6 Alternative Explanations and Robustness Checks

Differences in local and international responses to elections could be driven by differences in market liquidity. If local stock markets are less liquid than international fund markets, then local volatility could be higher even with little trading activity, in which case local price movements would not necessarily reflect domestic investor responsiveness, but rather liquidity constraints and other inefficiencies. Differences in liquidity, however, do not seem to explain differences in volatility. Fund prices are more volatile than NAVs in most cases, as their larger standard deviation indicates (Table 1). Moreover, as Figure 7 shows, local liquidity seems unrelated to price differentials between country funds and NAVs (both in levels and absolute value) and to differences in volatility across the two markets. If anything, the right panel in Figure 7 suggests that higher local liquidity may be associated with higher volatility in local relative to international prices. These conclusions hold across countries and within countries over time (Table A22), and suggest that the estimated differences in responses to elections could be conservative.

Alternatively, domestic responses could be due to sectoral lobbying patterns and reciprocated sector-specific policies to be expected from different governments (Bechtel and Füss 2010). While the present data is not suitable for testing sector-based explanations, it is unlikely these explanations would account for the observed patterns. Sector-based models are useful for understanding cross-sector variation in market responses, but less so for predicting market-wide responses, as the market-wide outcome depends on the net result across winning and losing sectors. Because country funds tend to hold diversified portfolios that track broader market sentiment better than sector-specific expectations (see Table A4), sectoral patterns alone could not explain the overwhelmingly negative or positive market-wide reactions to many elections.

The findings also hold when controlling for exchange rate movements (Tables A23–A24), exchange rate regime (Table A25), and capital account openness (Table A26). Because the fund price and NAV are denominated in US dollars, election-induced exchange rate movements might con-

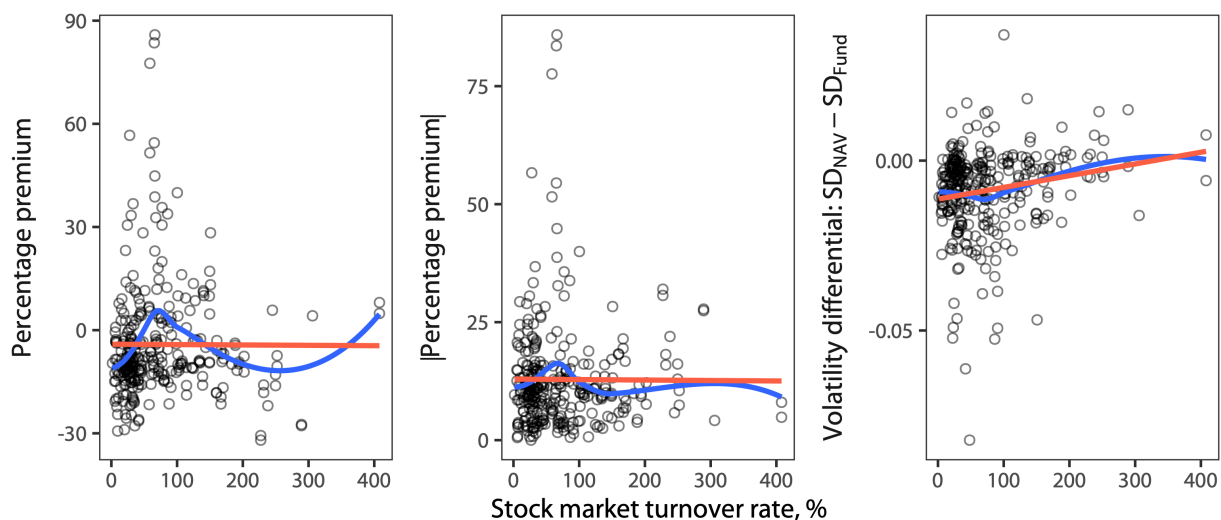


Figure 7. Liquidity and differences in local and global stock market behavior. Figure shows the relationship between local stock market liquidity measured by the annual turnover ratio (value of domestic shares traded divided by their market capitalization) and the differential behavior of global and local markets, as captured by the annual average fund premium (in levels and absolute value) and differential local volatility (difference between the standard deviation of NAV and fund returns). Fitted linear (red) and loess (blue) curves ($n = 304$).

