

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

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**Abstract**

Recent theoretical models have shown that political uncertainty commands a risk premium (Pastor and Veronesi, 2013a). However, due to the difficulty of measuring the political uncertainty risk, the empirical evidence is scarce. In this paper, we take advantage of an unexpected political event which happened in China in 2012 -- Bo's scandal, and use it as a natural experiment to identify the impact of political uncertainty on asset prices. This event provides an ideal laboratory setting to test the causal link between political uncertainty and asset prices, because there is a definitive date when the political uncertainty unexpectedly increased. The political uncertainty risk models predict that increases in political uncertainty should cause stock prices to fall, especially for firms that are policy sensitive. We use three measures to capture political-sensitiveness of firms. We document that Bo's event causes a much more significant drop in stock prices of firms that are more politically sensitive as measured by the three proxies. We further differentiate the political uncertainty explanation from alternative explanations such as drops in the value of political connections and changes in future cash flows. We conclude that the evidence provides a strong support for the existence of political uncertainty risk but fail to support the other two explanations.

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## 1. Introduction

Recently, the impact of political uncertainty on asset prices has attracted a lot of attentions. Theoretical models suggest that an increase in political uncertainty should 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 (2011) analyzes how bond yields are affected by Knightian uncertainty. Pastor and Veronesi (2013a) show that political uncertainty commands a risk premium whose magnitude is larger in weaker economic conditions. Pastor and Veronesi (2013b) build a general equilibrium model and predict that the stock price should fall at the announcement of a policy change and that the price decline should be large if uncertainty about government policy is large. Croce, Nguyen, and Schmid (2012) show that the 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 (2011) develop an index of policy-related economic uncertainty, which is an average of several components related to uncertainty, and estimate its impact on aggregate output and employment. Pastor and Veronesi (2013a) use this political uncertainty index to confirm a political risk premium predicted by their model. Brogaard and Detzel (2012) use a search-based measure to capture country-by-country economic policy uncertainty and find that market returns fall and volatility increase when economic policy uncertainty increases. Boutchkova, Doshi, Durnev, and Molchanov (2012) document that political uncertainty affects industry return volatilities. Belo, Gala, and Li (2012) document that during Democratic presidencies, firms with higher government exposure experience higher cash

flows and stock returns, while the opposite pattern holds true during Republican presidencies. Kim, Pantzalis, and Park (2012) find that firms whose headquarters located in states whose leading politicians have closer proximity to the ruling party earn higher stocks returns and have more exposure to policy uncertainty. However, these empirical studies cannot rule out the issues of endogeneity.

In this study, we take advantage of an unexpected political event happened in China in 2012, Bo's scandal, to identify as an exogenous shock to political stability. This exogenous shock provides us an ideal laboratory to test the causal link between political uncertainty and asset prices, because there is a date when the political uncertainty unexpectedly increases. As will be discussed in detail in the next section, the Bo event is very significant about the stability of the country as there was a lot of uncertainty about whether the transfer of power and leadership from the fourth generation led by former President Hu Jintao and Premier Wen Jiabao to the fifth generation to be led by Xi Jinping and Li Keqiang would be smooth and peaceful.

We use three measures to capture policy sensitiveness of firms. The first one is the average of the event absolute returns around the adjustments of the RMB deposit-reserve ratio announced by the Central Bank of China. A larger absolute announcement return implies higher policy sensitiveness. The second measure is the proportion of state-owned enterprise (SOE) expenditures as of total expenditures in fixed asset investment in each province. Firms located in the province with a high proportion of SOE expenditures will be 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.

Using daily stock returns from A-shares of firms listed on Shanghai and Shenzhen Stock Exchanges around the Bo event, we find that increases in political uncertainty as measured by

Bo's event cause a significant drop in stock prices, especially for firms that are more sensitive to policy changes as measured by the above three proxies. The results are robust whether based on portfolio analysis or regression analysis. In addition, we find that the accounting performance based on returns on assets (ROA) or other profitability measures post Bo's event does not show any significant difference between firms that are the most and firms that are the least sensitive to changes in government policies. Finally, we document a significant increase in stock volatility right after Bo's event only for firms that are more sensitive to policy changes, but not for firms that are less sensitive. All these results suggest that it appears to be the discount rate news caused by the increase in political uncertainty rather than the cash flow news caused by expected decreases in firm's cash flows that leads to the drop in stock prices, especially for firms that are more sensitive to changes in government policies. Specifically, we conclude that the evidence provides a strong support for the existence of political uncertainty risk but fails to support the alternative explanation caused by the decrease in benefits from the potential loss of political connections.

Our paper makes several important contributions to the literature. First, consistent with the existing model predictions, we find that increases in political uncertainty cause contemporaneous drops 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. Third, shocks to political stability definitely cause increases in uncertainty or the discount rate, but they may not necessarily cause the reduction in firms' future cash flows as evidenced in our case.

The remainder of the paper proceeds as follows. In Section 2, we describe the background of Bo's political scandal and the uncertainty of 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. Background of 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 in the 18<sup>th</sup> National Congress of the Communist Party of China, held in fall 2012 in Beijing. Hu Jintao and his administration were elected in 2002 and were named as the fourth generation of leadership in China.<sup>1</sup> The transition of power in 2002 was smooth and peaceful. People were expecting similar orderly political power transfer from the fourth to the fifth generation in 2012, until Bo Xilai's scandal caused an unexpected political turmoil. An article in South China Morning Post on October 1, 2012 represents this common view: "An even scarier thought is that mainland leaders 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."<sup>2</sup>

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.<sup>3</sup> He was once considered a rising star in Chinese politics and was thought to be a competitive candidate for the new Politburo Standing Committee in the 18<sup>th</sup> Party Congress.<sup>4</sup> Bo's past working experience was as mayor of Dalian; the governor of Liaoning province, and the Minister of Commerce. In 2007, he was appointed as

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<sup>1</sup> See among others, Mohanty (2003).

<sup>2</sup> Wang Xinwen, "The frightening implications of Bo Xilai's harsh punishment," South China Morning Post, October 1, 2012.

<sup>3</sup> BBC News, "Profile: Bo, Xilai," September 21, 2012.

