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 financial investors' perceptions of candidates and their expected policies. Especially in developing countries, where political uncertainty is high and domestic conditions volatile, market reactions can be severe (Santiso 2013; Jensen and Schmith 2005; Hays, Freeman, and Nesseth 2003; Leblang 2002). Indeed, negative reactions may tempt candidates and newly-elected governments to make dramatic policy reversals, whereas positive reactions may amount to a stamp of approval (Barta and Johnston 2018; Campello 2015; Sattler 2013; Bechtel 2009; Bernhard and Leblang 2006).

With the advance of global financial integration in the last decades, scholars have increasingly focused on international markets as the main audience whose confidence policymakers seek to earn. Research extensively documents how global markets 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). The emphasis on international market actors reflects 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 increasingly assumed a world of closely integrated financial markets, where global investors have a central role in disciplining governments. Yet, while existing research has advanced 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 the trend toward financial liberalization, developing countries are still not as nearly financially open as industrial economies. Importantly, despite efforts to remove explicit barriers to capital flows, de facto financial integration has not kept pace with de jure liberalization (Bekaert et al. 2016). Implicit barriers still limit integration—from information frictions to weak domestic institutions. These

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 disproportionally weighted toward assets from their own home countries (Coeurdacier and Rey 2013). This home bias, which is acute in developing countries as I show below, implies that investors have systematically failed to take advantage of opportunities for global diversification, instead choosing to park their capital at home. In sum, by most available measures developing countries' de facto integration into global markets remains limited. (Figure 1)

Accordingly, this article identifies an important but overlooked role of domestic investors in state-market relations. I show that limited globalization puts domestic investors front and center in market responses to elections, in two main ways. First, domestic investors should respond more strongly to elections because of their higher 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 involve higher stakes for domestic investors, whose economic interests are closely tied to domestic economic 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 lead the way in responding to elections where they hold an information advantage. Despite major advances in information technology, global portfolio diversification still entails high information costs, often leaving international investors at a disadvantage 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 with the political environment, denser professional and political ties in the country, and the ability to interpret new information in context. The responses of domestic markets can therefore provide cues to international investors.

This 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. Importantly, country fund behavior is strongly correlated with the broader stock market, making country fund markets a useful microcosm of global markets where one can compare foreign and local investor responses.

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.

These findings offer a link between the extensive literature on the impact of political events on financial markets and the literature on the politics of financial globalization. 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 transmission of electoral shocks to foreign currency markets and the global banking system (Slaski 2021; Cunha and Kern Forthcoming). The results add to our understanding of these mechanisms by showing how implicit barriers to the fi-

nancial integration of developing countries, in the form of information frictions and home bias, combine to give domestic investors a leading role in global markets' reactions to politics.

Furthermore, when it comes to the politics of financial globalization, these findings point out how limited financial integration affects the politics of market discipline. In a partially globalized world, local investors remain a key audience in the confidence game between governments and markets. While existing research has studied domestic financial markets in isolation from debates about globalization and market discipline, this study indicates that local markets drive global markets in rewarding and punishing domestic choices. Domestic markets thus provide a missing piece of the puzzle of market discipline in less than fully integrated economies. The findings are particularly relevant in light of recent trends in the global political economy, such as the decline in financial openness following the 2007-08 global financial crisis, the demise of the technocratic consensus against capital controls, and the rise of economic nationalism in developing and developed countries alike. As the political impetus for integration subsides, domestic markets are likely to remain central in the interaction between politics and markets in the developing world.

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 group of capital owners and allows us to assess whether and how markets constrain domestic policy and politics. 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.

Financial investors worry about elections to the extent that leadership turnover produces policy change that affects investment returns. Right-of-center governments, for instance, tend to adopt investor-friendly policies, such as fiscal discipline, low inflation, capital account openness, low capital taxation, and a regulatory environment conducive to investment (Bechtel 2009; Wibbels and Arce 2003; Oatley 1999). In contrast, left governments tend to be more redistributive and inter-

ventionist, preferring higher spending, larger budget deficits, higher inflation tolerance, more progressive taxation, and greater regulations on capital flows (Campello 2015; Oatley 1999). Elections can thus bring about stark policy changes in developing countries, where governments typically have greater policy discretion (Fatás and Mihov 2013; Nooruddin 2011). Following such expected partisan differences in economic policy, markets tend to punish the election of left governments (or expectation thereof), with higher interest rates (Campello 2015; Hardie 2006), depressed stock prices (Sattler 2013; Bechtel 2009), and lower credit ratings (Barta and Johnston 2018). Similarly, the election of a left government may prompt fund managers to shift assets out of the country, and currency traders to launch speculative attacks (Santiso 2013; Leblang 2002).

Beyond concerns with partisanship, electoral uncertainty in itself can deter investment and trigger negative market reactions. Investors are averse to the uncertainty inherent in weakly institutionalized political environments, and will require a premium for holding risky assets in periods of heightened uncertainty. Even relatively predictable elections may increase uncertainty, for example, over the composition of the future government (Bernhard and Leblang 2006). Developing countries are therefore more likely to face market volatility, capital outflows, and credit rating downgrades in electoral periods than in "non-political" times (Brooks, Cunha, and Mosley 2022; Santiso 2013; Hays, Freeman, and Nesseth 2003; Leblang 2002).

However, while research has focused on the discipline imposed by global markets, in partially-integrated economies one should expect much of that market action to take place at home. Indeed, despite the trend towards greater financial liberalization since the 1990s, developing countries are still not nearly as financially open as developed ones, and de facto integration may have even decreased since the initial bout of liberalization (Figure 1). Given developing countries' limited integration into global capital markets, one should expect domestic markets to be a key locus of market-government relations.

