The Impacts of Political Uncertainty on Asset Prices:
Evidence from a Natural Experiment[*]

Laura Xiaolei Liu
Guanghua School of Management
Peking University
Email: laura.xiaolei.liu@gsm.pku.edu.cn

Haibing Shu
Hong Kong University of Science and Technology
Email: shu.haibing@gmail.com

K.C. John Wei
Hong Kong University of Science and Technology
Email: johnwei@ust.hk

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Abstract

Models for political uncertainty risk predict that increases in political uncertainty will cause stock prices to fall, especially for politically sensitive firms. We use the Bo Xilai political scandal in China in 2012 as a natural experiment to identify the impact of political uncertainty on asset prices. We document that the Bo scandal caused a much more significant drop in the stock prices of firms that were more politically sensitive. Further analysis shows that our evidence is mainly driven by the change in discount rate, providing strong support for the existence of political uncertainty risk.

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Abstract

Models for political uncertainty risk predict that increases in political uncertainty will cause stock prices to fall, especially for politically sensitive firms. We use the Bo Xilai political scandal in China in 2012 as a natural experiment to identify the impact of political uncertainty on asset prices. We document that the Bo scandal caused a much more significant drop in the stock prices of firms that were more politically sensitive. Further analysis shows that our evidence is mainly driven by the change in discount rate, providing strong support for the existence of political uncertainty risk.

1.   Introduction

Recently, the impact of political uncertainty on asset prices has attracted a lot of attention. Theoretical models suggest that an increase in political uncertainty will cause stock prices to fall, especially for firms that are more sensitive to policy changes. For example, Sialm (2006) analyzes the effects of stochastic taxes on asset prices. Croce, Kung, Nguyen, and Schmid (2012) also focus on taxes and show that in a production-based general equilibrium model, tax uncertainty generates a sizable risk premium. Ulrich (2013) analyzes how bond yields are affected by Knightian uncertainty. Pástor and Veronesi (2013a) show that political uncertainty commands a risk premium whose magnitude is larger under weaker economic conditions. Pástor and Veronesi (2013b) further build a general equilibrium model predicting that stock prices will drop upon the announcement of a policy change and that the price drop will be larger amid greater policy uncertainty. Croce, Nguyen, and Schmid (2012) also demonstrate that political uncertainty may increase the long-run risk.

Empirically, researchers have tried several different methods to construct the indexes of political uncertainty. For example, Baker, Bloom, and Davis (2013) develop an index of policy-related economic uncertainty, which is calculated as the average of several components related to uncertainty, and estimate its impact on aggregate output and employment. Pástor and Veronesi (2013a) use this political uncertainty index to confirm a political risk premium predicted by their model. Brogaard and Detzel (2015) use a search-based measure to capture country-by-country economic policy uncertainty and find that market return falls and volatility rises when economic policy uncertainty increases. Boutchkova, Doshi, Durnev, and Molchanov (2012) document that political uncertainty affects industry return volatility. Belo, Gala, and Li (2013) show that during Democratic presidencies, firms with greater government exposure have higher cash flows and

higher stock returns, while the opposite is true during Republican presidencies. Kim, Pantzalis, and Park (2012) find that firms whose headquarters are located in states whose leading politicians have closer proximity to the ruling party earn higher stock returns and are more exposed to policy uncertainty. These empirical studies have made important and significant contributions to the literature. However, none of them has been able to rule out the issue of endogeneity.

In this study, we identify an unexpected political event that occurred in China in 2012, the Bo Xilai scandal, as an exogenous shock to political stability. This exogenous shock serves as an ideal setting to test the causal link between political uncertainty and asset prices, because political uncertainty unexpectedly increased on a particular date. As will be discussed in detail in the next section, the scandal had very significant implications for the stability of the country at the time as there was a lot of uncertainty about whether the transfer of power and leadership from the fourth generation of leaders led by former President Hu Jintao and Premier Wen Jiabao to the fifth generation to be led by Xi Jinping and Li Keqiang would proceed smoothly and peacefully.

We use three measures to capture the policy sensitiveness of firms. The first one is the average of the absolute returns around the time when People's Bank of China announced its plans to adjust the reserve requirement ratio (RRR). A larger absolute announcement return implies higher policy sensitiveness. The second measure is the proportion of state-owned enterprise (SOE) expenditures in total expenditures on fixed asset investment in each province. Firms headquartered in a province with a higher proportion of SOE expenditures are more sensitive to policy changes. The third measure is the number of board of directors in a firm who have political connections. Politically connected firms are more policy-sensitive.

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Using daily stock returns from the A-shares of firms listed on the Shanghai and Shenzhen Stock Exchanges around the Bo scandal, we find that increases in political uncertainty as measured by the scandal caused a significant drop in stock prices, especially for firms that were more sensitive to policy changes as measured by the above three proxies. The results are robust no matter whether we use portfolio analysis or regression analysis. A drop in stock prices, however, may be caused by increases in the discount rate as predicted by political risk models such as that of Pástor and Veronesi (2013a; 2013b) or it may be caused by decreases in expected cash flows when political connections or political rents are lost. We therefore implement further tests to rule out these alternative explanations.

We first measure changes in expectations of a firm's cash flow based on changes in analysts' earnings forecasts for years 2012-2014 around the Bo scandal. We find that there is no statistically significant difference between the most policy sensitive firms and the least policy sensitive firms. To strengthen our results, we also measure changes in realized cash flow based on returns on assets (ROA) or other profitability measures after the Bo scandal, although realized cash flow contains look-ahead bias. We also find that there is no significant difference between the two sets of firms. On the other hand, we document a significant increase in stock volatility right after the Bo scandal only for firms that were more sensitive to policy changes. All these results are consistent with the predictions of the political risk models proposed by Pástor and Veronesi (2013a; 2013b). In particular, it is the change in the discount rate caused by the increase in political uncertainty rather than the change in cash flow news caused expected decreases in firm's cash flow that leads to the drop in stock prices, especially for firms that were more sensitive to changes in government policy. To conclude, the evidence provides strong support for the existence of political uncertainty risk.

Our paper makes several important contributions to the literature. First, consistent with the predictions of existing models, increases in political uncertainty will cause a contemporaneous drop in share prices and the drop is more significant for firms that are more sensitive to policy changes. Second, using exogenous shocks to political stability provides a much cleaner setting to test the causal link from political uncertainty to share prices.[1] Third, shocks to political stability will undoubtedly cause uncertainty and/or the discount rate to go up but may not necessarily reduce firms' future cash flows.

The remainder of the paper proceeds as follows. In Section 2, we briefly describe Bo's political scandal and the uncertainty of the leadership transition in China. In Section 3, we develop our hypotheses. In Section 4, we describe our data. Section 5 presents and discusses our results, while Section 6 tests for alternative explanations. Finally, Section 7 concludes the paper.

2. Bo's Political Scandal and Leadership Transition in China in 2012

Year 2012 witnessed the transition of power in China. Former President Hu Jintao and Premier Wen Jiabao stepped down and new leaders in the Politburo Standing Committee (PSC) were elected at the 18th National Congress of the Communist Party of China held in fall 2012 in Beijing. Hu Jintao and his administration were elected back in 2002 as the fourth generation of leaders in China.[2] The transition of power in 2002 was smooth and peaceful. In 2012 the political power transfer from the fourth to the fifth generation was proceeding in a similarly orderly manner, that is, until the Bo Xilai scandal emerged which rocked Beijing. An article in South China Morning Post on October 1, 2012 wrote: "An even scarier thought is that mainland leaders

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[1] Kelly and Ljungqvist (2012) use the announcement of brokerage mergers and closures as exogenous shocks to the firms followed by these brokerage firms to study the causal link from changes in asymmetric information to the changes in the cost of capital measured by stock announcement returns. We use a similar identification strategy but study a different research question.

[2] See Mohanty (2003) among others.

were reportedly divided on how to deal with Bo after the scandals broke. This led to months of political uncertainty about the party's plan to install a new generation of leaders, including Xi, who will take over as president, and current Vice-Premier Li Keqiang, who will be named premier."[3]

Bo Xilai is the son of Bo Yibo, one of the "Eight Immortals," the most powerful elders in China's Communist Party in the 1980s and 1990s.[4] He was once considered a rising star in Chinese politics and a strong candidate for the new Politburo Standing Committee at the 18th Party Congress.[5] Bo formerly served as the mayor of Dalian, the governor of Liaoning province, and the Minister of Commerce. In 2007, he was appointed as the leader of Chongqing, and was inducted into the 25-member Politburo.[6] The Bo administration in Chongqing adopted a set of economic and social policies widely known as the "Chongqing model," which represented increased state control and was seen as a departure from the mainstream state policy.[7]

The Bo scandal first broke in February 9, 2012, when the former police chief of Chongqing, Wang Lijun, reportedly fled to the U.S. consulate in Chengdu and asked for political asylum but later left the consulate voluntarily.[8] The Wang incident aroused much public suspicion. But it was not until March 14, 2012, when Premier Wen Jiabao gave a press conference at the National People's Congress, that Bo was implicated in the incident.[9] On March 15, 2012, Bo Xilai was dismissed from his Politburo post in the Communist Party of China.[10] In August 2012, Bo's wife,

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[3] Wang Xinwen, "The frightening implications of Bo Xilai's harsh punishment," South China Morning Post, October 1, 2012.
[4] BBC News, "Profile: Bo, Xilai," September 21, 2012.
[5] Jane Duckett, "China leadership transition," Political Insight, April 2012.
[6] "The Curriculum vitae of Bo, Xilai" by XinhuaNet, 2007.
[7] See Lu (2012) among others.
[8] http://news.xinhuanet.com/legal/2012-09/24/c_113183202.htm.
[9] Wen Jiabao said that "The present Chongqing municipal party committee and the municipal government must reflect seriously and learn from the Wang Lijun incident." Taken from: http://news.xinhuanet.com/politics/2012-03/14/c_111655106_8.htm.
[10] http://www.china.com.cn/policy/txt/2012-03/15/content_24905206.htm.