<sup>4</sup> Jane Duckett, "China leadership transition," Political Insight, April 2012.

leader of a southwestern city of China, Chongqing, and was promoted as a membership of the 25-member Politburo.<sup>5</sup> A set of economic and social policies adopted by Bo administration in Chongqing was widely known as the “Chongqing model,” which represents an increased state control and is looked at as a departure from the mainstream state policy.<sup>6</sup>

The Bo scandal first broke in February 9, 2012, when the former policy chief of Chongqing, Wang Lijun, entered the U.S. Consulate General in Chengdu without permission and reportedly asked the U.S. for political asylum and later left the consulate voluntarily.<sup>7</sup> The Wang Lijun incident caused a lot of suspicions in public. But it is only until March 14, 2012, when Premier Wen Jiabao gave a public speech in a press conference at the National People’s Congress, it was made clear that Bo was responsible for the scandal.<sup>8</sup> On March 15, 2012, Bo Xilai was dismissed from his Politburo post in the Communist Party of China.<sup>9</sup> In August, Bo’s wife, Bo Gu Kailai was given a suspended death sentence for murdering a British businessman.<sup>10</sup> Wang Lijun was sentenced to 15 years in prison for his role in covering up the murder.<sup>11</sup> Later it was revealed that that Bo Xilai knew of his wife’s role in the murder and on September 28, 2012 and Bo was expelled from the Communist Party and received a life sentence on September 22, 2013.<sup>12</sup>

Premier Wen made the public speech officially unveiling the scandal on March 14, 2012, which was the first time that the government’s opinion on Bo was made public. We argue that Bo’s scandal dramatically increased the political uncertainty about the orderly power transfer in 18<sup>th</sup> National Congress, as summarized in an article published in *Time*: “But with the downfall of

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<sup>5</sup> “The Curriculum vitae of Bo, Xilai” by XinhuaNet, 2007.

<sup>6</sup> See among other, Lu (2012).

<sup>7</sup> [http://news.xinhuanet.com/legal/2012-09/24/c\\_113183202.htm](http://news.xinhuanet.com/legal/2012-09/24/c_113183202.htm).

<sup>8</sup> 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](http://news.xinhuanet.com/politics/2012-03/14/c_111655106_8.htm).

<sup>9</sup> [http://www.china.com.cn/policy/txt/2012-03/15/content\\_24905206.htm](http://www.china.com.cn/policy/txt/2012-03/15/content_24905206.htm).

<sup>10</sup> [http://www.cq.xinhuanet.com/2012-08/20/c\\_112780997.htm](http://www.cq.xinhuanet.com/2012-08/20/c_112780997.htm).

<sup>11</sup> [http://news.xinhuanet.com/legal/2012-09/24/c\\_113183202.htm](http://news.xinhuanet.com/legal/2012-09/24/c_113183202.htm).

<sup>12</sup> [http://news.xinhuanet.com/legal/2012-09/28/c\\_113248574.htm](http://news.xinhuanet.com/legal/2012-09/28/c_113248574.htm).

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.”<sup>13</sup> This increasing uncertainty became obvious with the delay of the 18<sup>th</sup> Party Congress. The meeting was originally anticipated to be announced in late summer and to be held in October 2012 but was postponed to November 8, 2012. The delay in naming a specific date for the Congress is widely perceived as evidence of infighting and disagreement within the party, as stated in an article in *Los Angeles Times*: “The congress, widely anticipated in 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.”<sup>14</sup>

Figure 1 presents the number of online search for words including “Wang Lijun” or “Bo Xilai” from October 2011 to June 2012. Panels A and C show the Google searching numbers while Panels B and D present the numbers of search through Baidu, the most popular search engine in China. Panels A and B show the number of search in English, while Panels C and D show those in Chinese. The number of search is normalized with 100 representing the peak search interest. 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, especially for the English search. It reflects the public view that Bo, with his “Princeling” status, is a significant political figure while Wang is relevant

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<sup>13</sup> “Party Intrigue: Will Political Scandal Delay China’s Once-a-Decade Leadership Transition?” by Hannah Beech, *Time*, May 9, 2012.

<sup>14</sup> “China may struggle to move beyond Bo Xilai scandal”, by Barbara Demick and Julie Makinen, *Los Angeles Times*, September 29, 2012.

only because he is an important subordinate of Bo. Second, the attention to both Wang and Bo rises dramatically during the scandal period. The Google search in Chinese for Wang and Bo, as illustrated in Panel C, rises from almost zero to the first peak in the week of February 9, 2012, which is about 30% of the highest search amount during this period, which occurred in the week of April 11, 2012, when the Central Committee in China decided to launch an investigation of Bo. Another peak emerged in the week of March 14, 2012, after Premier Wen's talk. The search interest of Bo is about three to five times more than that for Wang after Premier Wen's talk.

To further establish the impact of Bo's scandal on political uncertainty, we report the Baidu search interest for "revolution" in Chinese. The search per day rocketed from almost none to more than 40,000 on the second half of March 2012. This online search interest further confirms our argument that Bo's event has such an importance that it raised people's concern on the possibility of a revolution. Probably more direct evidence is the fact that these concerns even have 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 tried to establish the evidence that Bo's event represented a significant increase of political uncertainty. We will next discuss how we can take advantage of this event to test the impact of political uncertainty on asset prices.

### **3. Hypotheses Development**

The theory on political uncertainty (e.g., Pastor and Veronesi, 2012a) predicts that political uncertainty commands a risk premium. In equilibrium, risk-averse investors are unwilling to hold stocks during the periods with high political uncertainty. To compensate for the risk of holding



stocks, investors ask for a higher expected return. In other words, stock prices should drop to reflect this higher required rate of return. We thus expect that the day when the political uncertainty increases, the stock prices should fall. If political uncertainty represents a risk, firms with more exposure to this political risk should be affected more during the period when political uncertainty is high. We construct three proxies for policy-sensitiveness reflecting the sensitiveness with respect to the monetary policy, fiscal policy, and political connections.

We first consider the stock return around the announcements on the adjustment of deposit-reserve ratio. The deposit-reserve ratio is one of the most important monetary policies implemented by central government in China, which has direct impact on the market interest rate. A monetary policy-sensitive firm should have larger response with respect to these announcements. On the other hand, if a firm's operation and financing activities are more independent of the government's policy, it will be less likely to experience volatile stock price movement 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 with respect to each firm. We measure the proportion of government expenditures as of total fixed assets expenditures in each province. We assign firms to each province based on their main operation locations. Firms located in provinces with high government expenditures are more fiscal policy-sensitive.