Like global market reactions, local market reactions to elections can affect governments and the real economy. On the one hand, positive market responses may signal policy competence and serve as a stamp of approval for candidates and governments. On the other hand, domestic volatility can

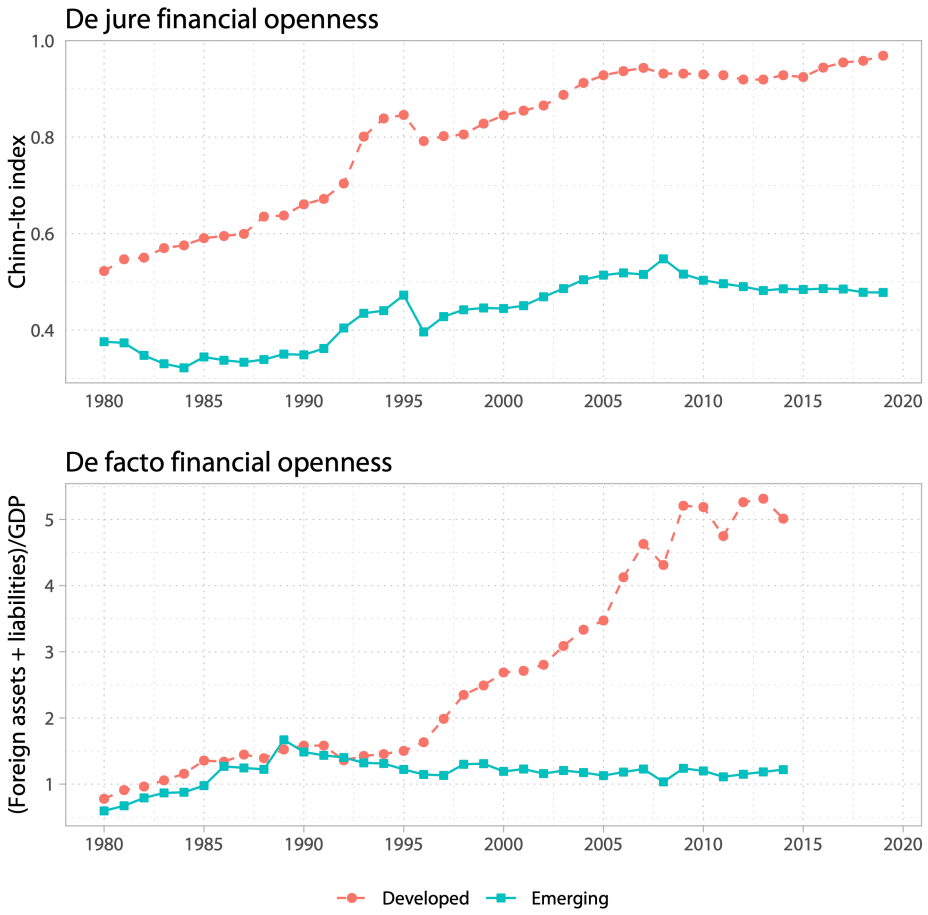

Figure 1. Average de jure and de facto financial openness in developed and emerging economies. Top panel shows the Chinn-Ito index of de jure financial openness; bottom panel shows the Lane and Milesi-Ferretti (2007) measure of de facto financial integration.

affect governments' financing costs and damage economic growth by raising the cost of capital for private firms and by delaying investment decisions as firms hedge market uncertainty. Domestic market reactions can therefore seriously increase the costs of deviating from investors' preferred policies. Indeed, this form of "market defection" has long been recognized as a source of structural power for domestic capital owners (Lindblom 1977). In what follows, I thus incorporate domestic investors and their relationship with foreign investors into a model of market responses to politics in partially-integrated economies.

3 Local Investors, International Investors, and Political Risk

The limits of financial globalization in the developing world imply a departure from standard open economy models of financial market-government relations. I derive implications from two of these limitations—home bias in portfolio allocation and information frictions—for the interaction between financial markets and democratic processes. These two characteristics 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 the response of global markets 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 the amount of risk and uncertainty posed by an election and how exposed investors are to that risk. The more investors' returns depend on the overall 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 domestic political risk than investors whose portfolios are globally diversified (Freeman and Quinn 2012; Stulz 2005), especially in developing countries, where elections can bring about significant policy volatility (Fatás and Mihov 2013; Nooruddin 2011).

Existing work has implicitly or explicitly assumed similar exposure to political risk by domestic and foreign portfolio investors. However, in most countries local investors are disproportionately invested in their home markets. This phenomenon, known as home bias, is well documented and refers to investors' tendency to invest disproportionately 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 demonstrates that the overall risk of a portfolio is inversely proportional to the correlation among the assets held in that portfolio. Therefore, when it comes to political risk, portfolios with assets from a single country, where all assets are susceptible to the same na-

tional economic policy shocks, will be riskier than internationally-diversified portfolios, as long as risks across countries are not perfectly correlated. One of the workhorse models of global portfolio allocation—the international capital asset pricing model (ICAPM)—thus prescribes that investors should hold stocks from different countries in proportion to those countries' share of world market capitalization (Coeurdacier and Rey 2013; Lewis 1999).

However, despite global trends towards financial openness and the growth of global capital markets, 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). Though such home bias in OECD economies has decreased over time, it remains high and pervasive (Coeurdacier and Rey 2013; Cooper, Sercu, and Vanpée 2013). In developing economies, home bias is even more acute and has been largely stagnant over time (Figure 2), consistent with these countries' low level of de facto integration into global markets.(Mishra 2015; Cooper, Sercu, and Vanpée 2013) In this regard, developing countries have stayed on the sidelines of financial globalization, as local investors remain tethered to the home market.