Bo Gu Kailai was charged with the murder of British businessman and given a suspended death sentence.[11] Wang Lijun was sentenced to 15 years in prison for his role in covering up the murder.[12] Later it was revealed that Bo Xilai knew of his wife's role in the murder. On September 28, 2012, Bo was expelled from the Communist Party. On September 22, 2013, Bo was found guilty on all counts, including accepting bribery and abuse of power, and was stripped of all his personal assets and sentenced to life imprisonment.[13]

Premier Wen made public Beijing's views toward Bo for the first time on March 14, 2012. We argue that the Bo scandal dramatically heightened the political uncertainty surrounding the upcoming power transfer at the 18th National Congress, as summarized in an article published in *Time*: "But with the downfall of Bo Xilai, … factional rivalries may well be hardening between at least two main camps: the princelings (offspring of Communist Party royalty, including Xi) and the Communist Youth League alumni (represented by presumed future No. 2 Li). … But with prominent princeling Bo sidelined and his wife suspected in the murder of a British businessman in China, the delicate balance of power between the various factions within the Party may well be upset."[14] This increasing uncertainty became obvious with the delay of the 18th Party Congress. The meeting was originally anticipated to be announced in late summer and held in October 2012 but was instead postponed to November 8, 2012. The delay in naming a date for the Congress was widely perceived as evidence of infighting and disagreement within the Party. As one article in *Los Angeles Times* wrote: "The congress, widely anticipated in

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[11]http://www.cq.xinhuanet.com/2012-08/20/c_112780997.htm.
[12] http://news.xinhuanet.com/legal/2012-09/24/c_113183202.htm.
[13] http://en.wikipedia.org/wiki/Bo_Xilai.
[14] "Party Intrigue: Will Political Scandal Delay China's Once-a-Decade Leadership Transition?" by Hannah Beech, Time, May 9, 2012.

October, was apparently pushed back amid discord among party elders over how to deal with Bo, 63, a charismatic figure who had been a top contender for a leadership post."[15]

Figure 1 presents the number of online searches for the words "Wang Lijun" or "Bo Xilai" from October 2011 to June 2012. Panels A, B and C of Figure 1 show the search volume on Google, while Panel D presents the search volume on Baidu—the most popular search engine in China. Panels A and B show the number of searches made in English, while Panels C and D show the number of searches made in Chinese. The time-series patterns reported in these four panels are rather similar. Several features of the graphs are worth discussing.

First, Bo drew significantly more attention than Wang over almost the entire time period in terms of the number of searches in English. It reflects the public view that Bo, with his "princeling" status, is a prominent political figure, while Wang is relevant only because he is one of Bo's top lieutenants. Second, the amount of attention given to both Wang and Bo rose dramatically during the scandal period. In the week of February 9, 2012, as illustrated in Panel C the number of Google searches in Chinese for Wang and Bo rose from almost zero to the first peak, which was about 30% of the highest search volume during this period. The search volume reached an all-time high in the week of April 11, 2012, when the Central Committee in China decided to launch an investigation of Bo. The second peak emerged in the week of March 14, 2012, after Premier Wen's speech. The interest in Bo was about three to five times stronger than the interest in Wang in terms of the search volume after Premier Wen's speech.

To further establish the impact of the Bo scandal on political uncertainty, we report the number of Baidu searches for "revolution" in Chinese. The search index per day shot up from

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[15] "China may struggle to move beyond Bo Xilai scandal," by Barbara Demick and Julie Makinen, Los Angeles Times, September 29, 2012.

almost none to more than 40,000 in the second half of March 2012. [16] This online search interest further confirms our argument that the Bo scandal carried such serious implications that it raised public concerns over the possibility of a revolution. More direct evidence for our argument is the fact that these concerns even had an impact on firms' real activities. On April 3, 2012, South China Morning Post reported that "… two global firms that (plan to) set up Yuan-dominated private equity funds there have decided to put negotiations on hold due to concerns about political uncertainties…."

In this section, we have established that the Bo scandal led to significant increases in political uncertainty in China.[17] In the next section, we will discuss how we can take advantage of this event to test the impact of political uncertainty on asset prices.

3. Hypothesis Development

The theory on political uncertainty (e.g., Pástor and Veronesi, 2013a) predicts that political uncertainty commands a risk premium. In equilibrium, risk-averse investors will avoid holding stocks during periods of high political uncertainty or they will demand a higher expected return for holding such stocks. In other words, stock prices should drop to reflect this higher required rate of return amid increasing political uncertainty (e.g., Pástor and Veronesi, 2013b). We thus expect stock prices to fall when political uncertainty increases. If political uncertainty represents a risk, firms with higher exposure to this political risk should be more affected when political uncertainty is high. We construct three proxies for policy sensitiveness with respect to three different dimensions, namely the monetary policy, the fiscal policy, and political connections.

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[16] According to the official explanation of the Baidu index, the number of the search index displayed on its platform does not refer to real search times on Baidu, but they are positively related. Therefore, it is more meaningful to compare the change of itself over time.

[17] The Bo scandal on political uncertainty should only have a short-term effect due to the tight control of the Communist Party.

We first consider the stock return around the announcements of a RRR adjustment. The RRR is one of the most important monetary policies implemented by China's central government and has a direct impact on the market interest rate. A monetary policy-sensitive firm would respond more strongly to these announcements. On the other hand, if a firm's operation and financing activities are more independent of the government's monetary policy, its stock price would be less likely to experience volatility due to these policy announcements. We thus measure a firm's monetary policy sensitiveness by the average of the absolute values of announcement returns over event days.

Secondly, we quantify the relevance of the government's fiscal policies to each firm in China. We measure the proportion of government expenditures in total fixed asset expenditures in each province. We assign firms to each province based on their headquarters. Firms located in provinces with higher government expenditures are more fiscal policy-sensitive.

Finally, we construct a political connection measure. We argue that politically connected firms are more exposed to the risk of political uncertainty. Previous studies have documented that political connections have value (e.g., Fisman, 2001), but that is true only if the people involved remain in power. Growing uncertainty surrounding a power transition increases the possibility that these connections will lose their value. As a result, politically connected firms are more sensitive to political uncertainty.

Using these three measures as proxies for policy sensitiveness, we derive the following hypothesis from political uncertainty risk models:

H1: The aggregate announcement returns around the Bo scandal are negative. In addition, these announcement returns are more negative among firms that have larger absolute returns around

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the past announcements of RRR adjustments, among firms whose headquarters are located in the provinces with more government expenditures, and among more politically connected firms.

The announcement returns around the Bo scandal may be negative for several alternative reasons. Besides the increase in the risk premium (i.e., the discount rate news), an alternative explanation is the decrease in future cash flow (i.e., the cash flow news). If we consider a simple discounted cash flow model of stock price, a negative return or in another words, a drop in stock prices, can arise due to an increase in the expected discount rate or a decrease in expected future cash flow. If it is due to the latter, we would expect that analysts' earnings forecasts as measures of expected cash flow will drop after the scandal and that firms' future operating performance—as captured by the realized cash flow—will drop after the event. No such prediction of future cash flows can be made based on the political uncertainty risk story. The cash flow hypothesis is stated as follows:

H2: The cash flow explanation predicts that expected cash flow will drop around the Bo scandal while the political uncertainty explanation makes no such prediction.

Future cash flow could fall if political connections lose their value. It is possible that the negative returns are driven by the reduced value of political connections for politically connected firms and not by increasing uncertainty. To differentiate one explanation from the other, we investigate the change in stock return volatility over the scandal period. If the negative return during the scandal period is caused by increasing uncertainty, we would expect stock return volatility to increase over the same period. On the other hand, if the negative return only reflects

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a fall in future cash flow, there would be no rise in volatility. The above discussions lead to our third hypothesis:

H3: The political uncertainty explanation predicts that stock return volatility will increase after the Bo scandal, while the cash flow explanation associated with political connections makes no such prediction.

4. Data Description

We collect financial information on firms from the China Stock Market and Accounting Research Database (CSMAR) maintained by GTA Information Technology. Our initial sample includes all non-financial firms publicly listed for at least one year and traded in the A-share market in mainland China as of the end of 2011. Financial firms are excluded because their financial statements are compiled under different accounting standards. We drop another 144 firms because there is not enough data to calculate abnormal stock returns around the Wang scandal or/and the Bo scandal using the market model.[18] After excluding another 30 firms for which information on other variables used in our analyses is missing, the final sample consists of 1,862 unique firms. All the variable definitions are given in Appendix A.

The announcement dates for the RRR adjustments are collected from People's Bank of China website.[19] Appendix B summarizes the 31 announcements made from January 2007 to December 2011. For each announcement, we measure the three-day cumulative abnormal return around the announcement date for each firm, and rank all the firms by the absolute value of these

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[18] To make sure that there are no other confounding corporate events, we require that the number of normal trading days be no less than 100 days during the period from August 7, 2011 to February 6, 2012 when calculating the abnormal stock return. Stock trading must be suspended if there is any material and uncertain event going on with the firm until all uncertainties are clear in China.

[19] http://www.pbc.gov.cn/publish/goutongjiaoliu/524/index.html

cumulative abnormal returns. The rank is further converted into a number between 0 and 1.[20] Finally, we take the value-weighted average for each firm over all the announcement events for firms with enough data. The weight is the aggregate market absolute return over the event day. Since the market reaction around the announcement day captures the surprise component of the policy, the weighting scheme assigns a larger weight to the announcements containing a bigger surprise for the market. We name this variable as *Policy announcement*.

Total investment in fixed assets in each province is obtained from the 2010, 2011, and 2012 China Statistical Yearbooks. According to these yearbooks, the investment in fixed assets in China is classified by the ownership of investment entities and regions. For each province, we use the investment from state-owned enterprises (SOE) as a proxy for government investment. This variable is termed as *Fixed investment*. The remaining entities are classified as private sectors. As a robustness test, we also consider the average ratios over 2009, 2010 and 2011 to reduce noise in year 2010. The results when this alternative measure is used are very similar to the ones reported in the paper and are omitted to save space. We obtain a firm's headquarter location from CSMAR.