Last but not least, 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 connection has value (e.g., Fisman, 2012). However, the value exists only if the connected people or networks remain in power. Increasing the uncertainty of power

transition increases the possibility of losing the value attached to these connections. As a result, political-connected firms are more sensitive to political uncertainty.

Using these three measures as proxies for political-sensitiveness, we have the following hypothesis:

*H1: The aggregate announcement return around Bo's event should be negative. In addition, the announcement return around the event days should be lower for firms that have larger absolute returns around the past announcements of interest rate changes, among firms which have their main operations located in the provinces with more government expenditures, and for firms which are more politically-connected.*

The potential negative announcement returns over Bo's event may emerge for several alternative reasons. Besides the increase in the risk premium, an alternative explanation is the decrease in future cash flow. If we consider a simple discounted cash flow model of stock price, a negative return or in another words, a drop in stock price, would be due to an increase in the discount rate or a decrease in future cash flow. If the negative return is caused by the cash flow effect, we would expect future operation performance, which captures the realized cash flow, to drop post the event. There is no such a prediction based on the political risk story. The cash flow hypothesis is stated as follows:

*H2: The cash flow explanation predicts that operation performance will worse off post Bo's event while the political uncertainty explanation has no such a prediction.*

A specific channel for the decrease in future cash flow is through losing the value of political connections. It is possible that the negative returns are only driven by politically connected firms losing the value of political connections without any increase in uncertainties. To differentiate these two explanations: losing value of political connections versus increasing uncertainty about the value of political connections, we investigate the change in stock return volatilities over the event time. If the negative return during the event time is caused by increasing uncertainty, we would expect stock return volatility to increase over the event period. On the other hand, if the negative return during the event time only reflects losing future cash flow, there will be no increasing in volatility. The above discussions lead to the following hypothesis:

*H3: The political uncertainty risk explanation predicts that stock return volatility will increase post Bo's event, while the cash flow explanation has no such a prediction.*

#### **4. Data Description**

A firm's financial information is from the China Stock Market & Accounting Research Database (CSMAR), maintained by GTA Information Technology. Our initial sample includes all non-financial firms publicly traded in the A-share market in mainland China as of the end of 2011 and must have been listed for at least one year. Financial firms are excluded because their financial statements are compiled under different accounting standards. 144 firms are dropped due to no enough data to calculate abnormal stock returns around the Wang Lijun event and the Bo Xilai event using the market model.<sup>15</sup> After excluding 30 firms with missing information on

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<sup>15</sup> To make sure there are no other corporate confounding events, we require the number of normal trading days must 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 is mandated to be suspended if there is any material and uncertain event going on with the firm until all uncertainties are clear in China.

other variables used in our analyses, the final sample consists of 1,862 unique firms. All the variable definitions are listed in Appendix A.

The announcement dates for the deposit-reserve ratio adjustments are collected from People's Bank of China website.<sup>16</sup> Appendix B summarizes a list of 31 announcements 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 cumulative abnormal returns. The rank is further converted into a number between 0 and 1.<sup>17</sup> Finally, we take a value weighted average for each firm over all the announcement events when the firms have enough data. The weight is the aggregate market return over the event day. Since the market reaction over the announcement day captures the surprise components of the policy, the weighting schedule assigns a higher weight to the announcements that have bigger surprise to the market. The variable is called the Policy Announcement.

Total investment in fixed assets in each province is obtained from China Statistical Yearbook 2010, 2011 and 2012. According to the Statistics Yearbook, 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 rest entities are classified as private sectors. As a robust test, we also consider average ratios over 2009, 2010 and 2011, to reduce noises in year 2010. The results for using this alternative measure are very similar to the ones reported in the paper, which are omitted to save space. A firm's main operation location is obtained from CSMAR.

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<sup>16</sup> <http://www.pbc.gov.cn/publish/goutongjiaoliu/524/index.html>

<sup>17</sup> The conversion is calculated by as  $\text{rank}/(\text{the number of observations} + 1)$ .

Finally, the political connection data are hand-collected from the CV of the public companies' board directors. These CVs are obtained from these firms' 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 senior managers who have the above mentioned connections. The political connection variable is the natural logarithm of one plus the number of connected senior managers.

## **5. Empirical Results**

Table 1 reports the summary statistics for the main variables used in the paper. All the variables are RMB dominated. The natural logarithm of the market value of assets has both a mean and median of around 15. The book to market equity ratio (B/M) has a mean of 0.4 and the median slightly lower than the mean. The leverage ratio is around 0.45 with the 25 percentile of around 0.25 and the 75 percentile of around 0.60. The summary statistics suggest that our sample is comparable to the sample used in other studies such as Li, Liu, and Wang (2014) and Giannetti, Liao, and Yu (2014).

Table 2 summarizes two political-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. Real-estate industry has the highest sensitiveness. This result is quite intuitive as real-estate industry heavily depends on external financing for the development. Any interest rate related policy changes would have a huge impact on the financing costs of real-estate firms, and thus affect the value of these firms. The other monetary policy-sensitive industries include mining and

transportation, arguably also the industries depending on external financing. On the other hand, information technology, furniture, and other manufacturing are the least sensitive industries.

Panel B of Table 2 has the list of provinces ranked in ascending order by the proportion of government expenditures. The province having the highest government investment is Tibet, which is in part due to the fact that Tibet has less active private investments. Since government investment is the main source for the development in Tibet, firms located there have no doubt being more sensitive to the potential changes in government policies. Gansu and Qinghai provinces are the runner-ups, reflecting China's Great Western Development Strategy.<sup>18</sup> On the other extreme, Shandong, Henan, Jiangsu, and Liaoning have less investment from stated-owned enterprises.