For domestic investors, whose assets are overwhelmingly tied to the domestic economy, elections may thus represent a significant source of investment risk and uncertainty, in particular the risk of partisan turnover that may result in adverse policy changes such as higher capital taxation, stricter regulation, and greater tolerance towards deficit spending and inflation. Such uncertainty over future policy is particularly salient in developing country elections (Brooks, Cunha, and Mosley 2022). For one, these countries typically have weakly institutionalized party systems characterized by personalistic rather than programmatic representation and uninformative party labels, which heightens uncertainty over leadership turnover 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 tend to produce high electoral volatility, which when coupled with considerable policy discretion, can lead to wide swings in economic policy (Cohen, Salles Kobilanski, and Zech-

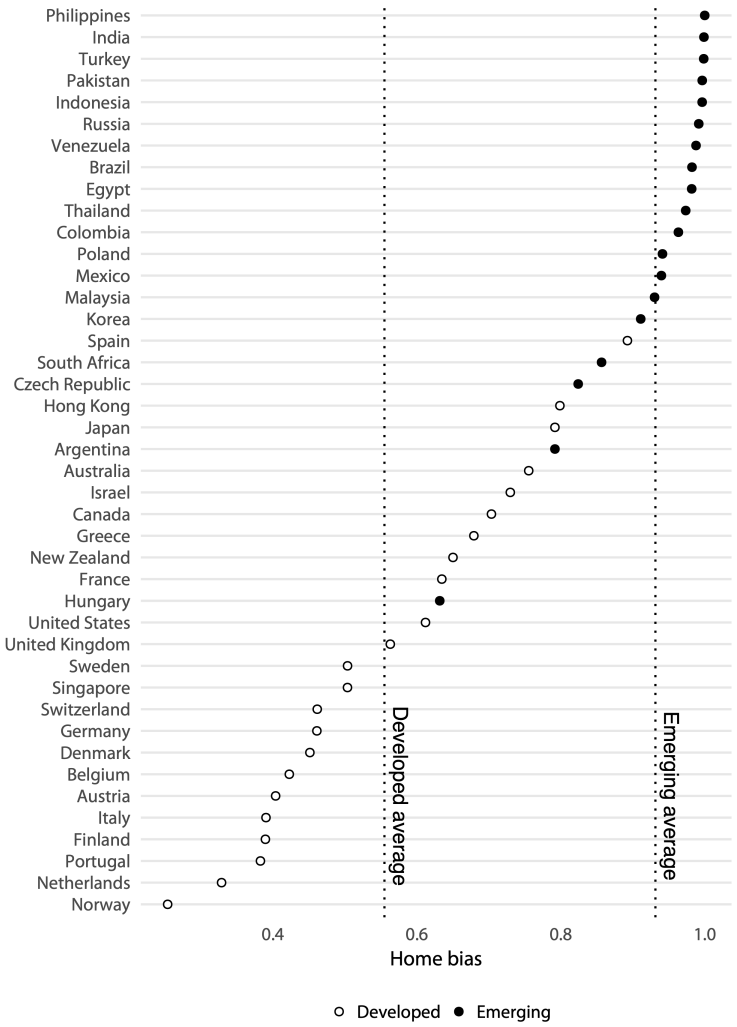

Figure 2. Home bias in emerging and developed markets. Measure ranges from zero (when investors hold stocks from home country in proportion to the country's share of the world portfolio) to one (when investors exclusively hold stocks from home country). Source: Mishra (2015).

meister 2018; Fatás and Mihov 2013). Of particular concern for financial investors is distributive conflict resulting from high economic inequality, which increases demand for redistributive policies at the ballot. As a result, electoral turnover in developing democracies comes with a great deal of uncertainty and non-negligible risks of adverse policy shifts for investors.

With portfolios heavily concentrated in home assets, developing country investors are overexposed to electoral risk and therefore should be highly responsive to election-induced uncertainty. To the extent that elections can change the course of economic policy and affect investment returns, electoral risk should disproportionately affect the interests of these investors relative to foreign in-

vestors. 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 into safer and more liquid assets such as fixed income and international reserve assets such as hard currency and gold. Similarly, investors will move into riskier local assets when they expect a favorable election outcome.

Compared to domestic investors, we should expect more muted responses to elections from international markets. Local investors' overexposure to the home market means that the their economic fate is tied to domestic policy and national economic performance (Freeman and Quinn 2012). Thus, national elections should greatly affect the interests of domestic investors, while having a more limited effect on foreign investors, since the latter will typically only have a small share of their assets invested in any given developing country. Indeed, the very purpose of diversification towards emerging markets is to take advantage of return opportunities while reducing overall risk through uncorrelated assets. International investors therefore will be less affected by any single developing country election, as these account for a limited share of their total portfolio risk. As a result, we should observe larger price movements in domestic markets than international ones. In other words, as investors reward and punish countries for their political choices, much of the action should occur in local markets.

3.2 Information Asymmetries and the Domestic Investor Lead

Domestic markets should also lead the response of international markets to elections where local investors hold an information advantage with regard to domestic politics. Despite claims that advances in information technology have erased distances and nearly eliminated information costs for cross-border investing, research in international finance systematically finds that information costs and the information advantages from location still matter a great deal for portfolio investing.

Existing research shows that proximity to information 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 international investors. In developed and developing markets alike, the trading patterns of local investors are consistent with an information advantage (Ferreira et al. 2017); local investors typically 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).

Information asymmetries between local and foreign investors should affect the interaction between financial markets and politics. Existing informational 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, investors with lower costs will 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 for information costs, as they can infer changes in asset values from market prices.[2] Therefore, different incentives for information acquisition can result in dynamics of information transmission, or rational contagion, from informed to less well-informed traders.

Information asymmetries are pervasive in global capital markets. Maintaining a global portfolio typically 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 effect of political events on expected risk and return is a complex task. Investors must take into account the institutional environment and the preferences and strategies of political actors. Assessing political risk is especially challenging in developing countries, where weak institutions and volatile conditions—such as personalistic representation, uninformative party labels, high electoral volatility, and low government transparency—

[2] A 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).

sharply raise information costs (Ferreira et al. 2017).

Under these conditions, local investors can have access to more precise signals about political risk. 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 can exploit political connections that afford them access to privileged information (Braun and Raddatz 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-return assessments.

The information-based model predicts that foreign investors will take advantage of price signals from 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, as investing in complex and uncertain environments such as developing countries "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 in assessing political risk.

We should thus 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

[3] "Investors will shun chaotic Brazil until signs of progress." *Financial Times*, June 19, 2019.

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 electoral risk.