Finally, the political connection data are hand-collected from the curriculum vitae (CV) of the public companies' board directors available from the annual reports. Following Fan, Wong, and Zhang (2007), we define a person as politically connected if he or she was or is an official of the central government, a local government, or the military. We count the number of directors on the board who have the abovementioned connections. The political connection variable is the natural logarithm of one plus the number of politically connected board directors.

5.   Empirical Results

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[20] The conversion is calculated by rank/(number of firms + 1).

5.1　　Summary statistics

　　Table 1 reports the summary statistics for the main variables used in the paper. All the variables are denominated in RMB.[21] The natural logarithm of the market value of equity one week before the Wang scandal (LnSZ_1) has a mean of 22.118 (which equals 4.034 billion yuan) and a median of 21.925 (which equals 3.326 billion yuan). The book-to-market equity ratio (B/M_1) has a mean of 0.463 and a median of 0.418 which is slightly lower than the mean. The average market value of equity is higher and as a result the book-to-market equity is lower one week before the Bo scandal than one week before the Wang scandal. The leverage ratio is around 0.445 with the 25th percentile of around 0.264 and the 75th percentile of around 0.621. The summary statistics suggest that our sample is comparable to those used in other studies such as Li, Liu, and Wang (2014) and Giannetti, Liao, and Yu (2014).

　　Table 2 summarizes two policy sensitiveness measures. Panel A of Table 2 reports the monetary policy sensitiveness measure across industries. For each industry, we take the equal-weighted average of the firm-level measures across all firms in that particular industry. The real estate industry has the highest sensitiveness with a mean value of 0.583. This result makes sense as the real estate industry heavily depends on external financing for their development. Any interest rate-related policy changes would have a huge impact on the financing costs of real estate firms and potential home buyers, and thus affect the value of these firms. The other monetary policy-sensitive industries include mining (mean = 0.514) and transportation (mean = 0.485), which arguably also rely strongly on external financing. On the other hand, information technology (mean = 0.338), furniture (mean = 0.341), and other manufacturing industries (mean = 0.342) are the least sensitive industries.

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[21] At the end of 2011 and 2012, one US dollar equals 6.30 and 6.22 RMB, respectively.

Panel B of Table 2 reports the list of provinces ranked in ascending order by the proportion of government expenditures. The province having the highest government investment is Tibet (ratio = 0.72), which is in part due to the fact that Tibet attracts less private investments. Since government investment is the main source of financing for development in Tibet, firms located there are no doubt sensitive to potential changes in government policies. Gansu (ratio = 0.523) and Qinghai (ratio = 0.471) provinces are the runner-ups, reflecting China's Great Western Development Strategy.[22] At the other extreme, Shandong (ratio = 0.142), Henan (ratio = 0.164), Jiangsu (ratio = 0.175), and Liaoning (ratio = 0.206) attract less investment from SOEs.

5.2   Results from univariate tests

Table 3 reports results from univariate tests. We construct a three-day (t-1, t+1) cumulative abnormal return (CAR) around the scandal date. To obtain the abnormal return, we estimate a market model as follows:

$$Ret_{i,t} = \alpha_i + \beta_i R_{M,t} + \epsilon_{i,t},$$

where $Ret_{i,t}$ is the return on stock i on day t and $R_{M,t}$ is the equal-weighted market return on day t.[23] The model is estimated for each firm over the six-month period prior to the Wang scandal to obtain the estimated coefficients $\hat{\alpha}_i$ and $\hat{\beta}_i$. The realized market returns ($R_{M,\tau}$) and realized individual firm returns ($Ret_{i,\tau}$) over the event window (τ = -1, 0, 1, where 0 is the announcement date) are used to construct the abnormal return (*ARet*) as $ARet_{\tau,t} = Ret_{i,\tau} - (\hat{\alpha}_i + \hat{\beta}_i R_{M,\tau})$. The CAR is calculated as $\sum_{\tau=-1}^{1} ARet_{\tau,t}$, using the three-day centering around the scandal.

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[22] The Great Western Development Strategy is a campaign "to promote the fast and healthy development of the western areas" in order to address economic development inequalities between China's western hinterlands and coastal east. The development of infrastructure is an important component of the strategy.
[23] The empirical results throughout the paper are essentially the same if we use value-weighted market return in calculating abnormal returns.

Table 3 reports the cumulative abnormal returns over the three-day around the Wang scandal and the three-day around the Bo scandal based on equal-weighted returns. The cumulative abnormal return represents the six-day return from both events. We further group firms by the three policy sensitiveness measures. For each measure, we group firms into terciles based on the sorting variable and report equal-weighted CAR. The table only reports the results for the two extreme terciles to save space. Following previous literature (e.g., Brown and Warner, 1985), we use the standard deviation of prediction errors in the estimation period to test the statistical significance of abnormal returns during the scandal period.

For the monetary policy sensitiveness measure (Panel A), the more sensitive firms have CARs that are 0.877% lower than those of less sensitive firms. The difference is statistically significant at the 1% level. For the fiscal policy sensitiveness measure (Panel B), the return difference between the two extreme groups is 0.752%. For the political connection measure (Panel C), more sensitive firms have CARs that are 0.603% lower than those of less sensitive firms. The last panel (Panel D) uses a combined measure as a sorting variable, which is the sum of three measures standardized to have a mean of 0 and standard deviation of 1. This combined measure can diversify away the error in each individual measure. This measure yields similar results but with a larger magnitude. Specifically, the "More minus Less" return difference rises to around -1.093%. For a median firm in the sample (= 3.568 billion yuan), this represents a wealth loss of about 38.42 million yuan during the six-day event window.[24] We argue that this is not only statistically significant but also economically important.

The finding that the returns during the scandal period are always more negative for more sensitive firms than for less sensitive firms is consistent with Hypothesis 1. Increasing political uncertainty causes stock prices to fall, especially for policy-sensitive firms. The fact that the

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[24] The value is computed as exp[(21.925+22.066)/2)]*(1.06%+1.093%)/2 = 38.42 million yuan.

combined measure yields higher return spreads suggests that all three measures capture slightly different dimensions of policy sensitiveness.

5.3   Baseline results from regression analysis

Previous studies have documented that cross-sectional stock returns are also associated with firm characteristics (e.g., Fama and French (1992); Daniel, Titman, and Wei (2001)). The results in Table 3 do not consider other factors that may affect stock returns. Table 4 reports regression results with control variables. We control for firm size (LnSZ), book-to-market equity (B/M), leverage (Leverage), and the return over the past week (BHR1). BHR1 is the buy-and-hold stock return from two weeks to one week before the event (Wang Lijun or Bo Xilai). All three policy sensitiveness measures have a significantly negative impact on CARs even with these controls. More specifically, the coefficients on *Policy announcement*, *Fixed investment*, *Political connection*, and *All three* are -1.228 (t-stat = -4.36), -3.227 (t-stat = -5.28), -0.340 (t-stat = -3.33), and -0.272 (t-stat = -6.06), respectively. All four coefficients are highly significant at the 1% level.

Panels A and B of Table 5 report results for the Wang scandal and the Bo scandal, respectively. For the Wang scandal, only the first policy sensitiveness measure (i.e., *Policy announcement*) has a significant coefficient at -0.184 (t-stat = -2.08). The combined measure also has a significant coefficient, which is obviously driven by the first measure. The estimated coefficient on *All three* is -0.032 and is significant at the 10% level (t-stat = -1.68).

In contrast, for the Bo scandal, all three measures and the combined measure carry highly significant coefficients. In particular, the coefficients on *Policy announcement*, *Fixed investment*, *Political connection*, and *All three* are -1.042 (t-stat = -4.59), -2.94 (t-stat = -5.07), -0.265 (t-stat

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= -2.67), and -0.232 (t-stat = -4.97), respectively. All four coefficients are highly significant at the 1% level. These results are consistent with the news search results reported in Figures 1 and 2 in that the Wang scandal was the less important one. By itself, the Wang scandal had little effect on the power transition. Only when Bo was implicated did the whole saga become a crisis for Beijing.

5.4   Is ownership important?

Before we go on to test alternative explanations, we carry out tests across two subsamples: SOEs and non-SOEs. Previous studies have documented the important differences between SOEs and non-SOEs. However, there is no clear theoretical guidance on whether political uncertainty is more prominent for SOEs or non-SOEs. One may argue that all SOEs are similar in that they all belong to the government and no matter who is in power, these stated-owned assets will always form an integral part of the authority. This is especially true for those SOEs controlled by the central government, which we call central government-owned entities or agencies (*central SOEs* hereafter). Thus, SOEs should not differ significantly. In contrast, non-SOEs are more diverse and independent, thus are more vulnerable to potential policy changes. The policy sensitiveness results would be more prominent in the non-SOE subsample. On the other hand, one may also argue that SOEs are more sensitive to political uncertainty seeing as they belong to the authority, while non-SOEs are on their own any way so they are less affected by the power transition. At the end of the day, the difference in the effects of political uncertainty on CARs between these two subsamples is an empirical issue. Since *central SOEs* are more

closely related to the government, we exclude local SOEs from our analysis when comparing

SOEs and non-SOEs.[25]

Panels A and B of Table 6 report the regression results for the SOE subsample and the non-SOE subsample, respectively. For the SOE subsample, only the fixed investment measure has a marginally significant coefficient (coef. = -2.324 with t-stat = -1.82), while the other two measures are insignificant. The results suggest that government expenditures are a more direct measure of political uncertainty for SOEs, which is consistent with the nature of SOEs. On the other hand, the non-SOE subsample always generates significant results. For example, the coefficients on *Policy announcement*, *Fixed investment*, *Political connection*, and *All three* are -1.585 (t-stat = -3.47), -5.19 (t-stat = -4.84), -0.325 (t-stat = -1.88), and -0.363 (t-stat = -5.01), respectively. All four coefficients are highly significant at the 1% level except for the coefficient on *Political connection*, which is significant at the 10% level. The results reported in Table 4 are likely mainly driven by private firms.[26]

6. Alternative Explanations

6.1 The cash flow explanation

We have documented that the Bo scandal caused a significant drop in stock prices, especially for policy-sensitive firms. But a stock price drop may be caused by a cash flow effect or a discount rate effect. To differentiate the political uncertainty explanation from the cash flow

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[25] There are two ways to conduct the test to examine whether SOEs and non-SOEs differ in their response to a political event. Apart from the one used in the current analysis, we can also use an interaction term approach by including an interaction term *sensitiveness×SOE* in the regression, where SOE is a dummy with a value of one if a firm is an SOE and zero otherwise. The advantage of our subsample approach is that the regression coefficients are allowed to be different on all control variables as well. SOEs are different from non-SOEs in many ways. For example, as our results show, leverage has quite an effect on non-SOE firms but not on SOE firms, reflecting the fact that non-SOE firms are more financially constrained. This justifies our two-subsample test approach.