Table 3 reports results from univariate tests. We construct three-day ( $t-1, t+1$ ) cumulative abnormal return around the event 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 for stock  $i$  on day  $t$  and  $R_{M,t}$  is the return for the market on day  $t$ . The model is estimated for each firm over the one-year period pre-Bo's event to obtain the estimated  $\alpha_i$  and  $\beta_i$  ( $\hat{\alpha}_i$  and  $\hat{\beta}_i$ ). The realized market returns ( $R_{M,\tau}$ ) and realized individual firm returns ( $Ret_{i,\tau}$ ) over the event window ( $\tau = -1, 0, 1$ , where 0 is the announcement date) are used to construct abnormal return ( $ARet$ ) as follows,  $ARet_{\tau,t} = Ret_{i,\tau} - (\hat{\alpha}_i - \hat{\beta}_i R_{M,\tau})$ . The cumulative abnormal return ( $CAR(-1, 1)$ ) is calculated as  $\sum_{\tau=-1}^1 ARet_{\tau,t}$ .

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<sup>18</sup> The Great Western Development Strategy is a campaign "to promote the fast and healthy development of the western areas" in order to address inequalities between China's western hinterlands and coastal east. The development of infrastructure is an important component of the strategy.

Table 3 reports the equal-weighted and value-weighted cumulative abnormal returns over the three days around Wang's event and the three days around Bo's event. The cumulative abnormal return represents the six-day return. We further group firms by three policy sensitivity measures. For each measure, we group firms into terciles based on the sorting variable and report both equal-weighted and value-weighted CARs. 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 in the event period. For the monetary policy-sensitivity measure (Panel A), the more-sensitive firms have a CAR lower than those less-sensitive firms by 0.877% for the equal-weighted return and 0.855% for the value-weighted return. Both are statistically significant at the 1% level. For the fiscal policy-sensitivity measure (Panel B), the return difference between the two groups is around 0.75%. For the political connection measure (Panel C), more sensitive firms have a CAR being 0.6% lower than those 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 yield similar results with a larger magnitude. Specifically, the more minus less return difference rises to around 1%. For a median firm in the sample, it represents a wealth loss of about 33 million RMB during the six-day event window. We argue that this is not only statistically significant, but also economically important.

The evidence that the event-time returns are always lower for more sensitive firms than less sensitive firms is consistent with Hypothesis 1. Increasing political uncertainty causes stock price to fall, especially for policy-sensitive firms. The more minus less return difference always have similar magnitudes for value-weighted CARs and equal-weighted CARs, suggesting that the

results are not solely driven by small firms. The fact that the combined measure yields higher return spreads suggests that all three measures capture slightly different dimensions of policy sensitiveness.

Table 4 reports regression results with control variables. We control for size (LnSZ), book-to-market equity (B/M), leverage (Leverage), and the return over the past week (BHAR\_vwmkm or BHAR\_ewmkm). BHAR\_vwmkm (BHAR\_ewmkm) is the buy-and-hold stock return adjusted by value-weighted market return from 2 weeks before to 1 week before the Wang Lijun event. All three policy-sensitiveness measures are significant for both equal-weighted and value-weighted CARs even with these controls.

Table 5 reports Wang's event and Bo's event separately. Panel A reports the result from Wang's event Panel B from Bo's events. For Wang's event, only the first political-sensitiveness measure has a significant coefficient. The combined measure also has a significant coefficient, which is obviously driven by the first measure. For Bo's event, all three measures carry significant coefficients. These results are consistent with the news search results reported in Figures 1 and 2 in that Wang is a less important event. By himself, Wang is not important enough to influence the power transition. Only when the event is upgraded to involve Bo, the public starts to realize that this is an event with "revolution" as a possible consequence.

Before we move to test alternative explanations, we carry out tests across two subsamples: state-owned enterprises (SOE) and non-stated-owned enterprises (non SOE). Previous studies have documented the important difference between SOEs and non SOEs. However, there is no clear theory guidance on whether the political uncertainty should be more prominent in SOEs or non-SOEs. One can argue that all SOEs are similar in that they all belong to the government and no matter who are in power, these stated-owned assets will be an important part of authority.



Thus, there should be no significant difference among SOEs. Non-SOEs are more diverse and independent, thus more vulnerable to the potential policy changes. It would predict that the policy sensitiveness results would be more prominent in the non-SOE subsample. On the other hand, one can argue that SOEs, belonging to the current authority, are more sensitive to the political uncertainty, while non-SOE has to be on themselves any way so they are less affected by the power transition. In the end, the direction of the difference between these two subsamples is an empirical issue.

Table 6 reports the regression results across these two subsamples. The left panel uses reports the result from the SOE subsample while the right panel the non-SOE subsample. For the SOE subsample, only the fixed investment measure has a marginal significant coefficient, while the other two measures are insignificant. The results suggest that government expenditures are a more direct measure for political uncertainty for SOEs. On the other hand, non-SOE subsample always generates significant results. Value-weighted CARs generate similar patterns. It seems likely that the results reported in Table 4 are mainly driven by private firms.

## **6. Alternative Explanations**

We have documented that Bo's event caused a significant stock price drop, especially for firms which are more policy-sensitive. The price drop can be caused by a cash flow effect or a discount rate effect. To differentiate the political uncertainty risk explanation from the cash flow effect explanation, we investigate firms' operating performance post the events as illustrated in Hypothesis 2. We measure a firm's operation performance by earnings divided by total assets (ROA), operation profits divided by total assets, and sales divided by total assets. Sales, operation profits, and earnings are from the accounting statement one year post the events, and

assets are from the most recent financial statement pre-event. Most of the political sensitiveness measures have insignificant coefficient, while the third measure (political connections) has a significantly positive coefficient in two regressions. There is no evidence that post Bo's event, more political-sensitive firms experience worse operating performance. The lower return over the event period is thus more likely to be due to increased political uncertainty risk.

Finally, we test the change in volatilities as illustrated in Hypothesis 3. We measure the change in volatility between the post event and the pre event. Based on the evidence of Table 5 that Bo is a more important event, we focus on the post-Bo event only. Daily stock returns are used to construct volatility. For the post event, 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 to construct benchmark volatility because Wang's event occurred in early February. Using the one-month data from January 8, 2012 till February 8, 2012 yields qualitative and quantitative similar results. Table 8 shows that volatility increases significantly post Bo's event, especially for firms which are more politically sensitive. This evidence suggests that the results are more consistent with increasing uncertainty or the discount rate explanation rather than decreasing cash or the cash flow explanation.