4 Data and Methods

The main challenge in analyzing the response of domestic and international portfolio investors to elections is teasing out their respective responses. Traditional market data, such as stock and bond indices or exchange rates, are of limited use, since they capture aggregate trading activity by domestic and foreign participants alike. To test the above hypotheses, 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. This 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 single countries. Like other international funds, country funds allow investors to diversify toward foreign markets with potential liquidity advantages and without requiring knowledge of specific firms or industries in that 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 stock 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. Country funds thus allow investors to trade an entire country portfolio in a single transaction.

Empirically, a unique 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 fund's constituent stocks and is reported at least daily. Therefore, the net asset value prices demand for the country's stocks in the country's own stock market.

The country fund premium can be used as 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 country 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 all single-country closed-end funds whose target country is classified as an emerging or developing market by the main index providers, MSCI and FTSE, and has held general elections in the period under study. The sample excludes funds with a multi-country (regional or global) focus and funds whose target country does not hold regular general elections. The 21 funds in the sample invest primarily in stocks, as 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 sample statistics for the weekly return on the fund, the weekly return on the NAV, and the weekly fund premium. There is wide cross-country variation in fund premia; most funds

[4]Details about the sample, as well as fund mandates and holdings, 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

		Fund		*Net Asset Value*		*Premium*	
Fund Name	*Symbol*	*Mean*	*SD*	*Mean*	*SD*	*Mean*	*SD*
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: $Premium_t = [(Price_t/NAV_t) - 1] \times 100$.

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 studied 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 dynamics are likely representative of broader stock market dynamics. Therefore, country fund data can provide insight into the interaction between financial markets and politics beyond fund markets.

Note that the empirical strategy does *not* assume that domestic stock prices are determined

exclusively by domestic investor activity. The critical assumption is that the two populations of investors—those active in global centers and those active in local markets—are distinct, and that the influence of international and domestic investors in determining the fund price and NAV is proportional to their respective 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 relative to their local participation. However, existing research finds no consistent evidence that foreign investors "punch above their weight" in emerging markets (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 markets.

4.1 A Vector Error Correction Model of Cross-Border Contagion

I test the domestic investor lead hypothesis by assessing the direction of cross-border contagion between domestic and international markets within a vector error correction framework. I combine this approach with an event study to estimate the frequency and magnitude of domestic and international responses to elections. A vector error correction model (VECM) is a natural choice for these data, as it incorporates both short- and long-run relationships between international and local markets. Short-run changes in local stock prices are modeled as a function of past changes in international prices, and vice-versa. VECMs also capture the long-run relationship between local and international markets, with the responses of domestic and foreign markets modeled as a function of past deviations from their long-run equilibrium.

Thus, a VECM is well-suited for testing dynamics of information transmission between local and international 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 fund prices, which reflect global investor sentiment. Conversely, changes in the fund price should not be predictive of the NAV if information asymmetry holds.

Importantly, 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. As new information emerges, domestic investors will respond, moving the NAV away from the fund price. As foreign investors observe price changes in the local market, they will adjust their portfolios accordingly and bring the fund price closer to the NAV, reestablishing the equilibrium. Therefore, country fund prices should respond to deviations from the equilibrium.

I model these contagion dynamics using a fractional error correction model. Compared to a conventional ECM, a fractional ECM is more general, because it does not require strong assumptions about cointegration. In conventional ECMs, researchers must determine that the long-run equilibrium is stationary—i.e. that a linear combination of the parent series has order of integration zero, $I(0)$, as opposed to one, $I(1)$. Fractional cointegration relaxes this requirement, allowing the order of integration to be $I(d)$, with $0 < d < 1$ (Baillie and Bollerslev 1994).[5] Whereas in traditional cointegration deviations from equilibrium must be quickly corrected, fractional cointegration allows deviations from equilibrium to persist in the short-run but dissipate over longer horizons. Indeed, existing work highlights the importance of modeling fractional cointegration in asset price data (Bollerslev et al. 2013; Baillie and Bollerslev 1994).

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

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

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

[5] Formally, 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 ($d' < d$).

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 υ_{1t} and υ_{2t} are disturbance terms. The (fractionally integrated) error correction term is $\alpha[(1-L)^d - (1-L)]z_t$, in which 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 the results capture country-specific risks net of global market movements, the vector of controls, X_t, consists of market factors common to international and local equity markets, 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 coefficients of interest are α_1 and α_2, the error correction parameters. They capture the speed with which the fund price and NAV return to equilibrium after a shock. The magnitudes of α_1 and α_2 indicate the direction and strength of contagion dynamics between local and international capital markets. Higher absolute values of α_1 (α_2) indicate that the fund price (net asset value) is more responsive to equilibrium shocks. 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 and statistically significant. Likewise, if domestic investors lead the response to domestic shocks instead of lagging international markets, then α_2 should be small and statistically insignificant.

Additionally, if domestic prices are more informative of country risks than international prices, then the NAV should also have short-run predictive power over the fund price. One can conduct a Granger causality test for the joint null that the error correction parameter and the short-run parameters 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. Likewise, if international prices have little predictive value for domestic prices, we should fail to reject the joint null that α_2 and all γ_{2i} equal zero.

4.2 Estimating Market Responses to Elections

Given pervasive home bias and limits to financial integration in emerging markets, risks arising from elections should be mostly priced locally instead of globally. I test this hypothesis using multiple strategies. First, I assess abnormal market behavior during elections within the error correction framework described before by adding an event study component to the model. Event studies are widely used to estimate the effect of political events on asset prices. I estimate the abnormal return on the country fund and the net asset value during electoral periods to compare domestic and international responses. The 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. In a regression model, one can estimate abnormal returns by adding dummy variables for each day of the election window. I thus add the following term to the vector ECM: $\sum_{\tau=T_1}^{T_2} \beta_\tau D_{\tau,t}$, where $D_{\tau,t}$ are dummy variables coded one for day $t = \tau$ in the election window and zero otherwise, for $\tau = T_1, T_1 + 1, \ldots, T_2$. The election window is $T_1 \leq \tau \leq T_2$. In the main analysis, I code the electoral period as the 30 days before the election, including the election day.[6]

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 *CAR* on net asset values, while country fund *CAR*s should not be significant.