[26] There is another group of SOEs, namely local SOEs. In unreported results, we find that political uncertainty also has significant impacts on local SOEs. Its significance is higher than that for central SOEs but lower than that for private firms. The results are available upon request.

explanation stated in Hypothesis 2, we measure the expected change in cash flows based on changes in analysts' forecasted earnings to reflect investors' expectation. If the announcement return was driven by expected changes in cash flows, we should observe a significant change in analysts' earnings forecasts. We measure the change in earnings forecasts as the difference in the median forecasted earnings per share (EPS) between six months after and six months before the Bo scandal, divided by the stock price two days prior to that scandal. To ease understanding of the results, we convert the change to a percentage. We consider forecasts for years 2012, 2013, and 2014 because analysts routinely make multi-year-ahead earnings forecasts. Panels A, B and C of Table 7 report the results for years 2012, 2013, and 2014, respectively. We find that none of the policy sensitiveness measures are significantly and negatively related to these changes in earnings forecasts.

Besides changes in expected cash flows, we also use realized cash flow as a proxy for changes in investors' expectation of cash flow to strengthen our results. Although realized cash flows contain look-ahead bias information, if the result remains, it would strengthen our argument. We measure a firm's operation performance by net income divided by total assets (ROA), by operating profits divided by total assets (OPOA), and by sales divided by total assets (SOA). Table 8 presents the estimates with the dependent variable for the fiscal year of 2012. Panels A, B and C show the results for ROA, OPOA, and SOA, respectively. We include the one-year-lagged dependent variable to control for potential confounding factors such as the persistence of earnings. As we can see from Table 8, most of the policy sensitiveness measures have insignificant coefficients, while the third measure (political connections) even has a significantly positive coefficient in two regressions. More specifically, when ROA is used to proxy for cash flow, the estimated coefficient is 0.533 (stat = 3.14); when OPOA is used to

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proxy for cash flow, the estimated coefficient is 0.453 (stat = 2.65). These results contradict to the cash flow explanation. Thus there is no evidence to suggest that after the Bo scandal, firms that were more politically sensitive experienced worse operating performance.

Combining the results reported in Tables 7 and 8 suggests that the more negative returns for more politically sensitive firms than for less politically sensitive firms over the scandal period are more likely due to the increase in political uncertainty than to the reductions in expected or realized cash flow or earnings. All these results reject our Hypothesis 2 (i.e., the cash follow hypothesis).

6.2   The volatility effect

Finally, we test the change in volatility as stated in Hypothesis 3. We measure the change in volatility from before to after the Bo scandal. Based on the evidence in Table 5 that the Bo scandal was the more important one, we focus on the period after the Bo scandal only. Daily stock returns are used to construct volatility. We start from March 15, 2012 and use one-week or one-month daily stock return data to estimate stock return volatility. We use daily returns in January 2012 to construct benchmark volatility. We prefer to use January data because the Wang scandal occurred in early February. Using the one-month data from January 8, 2012 to February 8, 2012 yields qualitatively and quantitatively similar results. Panels A and B of Table 9 report the estimates based on the one-week window and the one-month window after the Bo scandal, respectively. The results in both panels show that volatility increased significantly after the Bo scandal, especially for firms that are more politically sensitive. For example, using one-week volatility as the dependent variable, the coefficients on *Policy announcement*, *Fixed investment*, *Political connection*, and *All three* are 0.317 (t-stat = 5.17), 0.776 (t-stat = 2.28), 0.096 (t-stat =

3.25), and 0.068 (t-stat = 10.65), respectively. All four coefficients are highly significant at the 1% level except for the coefficient on *Fixed investment*, which is significant at the 5% level. This evidence suggests that the results are more consistent with increasing uncertainty or the discount rate explanation rather than decreasing cash flow or the cash flow explanation (Hypothesis 3).

7.   Conclusion

Recent theoretical models and empirical evidence have shown that an increase in political uncertainty causes a contemporaneous drop in stock prices but an increase in future expected returns. However, previous empirical studies have not been able to rule out endogeneity issues. In this paper, we test the causal link between political uncertainty and asset prices in a natural experiment involving an exogenous shock to the political stability in China in 2012. The Bo Xilai political scandal posed the greatest threat to China's political stability in the years since the country began its economic reform in 1978. Due to its significance, the Bo scandal represents an ideal setting for us to test the impact of political uncertainty on asset prices in the absence of endogeneity.

Using daily stock returns from A-shares of firms listed on the two Chinese stock exchanges, we document that stock prices dropped significantly around the Bo scandal, in particular the stock prices of firms that were the most sensitive to changes in government policies. We measure the sensitiveness to policy changes using three proxies: (1) stock price sensitivity to the announcements of the adjustments of the reserve requirement ratio (RRR), (2) the proportion of SOE expenditures in total expenditures on fixed assets in each province, and (3) the degree of political connections. In addition, we find that the return volatility right after the Bo scandal increased significantly for the most policy-sensitive but not the least policy-sensitive firms.

Finally, the changes in analysts' earnings forecasts and the realized accounting performance after the Bo scandal are not significantly different between the most policy-sensitive and the least policy-sensitive firms. Our results are thus consistent with the existence of political uncertainty risk.

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Appendix A. Variable definitions

Variable	Definition and Data Source
Policy announcement	The weighted average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio during the period from 2007 to 2011. For each adjustment, we rank all firms by the absolute value of these cumulative abnormal returns in ascending order. This rank is further converted into a number between 0 and 1 using the formula: rank/(number of firms + 1). To reflect the relative significance of these adjustments, a weight is assigned to the absolute market return over the three-day window around the announcement to calculate this weighted average ranking variable. Source: manually collected from the People's Bank of China website.
Fixed investment	The average portion of fixed investment from government-owned entities over the three-year period from 2009 to 2011 at the province level. Source: China Statistical Yearbooks of 2010, 2011, and 2012.
Political connection	The natural logarithm of one plus the number of directors on the board who have political connections. A director is defined as politically connected if he or she is a current or former government bureaucrat following Fan et al. (2007). Source: manually collected from annual reports.
All three	The sum of policy announcement, fixed investment, and political connection, standardized to have a mean of 0 and standard deviation of 1.
CAR(Bo)	The cumulative abnormal return over the three-day window around the Bo Xilai scandal. Source: CSMAR.
CAR(Wang)	The cumulative abnormal return over the three-day window around the Wang Lijun scandal. Source: CSMAR.
CAR	The sum of CAR (Bo) and CAR (Wang). Source: CSMAR.
Vol_1w	The difference in volatility of daily stock return over the week following the Bo scandal and the whole month of January in 2012 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
Vol_1m	The difference in volatility of daily stock return over the one month following the Bo scandal and the whole month of January in 2012 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
ΔForecast EPS_2012	The change in analyst forecasted earnings per share (EPS) divided by the stock price two days prior to the Bo scandal in percentage for year 2012. The change in analyst forecasted earnings per share is defined as the difference between the median forecasted EPS in the 6 months after the Bo scandal and the median forecasted EPS in the 6 months before the Bo scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
ΔForecast EPS_2013	The change in analyst forecasted EPS divided by the stock price two days prior to the Bo scandal in percentage for year 2013. The change in analyst forecasted earnings per share is defined as the difference between the median forecasted EPS in the 6 months after the Bo scandal and the median forecasted EPS in the 6 months before the Bo scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
ΔForecast EPS_2014	The change in analyst forecasted EPS divided by the stock price two days prior to the Bo scandal in percentage for year 2014. The change in analyst forecasted earnings per share is defined as the difference between the median forecasted EPS in the 6 months after the Bo scandal and the median forecasted EPS in the 6 months before the Bo scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
SD_EPS_2012	Standard deviation of analyst forecasted EPS for year 2012 in the (-6m, +6m) window around the Bo scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.

SD_EPS_2013	Standard deviation of analyst forecasted EPS for year 2013 in the (-6m, +6m) window around the Bo scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
SD_EPS_2014	Standard deviation of analyst forecasted EPS for year 2014 in the (-6m, +6m) window around the Bo scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
ROA	Net income divided by total assets for the fiscal year of 2012 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
ROA(2011)	Net income divided by total assets for the fiscal year of 2011 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
Operating Profit / Total Asset (OPOA)	Operating profit divided by total assets for the fiscal year of 2012 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
Operating Profit / Total Asset(2011)	Operating profit divided by total assets for the fiscal year of 2011 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
Sales/Total Asset (SOA)	Sales divided by total assets for the fiscal year of 2012 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
Sales/Total Asset(2011)	Sales divided by total assets for the fiscal year of 2011 in percentage. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
LnSZ_1	The natural logarithm of the firm market value as of one week before the Wang Lijun scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
B/M_1	Book-to-market ratio. Constructed as the book value of equity as of the end of 2011 divided by the market value of equity as of one week before the Wang Lijun scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
LnSZ_2	The natural logarithm of the firm market value as of one week before the Bo Xilai scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
B/M_2	Book-to-market ratio, constructed as the book value of equity as of the end of 2011 divided by the market value of equity as of one week before the Bo Xilai scandal. Winsorized at the 0.5% and 99.5% levels. Source: CSMAR database.
Leverage	Total liabilities divided by total assets, winsorized at the 0.5% and 99.5% levels. Source: CSMAR.
SOE	A dummy variable that equals one if the ultimate controller of a firm is a government-owned entity or a government agency, and zero otherwise. Source: CSMAR.
BHR1	Buy-and-hold stock return from two weeks to one week before the Wang Lijun scandal in percentage. Source: CSMAR.
BHR2	Buy-and-hold stock return from two weeks to one week before the Bo Xilai scandal in percentage. Source: CSMAR.
AbsBHR2	Absolute value of the buy-and-hold stock return from two weeks to one week before the Bo Xilai scandal. Source: CSMAR.
Beta	Beta obtained from the market model in estimating the cumulative abnormal return. Source: CSMAR.
Idiosyncratic risk	Idiosyncratic risk, defined as the standard deviation of the residual from the market model in estimating the cumulative abnormal return. Source: CSMAR.