## **7. Conclusion**

Recent theoretical models and empirical evidence show that an increase in political uncertainty causes a contemporaneous drop in stock prices but an increase in future expected returns. However, previous empirical studies cannot rule out the possibility of endogenous issues. In the paper, we use an exogenous shock to the political stability in China in 2012 as our natural

experiment to test the causal link between political uncertainty and asset prices. Bo Xilai's political scandal posits the most significant threat to China's political stability in the most recent years since China started their economic reform in 1978. Due to its significance, Bo's event represents an ideal setting for us to test the impact of political uncertainty on asset price without subject to endogenous issues.

Using daily stock returns from A-shares of firms listed in Chinese two stock exchanges, we document that stock prices drop significantly around Bo's event, in particular for firms that are the most sensitive to changes in government policies. We measure the sensitiveness to policy changes based on three proxies: (1) stock price sensitivity to announcements of the adjustments in the RMB deposit-reserve ratio, (2) the proportion of SOE expenditures as of total expenditures in fixed assets in each province, and (3) the degree of political connections. In addition, we find the return volatility right after post Bo's event increases significantly for the most policy-sensitive but not for the least sensitive firms. Finally, the accounting after post Bo's event is not significant different between the most policy-sensitive and the least sensitive firms. All these results support the political uncertainty hypothesis but fail to support the cash flow explanation.

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## Appendix A. Variable definitions

Variable	Definition and Data Source
Policy announcement	The weighted average ranking of the absolute return over 3-day window around the announcement of the adjustment of RMB deposit reserve ratio during the period of 2007 to 2011. For each adjustment, we construct an ascending ranking standardized by dividing the total number of valid firms by then. To reflect relative significance of these adjustments, a weight of absolute market return over 3-day window around the announcement is assigned accordingly to calculate this weighted average ranking variable. Source: Manual Collection.
Fixed investment	The average portion of fixed investment from government owned entities over 3-year period from 2009 to 2011 at province level. Source: Statistical Yearbook of 2010, 2011 and 2012.
Political connection	The natural logarithm of one plus the number of directors in the board who has 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) and Calomiris et al. (2010). Source: Manual Collection.
All three	The sum of standardized Policy announcement, Fixed investment and Political connection with mean 0 and standard deviation 1.
CAR_ew (Bo)	The cumulative abnormal return over 3-day window around Bo Xilai event based on market model with equal-weighted market return. Source: CSMAR database.
CAR_vw (Bo)	The cumulative abnormal return over 3-day window around Bo Xilai event based on market model with value-weighted market return. Source: CSMAR database.
CAR_ew (Wang)	The cumulative abnormal return over 3-day window around Wang Lijun event based on market model with equal-weighted market return. Source: CSMAR database.
CAR_vw (Wang)	The cumulative abnormal return over 3-day window around Wang Lijun event based on market model with value-weighted market return. Source: CSMAR database.
CAR_ew	The sum of CAR_ew (Bo) and CAR_ew (Wang). Source: CSMAR database.
CAR_vw	The sum of CAR_vw (Bo) and CAR_vw (Wang). Source: CSMAR database.

DifVol1w	The difference in volatility of daily stock return over one week post-Bo event and the whole month of January in 2012. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
DifVol1m	The difference in volatility of daily stock return over one month post-Bo event and the whole month of January in 2012. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
LnSZ_2	The natural logarithm of firm market value as of one week before Bo Xilai event. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
B/M_2	Book-to-Market ratio. Constructed as the book value of equity as of the end of 2011 divided by market value of equity as of one week before Bo Xilai event. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
LnSZ_1	The natural logarithm of firm market value as of one week before Wang Lijun event. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
B/M_1	Book-to-Market ratio. Constructed as the book value of equity as of the end of 2011 divided by market value of equity as of one week before Wang Lijun event. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
Leverage	Total liabilities divided by total assets. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
SOE	A dummy variable equals to one if the ultimate controller of a firm is a government owned entity or a government agency, and zero otherwise. Source: CSMAR database.
ROA	Net income divided by total assets for the fiscal year of 2012. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
ROA(2011)	Net income divided by total assets for the fiscal year of 2011. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
Operational Profit/Total Asset	Operating profit divided by total assets for the fiscal year of 2012. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
Operational Profit/Total Asset(2011)	Operating profit divided by total assets for the fiscal year of 2011. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.

Sales/Total Asset	Sales divided by total assets for the fiscal year of 2012. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
Sales/Total Asset(2011)	Sales divided by total assets for the fiscal year of 2011. Winsorized at 0.5% and 99.5% levels. Source: CSMAR database.
BHAR1_ewmkm	Buy-and-hold stock return adjusted by equal-weighted market return from -2 week to -1 week before Wang Lijun event
BHAR1_vwmkm	Buy-and-hold stock return adjusted by value-weighted market return from -2 week to -1 week before Wang Lijun event
BHAR2_ewmkm	Buy-and-hold stock return adjusted by equal-weighted market return from -2 week to -1 week before Bo Xilai event
BHAR2_vwmkm	Buy-and-hold stock return adjusted by value-weighted market return from -2 week to -1 week before Bo Xilai event
AbsBHAR2_rawret	Buy-and-hold raw stock return from -2 week to -1 week before Bo Xilai event
Beta_ew	Beta obtained from the market model in estimating cumulative abnormal return
Idiosyncratic_ew	Idiosyncratic risk obtained from the market model in estimating cumulative abnormal return



**Appendix B. Announcement dates of the adjustment of the RMB deposit reserve ratio from 2007 to 2011**

announcement dates	Adjustment size (big financial institutions)	Adjustment size (median and small 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 main variables used in the paper. Firm's financial information is from China Stock Market & Accounting Research Database (CSMAR), maintained by GTA Information Technology. Our initial sample includes all non-financial firms publicly traded in A-share market in mainland China as of the end of 2011 and must have been listed for at least 1 year.