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 ($\sim$ 1 calendar year) that do not fall within six months prior to or after an election. For each sampled non-electoral period,

[6]The 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.

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 leading 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 error correction specification described above, adding entropy as an exogenous term. The coefficient $\beta_{Entropy}$ captures the responsiveness of local and global markets to uncertainty shocks in the run-up to elections.

Finally, I incorporate heterogeneity in market responses based on the (expected) ideological make-up of the incoming government, using data from Herre (Forthcoming). I add a multiplicative term to the error correction model, $(Election_t \times LeftElected_t)$, that interacts an election period dummy variable with a government ideology dummy coded one if a left government is elected and zero otherwise, which captures differences in market expectations towards left vs. right and center governments. Beyond the expected ideology of the new government, markets may react more strongly to elections that result in a change in government partisanship. Therefore, I alternatively 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 switch from right/center to left and

from left to right/center, respectively, and zero otherwise.

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 full table of 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 in the thirty days before an election (election day included) 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.

A look at market responses to ex ante uncertainty throughout election campaigns, as captured in 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 uncertainty in Brazilian elections, a finding that is consistent with an institutional make-up that is conducive to high political uncertainty. In the institutional literature, Brazil is typically described as having weak party system institutionalization, high electoral volatility, and high fiscal policy volatility. Weak institutionalization and high electoral volatility combine to generate political opaqueness and uncertainty, while high discretion in the conduct of fiscal policy means that Brazilian elections pose high stakes for financial 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 study of the 2002 presidential election in Brazil, according to which foreign bondholders were not particularly sensitive to the unprecedented rise of the left-wing Workers' Party to the presidency, despite the severe distress in financial markets throughout the campaign.

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

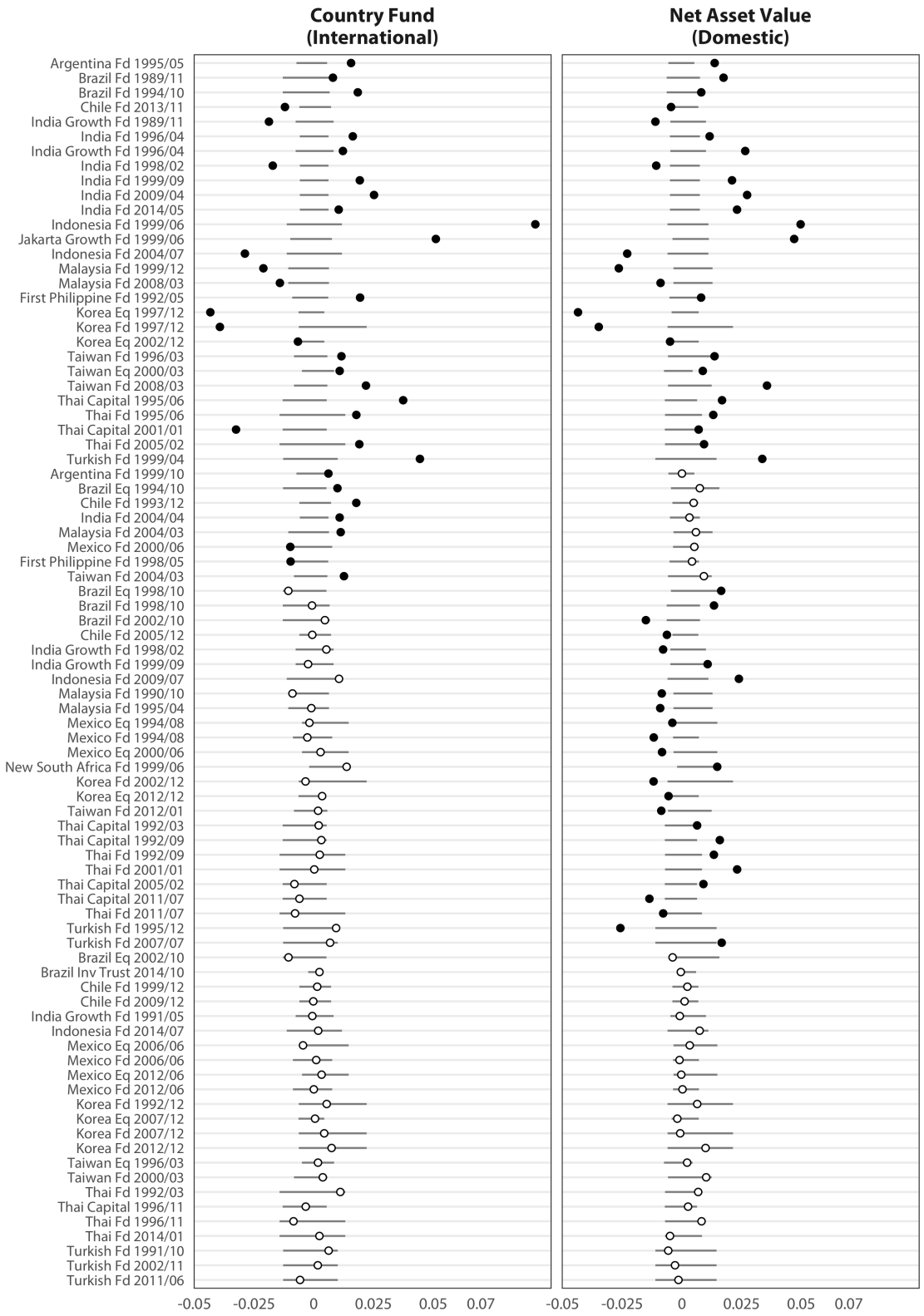

Figure 3. Median abnormal return of domestic and international assets in the run-up to elections. Points show median abnormal return in the thirty days before the election, election day included. Bars are 95% CIs from a bootstrapped distribution of median abnormal returns in non-electoral periods. Black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