Appendix B. Announcement dates of the adjustment of the reserve requirement ratio from 2007 to 2011

announcement date	Adjustment size (big financial institutions)	Adjustment size (small and medium financial institutions)
January 5, 2007	0.50%	0.50%
February 16, 2007	0.50%	0.50%
April 15, 2007	0.50%	0.50%
April 29, 2007	0.50%	0.50%
May 18, 2007	0.50%	0.50%
July 30, 2007	0.50%	0.50%
September 6, 2007	0.50%	0.50%
October 13, 2007	0.50%	0.50%
November 10, 2007	0.50%	0.50%
December 8, 2007	1.00%	1.00%
January 16, 2008	0.50%	0.50%
March 18, 2008	0.50%	0.50%
April 16, 2008	0.50%	0.50%
May 12, 2008	0.50%	0.50%
June 7, 2008	1.00%	1.00%
September 15, 2008	0.00%	-1.00%
October 8, 2008	-0.50%	-0.50%
November 26, 2008	-1.00%	-2.00%
December 22, 2008	-0.50%	-0.50%
January 12, 2010	0.50%	0.00%
February 12, 2010	0.50%	0.00%
May 2, 2010	0.50%	0.00%
November 19, 2010	0.50%	0.50%
December 10, 2010	0.50%	0.50%
January 14, 2011	0.50%	0.50%
February 18, 2011	0.50%	0.50%
March 18, 2011	0.50%	0.50%
April 17, 2011	0.50%	0.50%
May 12, 2011	0.50%	0.50%
June 14, 2011	0.50%	0.50%
November 9, 2011	0.50%	0.50%
November 30, 2011	-0.50%	-0.50%

Table 1. Summary statistics

This table provides summary statistics for the variables used in the paper. Financial information on firms is from China Stock Market and Accounting Research Database (CSMAR) maintained by GTA Information Technology. Our initial sample includes all non-financial firms listed for at least one year and publicly traded in the A-share market in mainland China as of the end of 2011. All variables are defined in Appendix A.

Variable	Mean	S.D.	p25%	p50%	p75%
Policy announcement	0.431	0.282	0.193	0.390	0.657
Fixed investment	0.280	0.089	0.230	0.257	0.363
Political connection	0.654	0.601	0.000	0.693	1.099
All three	0.000	1.773	-1.302	-0.085	1.170
CAR (Bo)	-0.301	4.671	-3.190	-1.189	1.459
CAR (Wang)	0.076	2.666	-1.632	-0.462	1.263
CAR	-0.225	5.488	-3.791	-1.094	2.232
Vol_1w	-0.235	1.092	-0.944	-0.272	0.410
Vol_1m	-0.679	0.916	-1.315	-0.696	-0.083
ΔForecast EPS_2012	-0.812	1.223	-1.246	-0.360	0.000
ΔForecast EPS_2013	-1.011	1.492	-1.566	-0.508	0.000
ΔForecast EPS_2014	-0.627	1.312	-1.145	0.000	0.000
SD_EPS_2012	0.168	0.153	0.068	0.125	0.210
SD_EPS_2013	0.230	0.194	0.105	0.172	0.290
SD_EPS_2014	0.306	0.292	0.113	0.207	0.390
ROA	3.468	5.401	1.092	3.152	6.001
ROA(2011)	4.642	5.467	1.961	4.189	6.965
Operating Profit/Total Asset	3.567	6.196	0.742	3.260	6.522
Operating Profit/Total Asset (2011)	4.914	6.254	1.716	4.497	7.684
Sales/Total Asset	66.402	49.448	33.969	54.393	83.046
Sales/Total Asset (2011)	69.581	51.326	35.577	57.690	87.615
LnSZ_1	22.118	0.961	21.447	21.925	22.601
B/M_1	0.463	0.252	0.289	0.418	0.585
LnSZ_2	22.251	0.945	21.592	22.066	22.749
B/M_2	0.407	0.226	0.253	0.366	0.514
Leverage	0.445	0.224	0.264	0.455	0.621
SOE	0.478	0.500	0.000	0.000	1.000
BHR1	2.797	3.645	0.630	2.575	4.334
BHR2	1.806	3.762	-0.650	1.253	3.494
AbsBHR2	0.029	0.030	0.010	0.021	0.038
Beta	0.995	0.210	0.861	0.997	1.145
Idiosyncratic	0.018	0.005	0.014	0.017	0.021

Table 2. Policy sensitiveness measures

Panel A of this table reports the average policy announcement measure across industries in ascending order. Panel B reports the fixed investment measure by province in ascending order.

Panel A. The ranking of industries by the policy announcement measure			
Industry	Policy announcement	Industry	Policy announcement
Information Technology	0.338	Pharmaceutical Products	0.433
Furniture	0.341	Metal	0.451
Other Manufacturing	0.342	Apparel	0.452
Communication & Culture	0.374	Agriculture	0.464
Food	0.377	Retail & Wholesale	0.469
Social Services	0.391	Utilities	0.470
Electronic	0.394	Conglomerate	0.483
Machinery	0.404	Transportation	0.485
Construction	0.414	Mining	0.514
Gas and Chemistry	0.416	Real Estate	0.583
Printing	0.419		

Panel B. The ranking of provinces by the fixed investment measure					
Province	Fixed Investment	Province	Fixed Investment	Province	Fixed Investment
Shandong	0.142	Hainan	0.285	Shanghai	0.380
Henan	0.164	Guangxi	0.296	Heilongjiang	0.397
Jiangsu	0.175	Hubei	0.303	Xinjiang	0.409
Liaoning	0.206	Fujian	0.303	Guizhou	0.432
Hebei	0.207	Hunan	0.324	Shanxi	0.434
Zhejiang	0.230	Ningxia	0.337	Yunnan	0.436
Jiangxi	0.235	Chongqing	0.349	Shaanxi	0.447
Anhui	0.241	Sichuan	0.363	Qinghai	0.471
Guangdong	0.257	Inner Mongolia	0.364	Gansu	0.523
Jilin	0.260	Tianjin	0.371	Tibet	0.720
Beijing	0.265				

Table 3. Univariate tests

The table presents the univariate test. CAR represents the equal-weighted cumulative abnormal return over the three-day window around the Wang scandal (February 9, 2012) or the three-day window around the Bo scandal (March 14, 2012). In each panel, all firms in the sample are split into three groups by a proxy of policy sensitiveness. In Panel A, the sorting variable is the weighted-average ranking of the absolute return over a three-day window around the announcement of the adjustment of the reserve requirement ratio during the period from 2007 to 2011. In Panel B, the sorting variable is the average portion of fixed investment from government-owned entities over the three-year period from 2009 to 2011 at the province level. In Panel C, the sorting variable is the natural logarithm of one plus the number of directors on the board who have political connections, while in Panel D, it is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1.

Panel A: Policy announcement				
	Less Sensitive	More Sensitive	More-Less	p-value
CAR	0.021%	-0.857%	-0.877%	0.002
Panel B: Fixed investment				
	Less Sensitive	More Sensitive	More-Less	p-value
CAR	0.212%	-0.540%	-0.752%	0.008
Panel C: Political connection				
	Less Sensitive	More Sensitive	More-Less	p-value
CAR	-0.061%	-0.665%	-0.603%	0.050
Panel D: All three measures				
	Less Sensitive	More Sensitive	More-Less	p-value
CAR	0.370%	-0.723%	-1.093%	0.000

Table 4. Regression results on policy sensitiveness proxies

This table reports the regression results to measure the effect of policy sensitiveness on cumulative abnormal returns (CAR). The dependent variable is CAR (-1, +1), which is the equal-weighted returns over the three-day window around the Wang scandal (February 9, 2012) or the three-day window around the Bo scandal (March 14, 2012). Policy announcement is the weighted-average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio. Fixed investment is the average portion of fixed investment from government-owned entities at the province level. Political connection is the natural logarithm of one plus the number of directors on the board who have political connections. *All three* is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1. LnSZ_1 and B/M_1 are the logarithm of a firm's market value and book-to-market ratio one week before the Wang scandal. Leverage is the ratio of total liabilities to total assets. BHR1 is the buy-and-hold stock return from two weeks to one week before the Wang scandal. The t-statistics are reported in parentheses. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels, respectively.

	(1)	(2)	(3)	(4)
Policy announcement	-1.228***			
	(-4.356)			
Fixed investment		-3.227***		
		(-5.277)		
Political connection			-0.340***	
			(-3.326)	
All three				-0.272***
				(-6.055)
LnSZ_1	0.386***	0.388***	0.400***	0.423***
	(2.709)	(2.683)	(2.760)	(2.965)
B/M_1	-3.687***	-3.778***	-3.659***	-3.740***
	(-9.338)	(-9.776)	(-9.160)	(-9.825)
Leverage	-1.985***	-2.310***	-2.344***	-1.982**
	(-2.661)	(-2.885)	(-2.959)	(-2.561)
BHR1	-0.130***	-0.131***	-0.127***	-0.135***
	(-3.955)	(-4.066)	(-4.042)	(-3.922)
N	1,862	1,862	1,862	1,862
Adjusted R^2	0.042	0.041	0.040	0.046

Table 5. Regression results on policy sensitiveness proxies over each of two scandal windows

This table reports the effect of policy sensitiveness on cumulative stock returns (CAR) around the Wang and Bo scandals separately. The dependent variable is CAR (-1, +1), which is the equal-weighted returns over the three-day window around the Wang scandal (February 9, 2012) in Panel A or the three-day window around the Bo scandal (March 14, 2012) in Panel B. Policy announcement is the weighted-average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio. Fixed investment is the average portion of fixed investment from government-owned entities at the province level. Political connection is the natural logarithm of one plus the number of directors on the board who have political connections. *All three* is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1. LnSZ_1 and B/M_1 (LnSZ_2 and B/M_2) are the logarithm of a firm's market value and book-to-market ratio one week before the Wang (Bo) scandal. Leverage is the ratio of total liabilities to total assets. BHR1 (BHR2) is the buy-and-hold stock return from two weeks to one week before the Wang (Bo) scandal. The t-statistics are reported in parentheses. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels, respectively.