Variable	Mean	Std	Median	P25	P75
Policy announcement	0.350	0.195	0.348	0.186	0.516
Fixed investment	0.280	0.089	0.257	0.230	0.363
Political connection	0.654	0.601	0.693	0.000	1.099
All three	0.000	1.784	-0.046	-1.266	1.228
CAR_ew (Bo)	-0.003	0.047	-0.012	-0.032	0.015
CAR_vw (Bo)	-0.011	0.047	-0.019	-0.039	0.008
CAR_ew (Wang)	0.001	0.027	-0.005	-0.016	0.013
CAR_vw (Wang)	0.008	0.027	0.002	-0.010	0.020
CAR_ew	-0.002	0.055	-0.011	-0.038	0.022
CAR_vw	-0.003	0.055	-0.012	-0.039	0.021
DifVol1w	-0.235	1.092	-0.272	-0.944	0.410
DifVol1m	-0.679	0.916	-0.696	-1.315	-0.083
LnSZ_2	15.343	0.945	15.158	14.684	15.841
B/M_2	0.407	0.226	0.366	0.253	0.514
LnSZ_1	15.210	0.961	15.017	14.540	15.693
B/M_1	0.463	0.252	0.418	0.289	0.585
Leverage	0.445	0.224	0.455	0.264	0.621
SOE	0.478	0.500	0.000	0.000	1.000
ROA	0.035	0.054	0.032	0.011	0.060
ROA_2011	0.046	0.055	0.042	0.020	0.070
Opprofit_asset	0.036	0.062	0.033	0.007	0.065
Opprofit_a~2011	0.049	0.063	0.045	0.017	0.077
Opreven_asset	0.664	0.494	0.544	0.340	0.830
opreven_as~2011	0.696	0.513	0.577	0.356	0.876
BHAR1_ewmkm	-0.002	0.036	-0.005	-0.022	0.014
BHAR1_vwmkm	0.020	0.037	0.017	-0.002	0.036
BHAR2_ewmkm	-0.002	0.038	-0.007	-0.026	0.015
BHAR2_vwmkm	0.023	0.039	0.017	-0.002	0.041
AbsBHAR2_rawret	0.029	0.030	0.021	0.010	0.038
Beta_ew	0.995	0.210	0.997	0.861	1.145
Idiosyncratic_ew	0.018	0.005	0.017	0.014	0.021

**Table 2, Policy sensitiveness measures**

Panel A reports the average policy announcement measure across industry by ascending order. Panel B lists fixed investment measure by province by ascending order.

Panel A. The ranking of industries by the measure of policy announcement					
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 measure of fixed investment					
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**

$CAR_{ew}$  ( $CAR_{vw}$ ) represents equal-weighted (value-weighted) CAR over (-1,1) for the two windows. The first window is Wang's event (February 9, 2012), while the second window is Bo's event (March 14, 2012). In each panel, all firms in the sample are grouped into three groups by a proxy of policy sensitivity. In panel A, the sorting variable is the average of absolute return over 3 day window around the announcement for the adjustment of RMB deposit reserve ratio. In panel B, the sorting variable is a dummy variable capturing whether the firm is in the province with high government fixed investment. In panel C, the sorting variable is natural logarithm of number of directors in the board who has political connections.

Panel A: policy announcement

	Less Sensitive	More Sensitive	More-Less	p-value
$CAR_{ew}$	0.021%	-0.857%	-0.877%	0.002
$CAR_{vw}$	-0.065%	-0.920%	-0.855%	0.003

Panel B: fixed investment

	Less Sensitive	More Sensitive	More-Less	p-value
$CAR_{ew}$	0.212%	-0.540%	-0.752%	0.008
$CAR_{vw}$	0.130%	-0.606%	-0.736%	0.009

Panel C: political connection

	Less Sensitive	More Sensitive	More-Less	p-value
$CAR_{ew}$	-0.061%	-0.665%	-0.603%	0.050
$CAR_{vw}$	-0.144%	-0.730%	-0.586%	0.055

Panel D: All three

	Less Sensitive	More Sensitive	More-Less	p-value
$CAR_{ew}$	0.219%	-0.809%	-1.028%	0.001
$CAR_{vw}$	0.123%	-0.871%	-0.993%	0.001

**Table 4. Regression on policy sensitivity proxies**

The dependent variable is CAR(-1,1) over two event windows. The first window is Wang's event (February 9, 2012), while the second window is Bo's event (March 14, 2012). Left panel use equal-weighted CAR while right panel uses value-weighted CAR. All variables are as defined in Appendix A. \*\*\*, \*\* and \* represent statistically significant at the 1%, 5% and 10% significance level.

	CAR <sub>ew</sub>				CAR <sub>vw</sub>			
Policy announcement	-0.016*** (-2.692)				-0.015*** (-2.644)			
Fixed investment		-0.030*** (-4.399)				-0.030*** (-4.450)		
Political connection			-0.003*** (-3.118)				-0.003*** (-3.100)	
All three				-0.002*** (-5.745)				-0.002*** (-5.721)
LnSZ_1	0.005*** (3.262)	0.005*** (3.229)	0.005*** (3.297)	0.005*** (3.478)	0.005*** (3.406)	0.005*** (3.365)	0.005*** (3.442)	0.005*** (3.620)
B/M_1	-0.033*** (-7.405)	-0.034*** (-7.601)	-0.033*** (-7.230)	-0.034*** (-7.664)	-0.033*** (-7.579)	-0.034*** (-7.787)	-0.033*** (-7.391)	-0.033*** (-7.862)
Leverage	-0.018** (-2.481)	-0.021*** (-2.610)	-0.022*** (-2.669)	-0.018** (-2.335)	-0.018** (-2.452)	-0.021*** (-2.580)	-0.022*** (-2.641)	-0.018** (-2.308)
BHAR[-2W,-1W]	-0.031 (-1.281)	-0.032 (-1.346)	-0.029 (-1.197)	-0.035 (-1.434)				
BHAR1_vwmkm					-0.045* (-1.904)	-0.047** (-1.990)	-0.043* (-1.858)	-0.049** (-2.037)
N	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862
Adjusted R <sup>2</sup>	0.036	0.035	0.034	0.039	0.035	0.035	0.034	0.039

**Table 5. Regressions on policy sensitivity proxies over two event windows separately**

The dependent variable for Panel A is CAR(-1,1) while event time 0 is February 9, 2012, while the dependent variable for Panel B is CAR(-1,1) over March 14, 2012. Left panel use equal-weighted CAR while right panel uses value-weighted CAR. All variables are as defined in Appendix A. \*\*\*, \*\* and \* represent statistically significant at the 1%, 5% and 10% significance level.