found the reported effects, as fund prices and NAVs may be affected by exchange rates even if there is no change in stock valuations. Moreover, gaps between domestic and international markets may be driven by financial openness or exchange rate regime, both of which mediate the transmission of shocks between the global and the domestic economy. The results, however, are invariant to these controls. Finally, the results remain substantively unchanged when testing for structural breaks before and after the 2007-8 Global Financial Crisis; when using more conservative McKinnon critical values for statistical inference; and when using a pre-election window of 60 days for estimating cumulative abnormal returns. All robustness checks appear in the SI.

7 Conclusion

Scholarship on financial globalization has made much progress in understanding the consequences of capital mobility for government autonomy in the developing world. Existing research has often focused on international markets as the main audience for governments, especially during critical events like elections. Nonetheless, given current limits to financial integration in developing coun-

tries, much remains to be learned about the oft-overlooked role of domestic markets. This study shows that domestic investors are particularly sensitive to domestic political risk and often drive international market responses.

The findings have implications for debates on financial globalization. Do markets constrain governments more or less than we previously thought? Early scholarship argued that growing financial internationalization limited government policy autonomy. At one extreme, the threat of capital flight would render governments unable to deviate from market-friendly policies. Others have pointed out, however, that capital mobility has a conditional impact on governments' room to maneuver. Whether and how much markets constrain governments depends, among others, on the country's level of economic development, political institutions, and the state of the global economy (Mosley 2003; Campello 2015; Ballard-Rosa, Mosley, and Wellhausen 2022). This study's results affirm this conditional interpretation.

On the one hand, developing countries' low level of de facto integration into global capital flows suggests that they may be less constrained by international capital than previously assumed. This is consistent with research that finds weak market constraints (Mosley, Paniagua, and Wibbels 2020; Spanakos and Renno 2009). While foreign capital is often seen as the culprit in debates about the costs of capital mobility, this study suggests some nuance. Rather, the role of foreign investors may be an indirect one—they transmit information from local actors in often opaque and distant countries to global markets. And given international markets' muted responses to elections, foreign participation may even have a stabilizing role at times, as foreign investors, with diversified portfolios and longer time horizons, are less likely to react dramatically to political events.

On the other hand, the findings suggest that even where financial integration is low, domestic finance may still play a disciplining role. For one, if domestic market reactions matter in industrial economies (Sattler 2013; Bechtel 2009), they may matter even more in emerging markets. Governments must still sell their policies to domestic investors. An important implication is that policies that hinder diversification and risk-sharing will make domestic markets ever more sensitive to political risk. Though debates have focused on how capital mobility leaves domestic governments

vulnerable to the interests of fickle foreign investors, limited financial integration may also carry its autonomy costs, as governments must appease wary local investors. A globally-diversified investor base at home could entail lower electoral stakes for local investors and greater government autonomy vis-à-vis domestic markets.

Future research should pay closer attention to local market actors and the dynamics of market discipline in partially integrated economies. With the dwindling impetus for further financial integration since the 2007-8 financial crisis, domestic markets are likely to remain key actors in market-government relations. Beyond the question of how constrained governments are, the type of constraint may be different in fully vs. partially integrated economies, since the risks faced by global investors in open economies are different from those faced by domestic investors in segmented markets. Moreover, conventional assumptions about financial integration should be reassessed and their implications for state-market relations investigated. What are the effects of de facto openness compared to de jure openness? Under what conditions will domestic markets effectively discipline governments compared to global markets? These findings call for greater attention to the distinction between nominal financial liberalization and effective financial integration as scholars specify their models of the global political economy.

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