Panel A: The Wang scandal				
	(1)	(2)	(3)	(4)
Policy announcement	-0.184**			
	(-2.083)			
Fixed investment		-0.161		
		(-0.279)		
Political connection			-0.055	
			(-0.943)	
All three				-0.032*
				(-1.679)
LnSZ_1	-0.179**	-0.180**	-0.176**	-0.175**
	(-2.309)	(-2.322)	(-2.276)	(-2.262)
B/M_1	-1.365***	-1.370***	-1.361***	-1.371***
	(-4.234)	(-4.352)	(-4.180)	(-4.298)
Leverage	0.305	0.251	0.252	0.293
	(0.809)	(0.666)	(0.687)	(0.778)
BHR1	-0.062***	-0.062***	-0.062***	-0.062***
	(-4.883)	(-4.990)	(-4.911)	(-4.843)
N	1,855	1,855	1,855	1,855
Adjusted R^2	0.018	0.017	0.017	0.018

Table 5 – Continued

Panel B: The Bo scandal

	(1)	(2)	(3)	(4)
Policy announcement	-1.042***			
	(-4.589)			
Fixed investment		-2.940***		
		(-5.073)		
Political connection			-0.265***	
			(-2.667)	
All three				-0.232***
				(-4.972)
LnSZ_2	0.710***	0.714***	0.717***	0.746***
	(6.624)	(6.550)	(6.615)	(7.027)
B/M_2	-1.938***	-2.027***	-1.920***	-1.975***
	(-3.836)	(-4.084)	(-3.963)	(-3.864)
Leverage	-2.108***	-2.379***	-2.418***	-2.098***
	(-2.811)	(-2.991)	(-2.986)	(-2.752)
BHR2	0.132***	0.131***	0.130***	0.131***
	(3.354)	(3.352)	(3.193)	(3.383)
N	1,862	1,862	1,862	1,862
Adjusted R^2	0.048	0.047	0.045	0.052

Table 6. Regressions on policy sensitiveness proxies by ownership

This table reports the effect of policy sensitiveness on cumulative abnormal returns (CAR) for SOEs and private firms separately. The dependent variable is CAR (-1, +1), which is the equal-weighted returns over the three-day window around the Wang scandal (February 9, 2012) or the three-day window around the Bo scandal (March 14, 2012). Panel A reports results for SOEs, while panel B presents results for private firms. SOEs are restricted to all those controlled by central government agencies or entities. Private firms are all non-SOEs. Policy announcement is the weighted-average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio. Fixed investment is the average portion of fixed investment from government-owned entities at the province level. Political connection is the natural logarithm of one plus the number of directors on the board who have political connections. *All three* is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1. LnSZ_1 and B/M_1 are the logarithm of a firm's market value and book-to-market ratio one week before the Wang scandal. Leverage is the ratio of total liabilities to total assets. BHR1 is the buy-and-hold stock return from two weeks to one week before the Wang scandal. The t-statistics are reported in parentheses. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels, respectively.

Panel A: SOEs				
	(1)	(2)	(3)	(4)
Policy announcement	-0.190			
	(-0.154)			
Fixed investment		-2.324*		
		(-1.823)		
Political connection			-0.052	
			(-0.143)	
All three				-0.091
				(-0.794)
LnSZ_1	-0.084	-0.104	-0.078	-0.073
	(-0.446)	(-0.543)	(-0.395)	(-0.389)
B/M_1	-3.129***	-3.121***	-3.113***	-3.085***
	(-3.307)	(-3.331)	(-3.343)	(-3.132)
Leverage	-0.323	-0.331	-0.352	-0.339
	(-0.240)	(-0.234)	(-0.256)	(-0.243)
BHR1	-0.141***	-0.144***	-0.140***	-0.142***
	(-5.265)	(-4.881)	(-4.746)	(-5.082)
N	256	256	256	256
Adjusted R^2	0.021	0.023	0.021	0.022

Table 6 – Continued

Panel B: Non-SOEs (Private firms)				
	(1)	(2)	(3)	(4)
Policy announcement	-1.585***			
	(-3.468)			
Fixed investment		-5.192***		
		(-4.840)		
Political connection			-0.325*	
			(-1.877)	
All three				-0.363***
				(-5.007)
LnSZ_1	0.495**	0.494**	0.513**	0.523**
	(2.325)	(2.265)	(2.279)	(2.420)
B/M_1	-2.726***	-3.026***	-2.768***	-2.996***
	(-3.572)	(-3.843)	(-3.377)	(-4.280)
Leverage	-2.051*	-2.643**	-2.605**	-2.084*
	(-1.768)	(-2.157)	(-2.085)	(-1.851)
BHR1	-0.146***	-0.151***	-0.144***	-0.152***
	(-3.040)	(-3.133)	(-3.011)	(-3.028)
N	972	972	972	972
Adjusted R^2	0.027	0.027	0.023	0.032

Table 7. Expected cash flow analyses

This table reports the effect of policy sensitivity on the change in analyst forecasted earnings per share (EPS). In Panels A, B and C, the dependent variables are changes in forecasted EPS divided by the stock price two days prior to the Bo scandal in percentage for years 2012, 2013 and 2014, respectively. The change in forecasted EPS (ΔForecast EPS)is defined as the difference between the median forecasted EPS in the six months after the Bo scandal and the median forecasted EPS in the six months before the Bo scandal. Policy announcement is the weighted-average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio. Fixed investment is the average portion of fixed investment from government-owned entities at the province level. Political connection is the natural logarithm of one plus the number of directors on the board who have political connections. *All three* is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1. SD_EPS_2012 (13/14) is the standard deviation of analyst forecasted EPS for year 2012 (2013/2014) in the (-6m, +6m) window around the Bo scandal. LnSZ_2 and B/M_2 are the logarithm of a firm's market value and book-to-market ratio one week before the Bo scandal. Leverage is the ratio of total liabilities to total assets. AbsBHR2 is the absolute value of the buy-and-hold stock return from two weeks to one week before the Bo scandal. Beta and idiosyncratic risk are market beta and idiosyncratic risk obtained from the market model in estimating cumulative abnormal returns. ROA(2011) is the net income divided by total assets for the fiscal year of 2011 in percentage. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels, respectively.

Panel A: ΔForecast EPS_2012				
	(1)	(2)	(3)	(4)
Policy announcement	0.048			
	(0.324)			
Fixed investment		0.711*		
		(1.667)		
Political connection			0.020	
			(0.330)	
All three				0.029
				(1.312)
SD_EPS	-2.834***	-2.794***	-2.835***	-2.809***
	(-8.124)	(-8.032)	(-8.120)	(-8.027)
LnSZ_2	0.084*	0.076	0.085*	0.076
	(1.728)	(1.546)	(1.753)	(1.531)
B/M_2	-1.082***	-1.067***	-1.075***	-1.075***
	(-4.466)	(-4.389)	(-4.429)	(-4.442)
Leverage	-0.860***	-0.838***	-0.846***	-0.890***
	(-3.430)	(-3.421)	(-3.448)	(-3.621)
AbsBHR2	-0.448	-0.364	-0.428	-0.356
	(-0.270)	(-0.221)	(-0.258)	(-0.215)
Beta	-0.637***	-0.649***	-0.632***	-0.655***
	(-3.204)	(-3.308)	(-3.219)	(-3.324)
Idiosyncratic	0.176*	0.173*	0.178*	0.183*
	(1.867)	(1.840)	(1.890)	(1.940)
ROA(2011)	0.002	0.003	0.002	0.002
	(0.123)	(0.274)	(0.142)	(0.130)
N	901	901	901	901
Adjusted R^2	0.186	0.189	0.186	0.188

Table 7 – Continued

	(1)	(2)	(3)	(4)
Policy announcement	0.106			
	(0.544)			
Fixed investment		0.650		
		(1.205)		
Political connection			0.108	
			(1.345)	
All three				0.051*
				(1.788)
SD_EPS	-2.336***	-2.313***	-2.333***	-2.297***
	(-6.913)	(-6.820)	(-6.877)	(-6.809)
LnSZ_2	0.071	0.065	0.071	0.056
	(1.263)	(1.131)	(1.270)	(0.986)
B/M_2	-1.273***	-1.250***	-1.252***	-1.254***
	(-4.369)	(-4.247)	(-4.285)	(-4.307)
Leverage	-0.903***	-0.846***	-0.884***	-0.936***
	(-2.841)	(-2.778)	(-2.879)	(-3.013)
AbsBHR2	-2.582	-2.501	-2.470	-2.392
	(-1.161)	(-1.132)	(-1.115)	(-1.082)
Beta	-0.520**	-0.526**	-0.512**	-0.557**
	(-2.162)	(-2.195)	(-2.137)	(-2.294)
Idiosyncratic risk	0.111	0.110	0.123	0.123
	(0.863)	(0.860)	(0.954)	(0.957)
ROA(2011)	0.021	0.023	0.021	0.021
	(1.336)	(1.472)	(1.348)	(1.354)
N	854	854	854	854
Adjusted R^2	0.139	0.140	0.141	0.142