Panel A: Wang's event

	CAR <sub>ew</sub>				CAR <sub>vw</sub>			
Policy announcement	-0.002**				-0.002*			
	(-1.985)				(-1.944)			
Fixed investment		-0.001				-0.001		
		(-0.112)				(-0.102)		
Political connection			-0.000				-0.001	
			(-0.855)				(-0.985)	
All three				-0.000*				-0.000*
				(-1.680)				(-1.743)
LnSZ_1	-0.001*	-0.001*	-0.001	-0.001	-0.002**	-0.002**	-0.002**	-0.002**
	(-1.651)	(-1.660)	(-1.620)	(-1.618)	(-2.554)	(-2.563)	(-2.514)	(-2.525)
B/M_1	-0.012***	-0.012***	-0.012***	-0.012***	-0.013***	-0.013***	-0.013***	-0.013***
	(-3.716)	(-3.791)	(-3.645)	(-3.752)	(-3.781)	(-3.847)	(-3.714)	(-3.817)
Leverage	0.004	0.003	0.003	0.004	0.003	0.002	0.002	0.003
	(1.097)	(0.941)	(0.978)	(1.043)	(0.818)	(0.656)	(0.685)	(0.768)
BHAR[-2W,-1W]	-0.016	-0.015	-0.015	-0.016				
	(-1.492)	(-1.462)	(-1.451)	(-1.518)				
BHAR1_vwmkm					-0.006	-0.006	-0.006	-0.006
					(-0.610)	(-0.578)	(-0.580)	(-0.651)
N	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862
Adjusted R2	0.012	0.012	0.012	0.012	0.019	0.019	0.019	0.019

**Table 5 – Continued**

Panel B: Bo's event

	CAR <sub>ew</sub>				CAR <sub>vw</sub>			
Policy announcement	-0.012** (-2.445)				-0.012** (-2.488)			
Fixed investment		-0.029*** (-5.000)				-0.029*** (-4.725)		
Political connection			-0.003*** (-2.780)				-0.003*** (-2.593)	
All three				-0.002*** (-4.771)				-0.002*** (-4.662)
LnSZ_2	0.007*** (6.938)	0.007*** (6.960)	0.007*** (6.994)	0.008*** (7.291)	0.009*** (7.961)	0.009*** (7.967)	0.009*** (7.971)	0.009*** (8.309)
B/M_2	-0.020*** (-4.152)	-0.021*** (-4.336)	-0.020*** (-4.218)	-0.020*** (-4.145)	-0.017*** (-3.000)	-0.017*** (-3.156)	-0.016*** (-3.044)	-0.017*** (-3.004)
Leverage	-0.022*** (-2.899)	-0.024*** (-3.132)	-0.025*** (-3.126)	-0.022*** (-2.869)	-0.020*** (-2.610)	-0.023*** (-2.857)	-0.023*** (-2.857)	-0.020*** (-2.593)
BHAR[-2W,-1W]	0.161*** (3.405)	0.162*** (3.444)	0.162*** (3.324)	0.160*** (3.406)				
BHAR2_vwmkm					0.141*** (3.046)	0.142*** (3.079)	0.142*** (2.966)	0.141*** (3.051)
N	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862
Adjusted R <sup>2</sup>	0.056	0.056	0.054	0.059	0.052	0.053	0.051	0.056

**Table 6. CAR over subsamples**

The dependent variable is CAR(-1,1) over two event windows. Panel A use equal-weighted return while panel B use value-weighted return. The left panel uses state-owned enterprise (SOE) subsample, while the right panel uses private firms subsample. All variables are as defined in Appendix A <sup>\*\*\*</sup>, <sup>\*\*</sup> and <sup>\*</sup> represent statistically significant at the 1%, 5% and 10% significance level.

Panel A: Equal-weighted CAR

	SOE Firms				Non-SOE (Private firms)			
Policy announcement	-0.001 (-0.120)				-0.015 <sup>***</sup> (-3.169)			
Fixed investment		-0.024 <sup>*</sup> (-1.825)				-0.045 <sup>***</sup> (-4.793)		
Political connection			-0.001 (-0.173)				-0.003 <sup>*</sup> (-1.674)	
All three				-0.001 (-0.738)				-0.003 <sup>***</sup> (-3.535)
LnSZ_2	0.002 (1.464)	0.002 (1.387)	0.003 (1.611)	0.003 (1.548)	0.008 <sup>***</sup> -4.022	0.008 <sup>***</sup> -4.091	0.008 <sup>***</sup> -4.029	0.009 <sup>***</sup> -4.295
B/M_2	-0.029 <sup>***</sup> (-3.569)	-0.029 <sup>***</sup> (-3.570)	-0.029 <sup>***</sup> (-3.490)	-0.029 <sup>***</sup> (-3.323)	-0.027 <sup>***</sup> (-2.944)	-0.030 <sup>***</sup> (-3.235)	-0.028 <sup>***</sup> (-2.982)	-0.030 <sup>***</sup> (-3.238)
Leverage	0.001 (0.111)	0.001 (0.108)	0.001 (0.084)	0.001 (0.100)	-0.019 <sup>*</sup> (-1.804)	-0.025 <sup>**</sup> (-2.183)	-0.024 <sup>**</sup> (-2.122)	-0.019 <sup>*</sup> (-1.864)
BHAR[-2W,-1W]	0.163 (1.322)	0.166 (1.344)	0.163 (1.306)	0.164 (1.315)	0.275 <sup>***</sup> -4.177	0.271 <sup>***</sup> -4.284	0.276 <sup>***</sup> -4.261	0.272 <sup>***</sup> -4.326
N	257	257	257	257	972	972	972	972
Adjusted R <sup>2</sup>	0.026	0.027	0.026	0.027	0.056	0.056	0.053	0.061