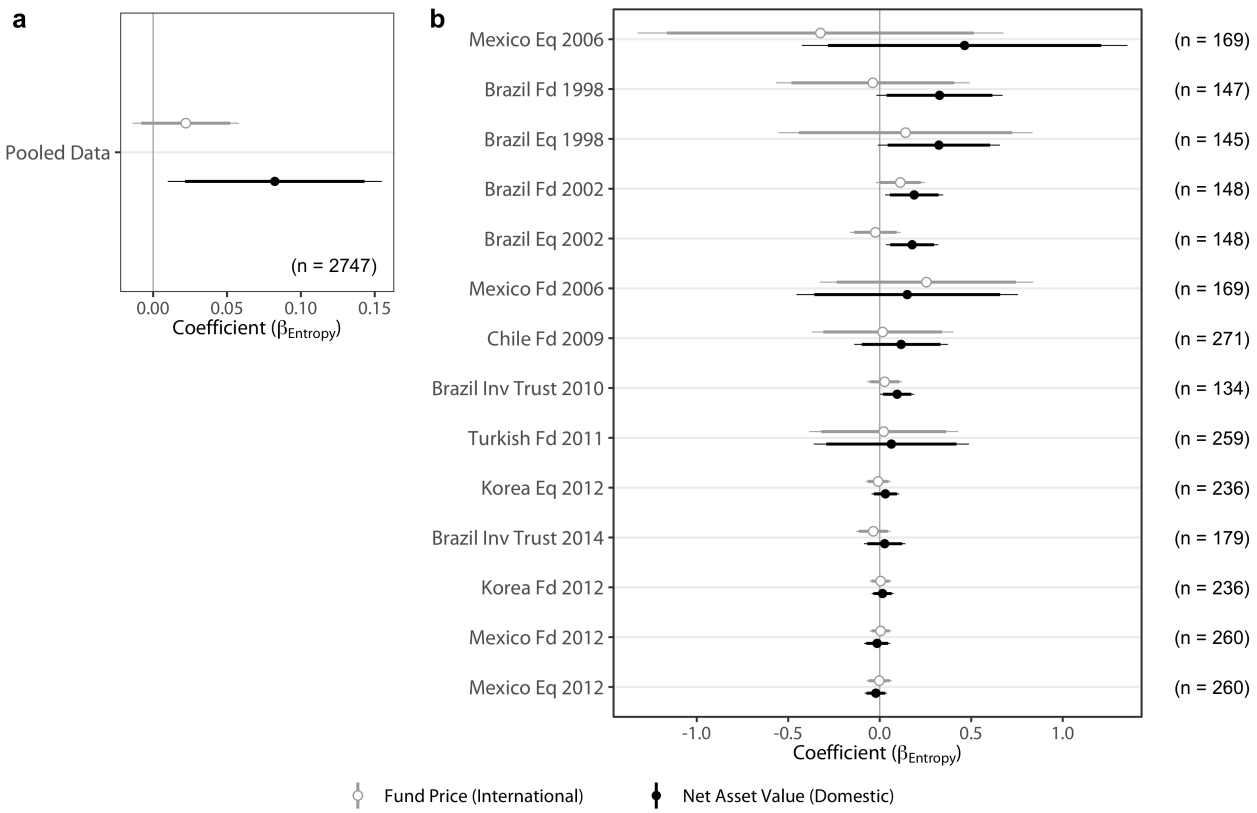

Figure 4. Electoral entropy, local markets, and international markets. Plot shows coefficients for the electoral uncertainty (entropy) variable, $\beta_{Entropy}$. Bars are 90% and 95% CIs. Panel (a) shows estimates from a time-series cross-sectional model of pooled fund data with country fixed effects 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.

elections than foreign markets, especially when left governments are elected. Furthermore, domestic markets react to partisan switches in government more than international markets, as reported in Table A18. This is the case both for partisan shifts from right/center to left and from left to right/center. Taken together, these findings underscore that domestic investors are indeed major drivers of responses to emerging market elections.

5.2 Do local markets lead global market responses?

The information asymmetry hypothesis further 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 series apart, they eventually return to their shared trajectory.

The error correction analysis provides evidence of the direction of the relationship 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 much each market responds 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 magnitude 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.

The analysis of daily country fund data further strengthens these conclusions. Daily market data allows for a more accurate estimation of the dynamics of information transmission. It is also suitable for examining domestic-to-foreign contagion around individual elections, thus allowing for possible heterogeneity across cases, as enough observations are available within any given election