Table 7 – Continued

Panel C: ΔForecast EPS_2014				
	(1)	(2)	(3)	(4)
Policy announcement	0.354			
	(0.816)			
Fixed investment		1.592		
		(1.521)		
Political connection			-0.063	
			(-0.425)	
All three				0.064
				(1.102)
SD_EPS	-0.952**	-0.949**	-0.975**	-0.944**
	(-2.488)	(-2.549)	(-2.540)	(-2.501)
LnSZ_2	0.098	0.109	0.116	0.096
	(0.954)	(1.040)	(1.103)	(0.926)
B/M_2	-0.456	-0.480	-0.508	-0.437
	(-0.909)	(-0.931)	(-1.002)	(-0.851)
Leverage	0.803	0.927	0.969	0.853
	(1.075)	(1.407)	(1.471)	(1.227)
AbsBHR2	-3.716	-3.449	-3.690	-3.641
	(-0.987)	(-0.933)	(-0.983)	(-0.967)
Beta	0.314	0.252	0.382	0.233
	(0.563)	(0.441)	(0.692)	(0.405)
Idiosyncratic risk	-0.015	-0.080	-0.050	-0.011
	(-0.057)	(-0.303)	(-0.182)	(-0.043)
ROA(2011)	0.028	0.031	0.029	0.027
	(0.938)	(1.029)	(0.964)	(0.908)
N	181	181	181	181
Adjusted R^2	0.024	0.032	0.020	0.027

Table 8. Cash flow analyses

This table reports the effect of policy sensitiveness on future firm accounting performance. In Panels A, B and C, the dependent variables are earnings divided by total assets (ROA), operating profits divided by total asset (OPOA), and sales divided by total assets (SOA), respectively, which are gathered from the accounting statement one year after the Bo scandal. Policy announcement is the weighted-average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio. Fixed investment is the average portion of fixed investment from government-owned entities at the province level. Political connection is the natural logarithm of one plus the number of directors on the board who have political connections. *All three* is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1. LnSZ_2 and B/M_2 are the logarithm of a firm's market value and book-to-market ratio one week before the Bo scandal. Leverage is the ratio of total liabilities to total assets. Dependent Var (t-1) is the one year lagged dependent variable for each corresponding regression specification. The t-statistics are reported in parentheses. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels, respectively.

Panel A: Return on Total Assets (ROA)				
	(1)	(2)	(3)	(4)
Policy announcement	-0.366			
	(-0.991)			
Fixed investment		-0.268		
		(-0.221)		
Political connection			0.533***	
			(3.141)	
All three				0.066
				(1.112)
LnSZ_2	0.735***	0.734***	0.696***	0.715***
	(4.603)	(4.559)	(4.376)	(4.450)
B/M_2	-2.636***	-2.646***	-2.694***	-2.625***
	(-5.101)	(-5.096)	(-5.260)	(-5.088)
Leverage	-3.212***	-3.325***	-3.372***	-3.410***
	(-4.435)	(-4.646)	(-4.694)	(-4.713)
Dependent var (t-1)	0.455***	0.454***	0.454***	0.456***
	(8.555)	(8.532)	(8.589)	(8.606)
N	1,862	1,862	1,862	1,862
Adjusted R^2	0.354	0.354	0.357	0.354

Table 8 – Continued

Panel B: Operating Profit/Total Asset (OPOA)				
	(1)	(2)	(3)	(4)
Policy announcement	-0.319			
	(-0.835)			
Fixed investment		0.517		
		(0.426)		
Political connection			0.453***	
			(2.652)	
All three				0.077
				(1.317)
LnSZ_2	0.438***	0.430***	0.408***	0.417***
	(2.875)	(2.796)	(2.687)	(2.712)
B/M_2	-2.286***	-2.271***	-2.337***	-2.275***
	(-4.537)	(-4.506)	(-4.674)	(-4.522)
Leverage	-1.855***	-1.956***	-2.003***	-2.056***
	(-3.198)	(-3.379)	(-3.443)	(-3.522)
Dependent var (t-1)	0.619***	0.620***	0.618***	0.620***
	(15.861)	(15.833)	(15.895)	(15.918)
Intercept	-4.310**	-4.435**	-4.179**	-4.034*
	(-2.104)	(-2.178)	(-2.046)	(-1.941)
N	1,862	1,862	1,862	1,862
Adjusted R2	0.480	0.480	0.481	0.480
Panel C: Sales/Total Asset (SOA)				
	(1)	(2)	(3)	(4)
Policy announcement	0.996			
	(0.703)			
Fixed investment		3.244		
		(0.813)		
Political connection			0.522	
			(0.876)	
All three				0.288
				(1.390)
LnSZ_2	0.335	0.327	0.309	0.283
	(0.828)	(0.806)	(0.756)	(0.689)
B/M_2	-1.013	-0.908	-1.062	-0.957
	(-0.629)	(-0.565)	(-0.658)	(-0.594)
Leverage	-0.461	-0.225	-0.182	-0.591
	(-0.245)	(-0.124)	(-0.101)	(-0.322)
Dependent var (t-1)	0.911***	0.911***	0.911***	0.911***
	(73.721)	(73.330)	(73.692)	(73.458)
Intercept	-1.918	-2.448	-1.536	-0.699
	(-0.311)	(-0.397)	(-0.248)	(-0.111)
N	1,862	1,862	1,862	1,862
Adjusted R^2	0.895	0.895	0.895	0.895

Table 9. Volatility comparison

This table reports the effect of policy sensitiveness on the change in daily stock return volatility from before to after the Bo scandal in percentage. For the post event, it is volatility in one week or one month starting from March 15th, 2012. The pre event period is the month of January in 2012. Panel A reports results using a one-week window (Vol_1w), while Panel B reports results using a one-month window (Vol_1m). Policy announcement is the weighted-average ranking of the absolute return over the three-day window around the announcement of the adjustment of the reserve requirement ratio. Fixed investment is the average portion of fixed investment from government-owned entities at the province level. Political connection is the natural logarithm of one plus the number of directors on the board who have political connections. *All three* is the sum of all three above policy sensitiveness measures, standardized to have a mean of 0 and standard deviation of 1. LnSZ_2 and B/M_2 are the logarithm of a firm's market value and book-to-market ratio one week before the Bo scandal. Leverage is the ratio of total liabilities to total assets. AbsBHR2 is the absolute value of the buy-and-hold stock return from two weeks to one week before the Bo event. Beta and idiosyncratic risk are market beta and idiosyncratic risk obtained from the market model with equal-weighted market returns in estimating cumulative abnormal returns. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels, respectively.

Panel A: Changes in volatility using a one-week window as a gap (Vol_1w)				
	(1)	(2)	(3)	(4)
Policy announcement	0.317***			
	(5.165)			
Fixed investment		0.776**		
		(2.283)		
Political connection			0.095***	
			(3.248)	
All three				0.068***
				(10.650)
LnSZ_2	-0.331***	-0.330***	-0.334***	-0.342***
	(-16.285)	(-15.056)	(-16.034)	(-15.784)
B/M_2	-0.035	-0.012	-0.034	-0.014
	(-0.667)	(-0.246)	(-0.731)	(-0.269)
Leverage	0.332*	0.415**	0.425**	0.332*
	(1.929)	(2.313)	(2.393)	(1.926)
AbsBHR2	4.130***	4.142***	4.211***	4.222***
	(5.985)	(5.936)	(5.774)	(6.301)
Beta	-0.903***	-0.891***	-0.888***	-0.904***
	(-7.004)	(-6.732)	(-7.039)	(-7.014)
Idiosyncratic	-0.471***	-0.474***	-0.467***	-0.462***
	(-10.423)	(-10.728)	(-10.701)	(-9.755)
N	1,862	1,862	1,862	1,862
Adjusted R^2	0.165	0.162	0.162	0.171

Table 9 – Continued

Panel B: Changes in volatility using a one-month window as a gap (Vol_1m)

|	(1)	(2)	(3)	(4)
Policy announcement	0.233***			
	(2.689)			
Fixed investment		0.277		
		(1.198)		
Political connection			0.076***	
			(3.995)	
All three				0.044***
				(4.626)
LnSZ_2	-0.276***	-0.274***	-0.278***	-0.283***
	(-11.323)	(-10.575)	(-10.754)	(-10.684)
B/M_2	-0.016	-0.008	-0.016	-0.003
	(-0.317)	(-0.135)	(-0.277)	(-0.051)
Leverage	0.513***	0.581***	0.581***	0.521***
	(3.311)	(3.387)	(3.446)	(3.310)
AbsBHR2	4.477***	4.482***	4.542***	4.538***
	(7.712)	(7.543)	(7.553)	(8.261)
Beta	-1.070***	-1.059***	-1.059***	-1.069***
	(-6.362)	(-6.247)	(-6.349)	(-6.384)
Idiosyncratic risk	-0.457***	-0.459***	-0.453***	-0.451***
	(-10.529)	(-10.881)	(-10.531)	(-9.959)
N	1,862	1,862	1,862	1,862
Adjusted R^2	0.239	0.234	0.236	0.241

Figure 1. Search intensity on Google and Baidu

Panel A. Search intensity for news on "Lijun Wang" and "Xilai Bo" in English on Google from Oct 2011 to Jun 2012 (the intensity peaked in the week of April 8 - 14, 2012)
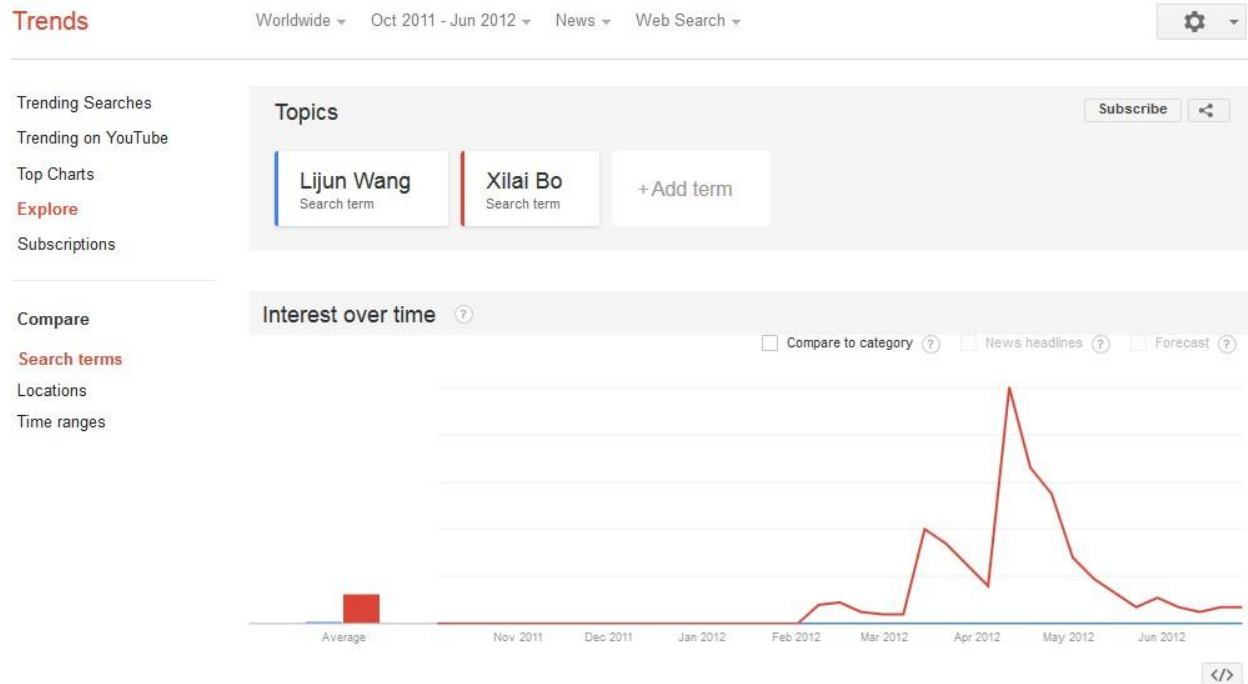
Panel B. Search intensity for news on "Wang Lijun" and "Bo Xilai" in English on Google from Oct 2011 to Jun 2012 (the intensity peaked in the week of April 8 - 14, 2012)
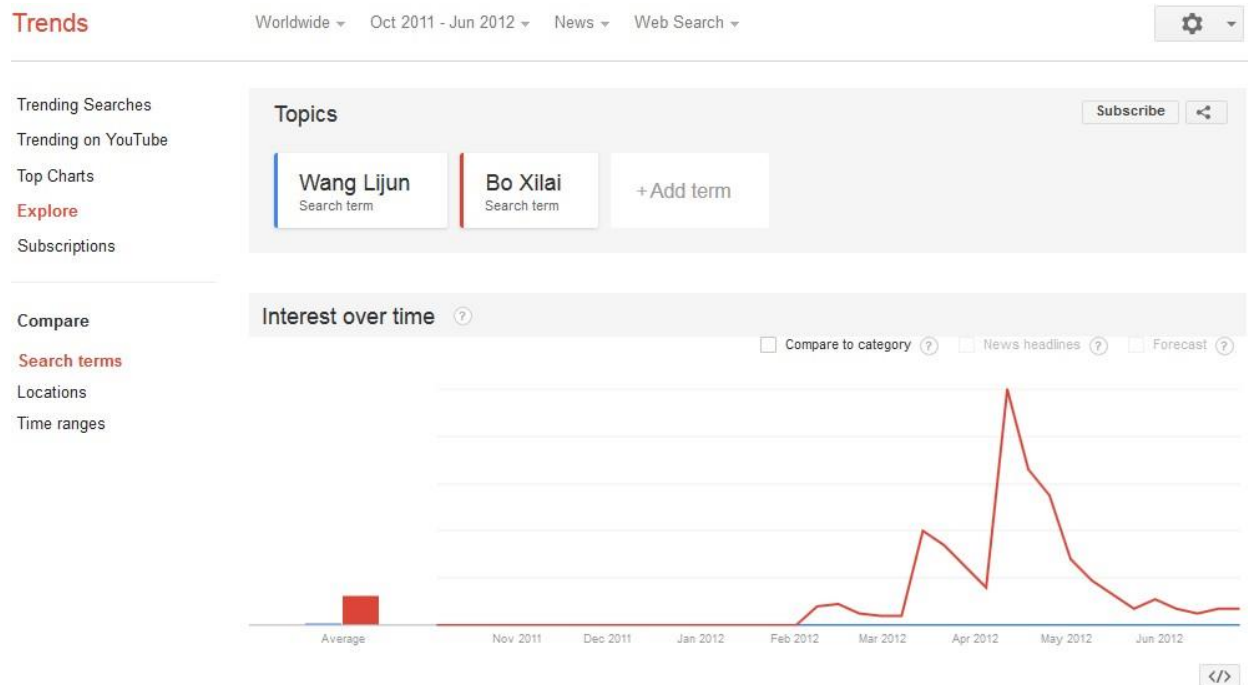
Panel C. Search intensity for news on "Lijun Wang" and "Xilai Bo" in Chinese on Google from Oct 2011 to Jun 2012 (the intensity peaked in the weeks of March 11 – 17 and April 8 - 14, 2012)
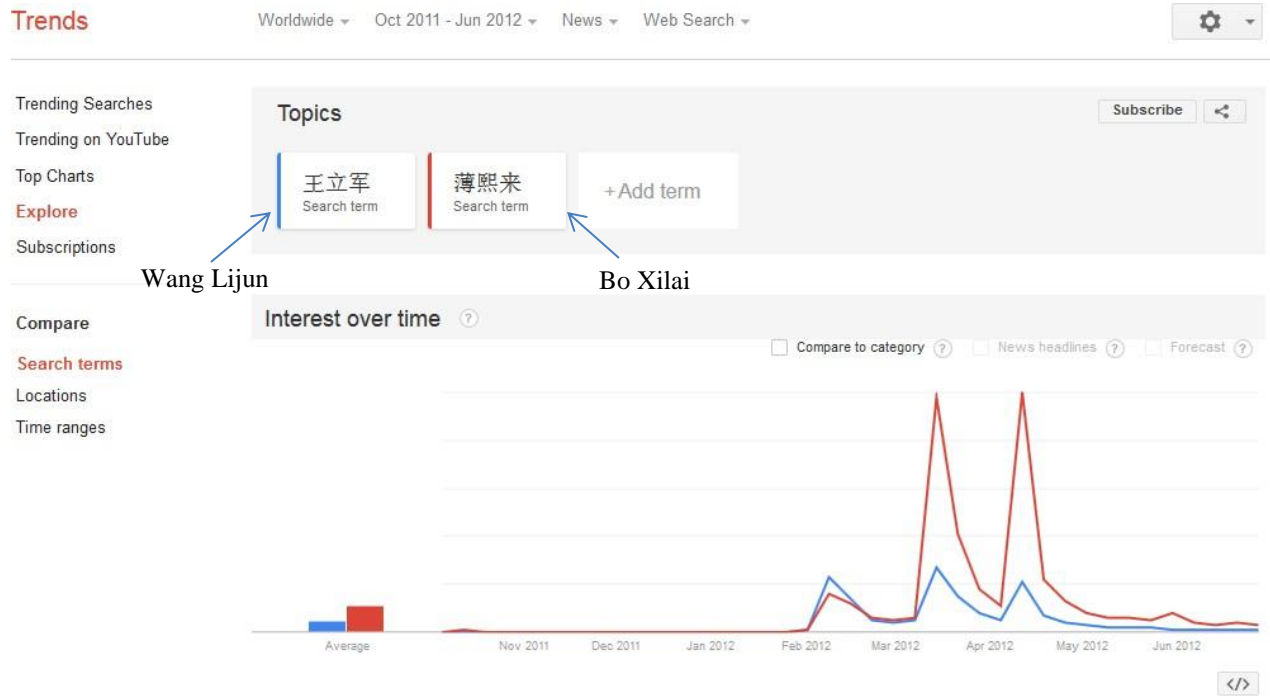
Panel D. Search intensity for news on and media coverage on "Lijun Wang" and "Xilai Bo" in Chinese on Baidu from Oct 2011 to Jun 2012 (the intensity peaked on February 10, March 15 and April 11, 2012)
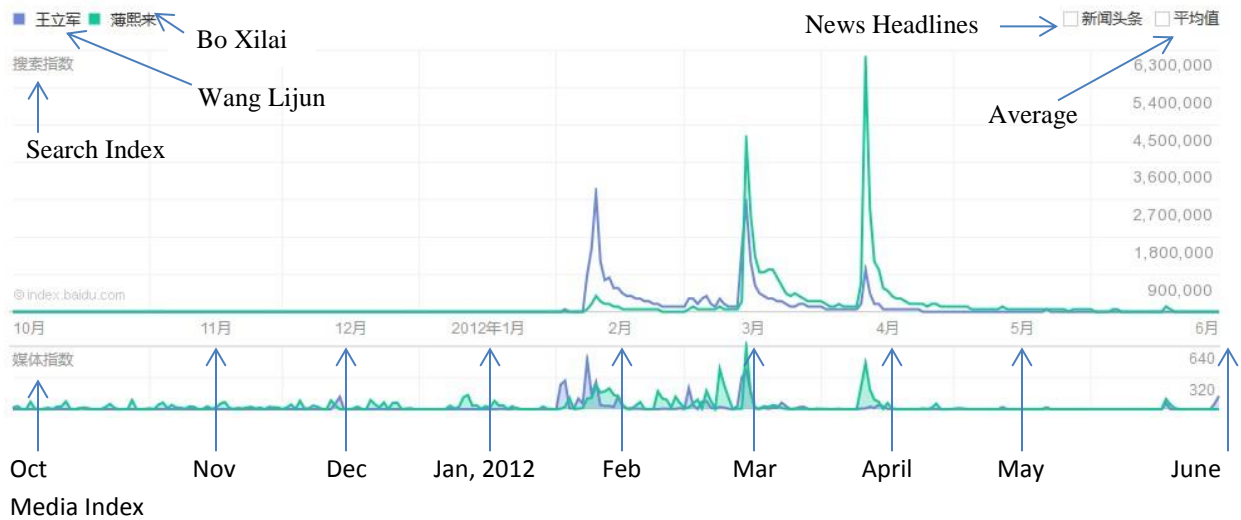
Figure 2. Baidu search results for "revolution" in Chinese

(The intensity peaked on March 21, 2012)