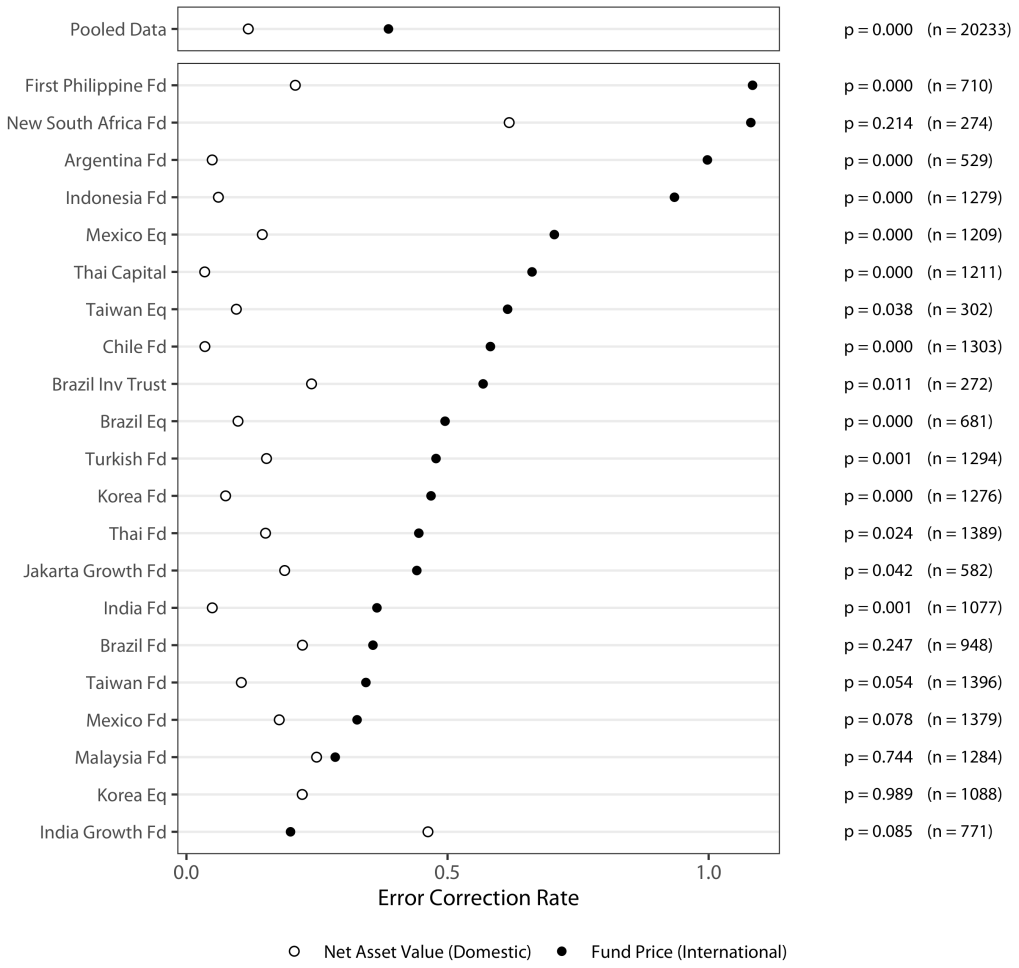

Figure 5. Do international markets follow domestic markets? Graph shows error correction rates for weekly fund and NAV returns (α_1 and α_2 in Eq. 1, respectively; in absolute value). Top row estimates obtained from a time-series cross-sectional model pooling all funds (with country fixed effects and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

year. 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 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 for the hypothesis that international markets follow the lead of domestic markets,

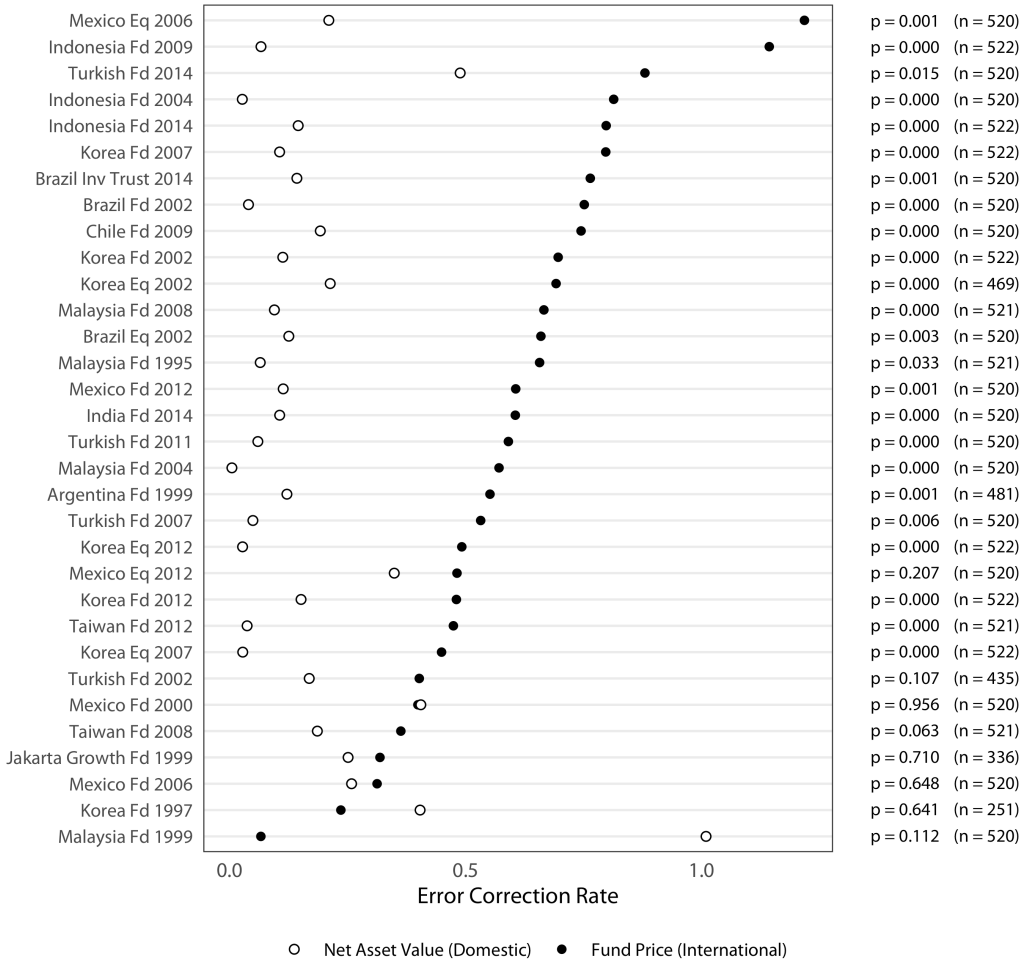

Figure 6. Do international markets follow domestic markets in election years? Error correction rates for daily fund and NAV returns around national elections (α_1 and α_2, respectively; in absolute value). p-values are for a two-sided test of the null that the two rates are equal.

while the reverse is not typically the case.

Finally, we can assess how predictive domestic market responses are of international market responses using tests of Granger causality. In the context of error correction models, testing if 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 prices help predict international prices for 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 markets price in more information about

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

		NAV → *Fund Price*		*Fund Price* → *NAV*		
Country Fund	Election	*F* Statistic	*p*-value	*F* Statistic	*p*-value	*N*
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* → *Fund Price* column tests if local prices help predict international prices (joint null: $\alpha_1 = 0$ and all $\gamma_{1i} = 0$); the *Fund Price* → *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.

local risks than global markets, and this information is typically transmitted 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 country fund markets, then local volatility could be higher even with sparse trading activity, in which case local price movements would not necessarily reflect domestic investor responsiveness, but rather liquidity constraints and pricing inefficiencies. However, differences in liquidity do not explain differences in volatility in the data. 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 indicates 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 amenable to testing for sector-based explanations, it is unlikely these would hold much explanatory power over 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.

In addition, the findings 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 changes to the exchange rate might confound the reported effects, as fund prices and NAVs may be affected by exchange rate movements even if there is no change in stock valuations. Moreover, gaps between domestic and international

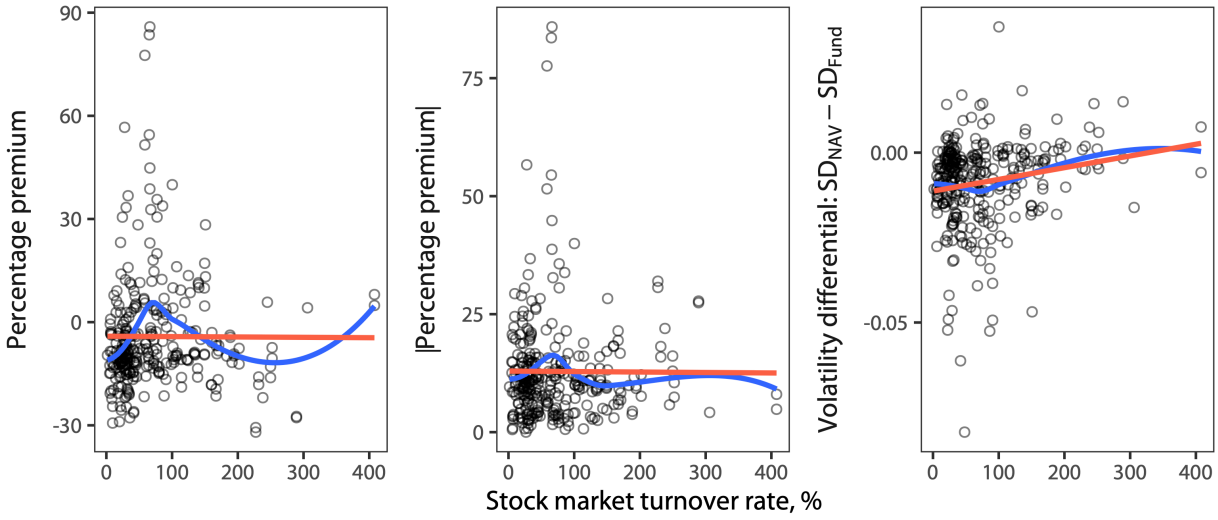

Figure 7. Liquidity and differences in local and global stock market behavior. Figure shows the relationship between local stock market liquidity measured by the annual turnover ratio (value of domestic shares traded divided by their market capitalization) and the differential behavior of global and 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).

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 adjustments. The results also remain substantively unchanged when testing for structural breaks in contagion dynamics before and after the 2007-08 Global Financial Crisis; when using more conservative McKinnon critical values for statistical inference; and when using instead a pre-election window of 60 days for estimating cumulative abnormal returns. All robustness checks appear in the SI.

7 Conclusion

Financial globalization scholarship has made much progress in understanding the consequences of international 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, much remains to be learned about the oft-overlooked role of domestic markets. In this article, I showed

that domestic investors are key actors in market responses to elections. Evidence from country fund data indicates that local stock markets are more sensitive to electoral risk and often lead the responses of global markets.

These 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 seriously limited government policy autonomy. At one extreme, the threat of capital flight would render governments unable to deviate from policy that caters to the interests of financial capital. Others have pointed out, however, that capital mobility has a conditional impact on governments' room to move. Whether and how much markets constrain national 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 de facto financial integration suggests that they might be less constrained by international capital than previously assumed. This would be consistent with research that finds weak market constraints (Mosley, Paniagua, and Wibbels 2020; Spanakos and Renno 2009). While foreign capital is often the culprit in debates about the autonomy costs of capital mobility, the present findings suggest a more nuanced view. Rather, the role of foreign investors may be an indirect one—they help transmit political information from local actors in often opaque and distant countries to global asset markets. But given international markets' muted responses to elections, foreign participation may even have a stabilizing role at times, as foreign investors, who typically have better diversified portfolios and longer time horizons, appear less likely to have extreme reactions to domestic political events.

On the other hand, the findings suggest that even where financial integration is low and global markets are insensitive to domestic risks, domestic finance may still play a disciplining role. For one, if domestic markets are sensitive to political risk in industrial economies (Sattler 2013; Bechtel 2009), they should be even more central to the interaction between markets and politics in the developing world. This suggests that governments must still sell their policies to domestic capital. An

important implication therefore is that policies that hinder diversification and risk-sharing should make domestic markets even more sensitive to domestic political risk. Though debates have traditionally focused on how capital mobility leaves domestic governments vulnerable to the interests of fickle foreign investors, limited financial integration also carries its own autonomy costs, as governments must appease local investors, who are overexposed to domestic risks. A globally-diversified investor base at home would entail entail lower stakes for local investors in national elections 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 less than fully integrated economies. With the impetus for financial integration on the wane since the 2007-08 Global Financial Crisis, domestic markets are likely to remain key actors in market-government relations. Scholars would thus do well to investigate further the politics of market discipline under limited financial globalization. Beyond the question of how constrained governments are, the type of constraint may be different in fully vs. partially integrated economies, as the risks faced by global investors in open economies are different than those faced by domestic investors in segmented markets. Moreover, conventional assumptions about financial integration in developing countries must be carefully assessed and their implications for state-market relations further investigated. How does de jure vs. de facto openness affect national economic and political choices? Under what conditions will domestic markets effectively discipline governments, and when will global capital markets play a larger role instead? Building on international finance research, the findings call for greater attention to the distinction between nominal financial liberalization and effective capital mobility as scholars specify their models of the global political economy.

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