**Table 6 – Continued**

Panel B: Value-weighted CAR

	SOE Firms				Non-SOE (Private firms)			
Policy announcement	-0.001 (-0.098)				-0.015*** (-3.132)			
Fixed investment		-0.024* (-1.926)				-0.044*** (-4.889)		
Political connection			-0.001 (-0.169)				-0.003 (-1.621)	
All three				-0.001 (-0.722)				-0.003*** (-3.516)
LnSZ_2	0.003* (1.717)	0.003* (1.665)	0.003* (1.914)	0.003* (1.795)	0.009*** (4.108)	0.009*** (4.172)	0.009*** (4.110)	0.009*** (4.364)
B/M_2	-0.028*** (-3.223)	-0.027*** (-3.229)	-0.027*** (-3.171)	-0.027*** (-3.007)	-0.026*** (-2.834)	-0.029*** (-3.129)	-0.027*** (-2.874)	-0.029*** (-3.117)
Leverage	0.002 (0.177)	0.002 (0.173)	0.002 (0.148)	0.002 (0.164)	-0.018 (-1.644)	-0.024** (-2.027)	-0.023** (-1.970)	-0.018* (-1.704)
BHAR[-2W,-1W]	0.174 (1.406)	0.176 (1.438)	0.173 (1.397)	0.174 (1.408)	0.247*** (3.927)	0.243*** (4.006)	0.248*** (3.972)	0.244*** (4.052)
N	257	257	257	257	972	972	972	972
Adjusted R <sup>2</sup>	0.027	0.028	0.027	0.028	0.050	0.049	0.046	0.054

**Table 7. Cash flow analyses**

The dependent variables are earnings divided by total assets (ROA), operation profits divided by total asset, and sales divided by total assets. Sales, operation profits and earnings are from the accounting statement one year post Bo's event, and asset is from the most recent financial statement pre Bo's event. All variables are as defined in Appendix A. \*\*\*, \*\* and \* represent statistically significant at the 1%, 5% and 10% significance level.

	ROA				Operational Profit/Total Assets				Sales/Total Assets			
Policy announce	-0.002 (-0.40)				0.000 (0.01)				-0.008 (-0.40)			
Fixed investment		-0.003 (-0.22)				0.005 (0.43)				0.032 (0.81)		
Political connect			0.005*** (3.14)				0.005*** (2.65)					0.005 (0.88)
All three				0.002 (1.34)				0.002 (1.56)				0.001 (0.32)
LnSZ_2	0.007*** (4.59)	0.007*** (4.56)	0.007*** (4.376)	0.007*** (4.42)	0.004*** (2.85)	0.004*** (2.80)	0.004*** (2.69)	0.004*** (2.67)	0.004 (0.86)	0.003 (0.81)	0.003 (0.76)	0.00 (0.80)
B/M_2	-0.026*** (-5.15)	-0.026*** (-5.10)	-0.027*** (-5.26)	-0.026*** (-5.07)	-0.023*** (-4.54)	-0.023*** (-4.51)	-0.023*** (-4.67)	-0.023*** (-4.517)	-0.010 (-0.63)	-0.0109 (-0.56)	-0.011 (-0.66)	-0.010 (-0.62)
Leverage	-0.033*** (-4.49)	-0.033*** (-4.65)	-0.034*** (-4.69)	-0.034*** (-4.72)	-0.020*** (-3.36)	-0.020*** (-3.38)	-0.020*** (-3.44)	-0.021*** (-3.59)	0.000 (0.02)	-0.002 (-0.12)	-0.002 (-0.10)	-0.003 (-0.14)
ROA_2011	0.455*** (8.52)	0.454*** (8.52)	0.454*** (8.59)	0.456*** (8.61)	0.619*** (15.90)	0.620*** (15.83)	0.618*** (15.90)	0.620*** (15.90)	0.911*** (73.40)	0.911*** (73.33)	0.911*** (73.69)	0.911*** (73.20)
N	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862
Adjusted R <sup>2</sup>	0.354	0.354	0.357	0.354	0.480	0.480	0.481	0.480	0.895	0.895	0.895	0.895

**Table 8. Volatility comparison**

The dependent variable is change of daily stock return volatility from pre event to post event. For post event, it is volatility one week or one month starting from March 15<sup>th</sup>. Left panel reports results using one week data while right panel reports results using one month data. The pre event volatility is measured using January, 2012's data. All variables are as defined in Appendix A. \*\*\*, \*\* and \* represent statistically significant at 1%, 5% and 10% significance level.

	Vol_1w				Vol_1m			
Policy announcement	0.317*** (5.165)				0.233*** (2.689)			
Fixed investment		0.776** (2.283)				0.277 (1.198)		
Political connection			0.095*** (3.248)				0.076*** (3.995)	
All three				0.068*** (10.650)				0.044*** (4.626)
LnSZ_2	-0.331*** (-16.285)	-0.330*** (-15.056)	-0.334*** (-16.034)	-0.342*** (-15.784)	-0.276*** (-11.323)	-0.274*** (-10.575)	-0.278*** (-10.754)	-0.283*** (-10.684)
B/M_2	-0.035 (-0.667)	-0.012 (-0.246)	-0.034 (-0.731)	-0.014 (-0.269)	-0.016 (-0.317)	-0.008 (-0.135)	-0.016 (-0.277)	-0.003 (-0.051)
Leverage	0.332* (1.929)	0.415** (2.313)	0.425** (2.393)	0.332* (1.926)	0.513*** (3.311)	0.581*** (3.387)	0.581*** (3.446)	0.521*** (3.310)
AbsBHAR2_rawret	4.130*** (5.985)	4.142*** (5.936)	4.211*** (5.774)	4.222*** (6.301)	4.477*** (7.712)	4.482*** (7.543)	4.542*** (7.553)	4.538*** (8.261)
Beta_ew	-0.903*** (-7.004)	-0.891*** (-6.732)	-0.888*** (-7.039)	-0.904*** (-7.014)	-1.070*** (-6.362)	-1.059*** (-6.247)	-1.059*** (-6.349)	-1.069*** (-6.384)
Idiosyncratic_ew	-47.134*** (-10.423)	-47.362*** (-10.728)	-46.652*** (-10.701)	-46.222*** (-9.755)	-45.684*** (-10.529)	-45.870*** (-10.881)	-45.281*** (-10.531)	-45.109*** (-9.959)
N	1,862	1,862	1,862	1,862	1,862	1,862	1,862	1,862
Adjusted R <sup>2</sup>	0.164	0.162	0.162	0.170	0.238	0.234	0.236	0.241

**Figure 1**

Panel A. News search intensity on “Lijun Wang” and “Xilai Bo” in English from Google: Oct 2011 to Jun 2012 (The attention peaked on April 11, 2012)

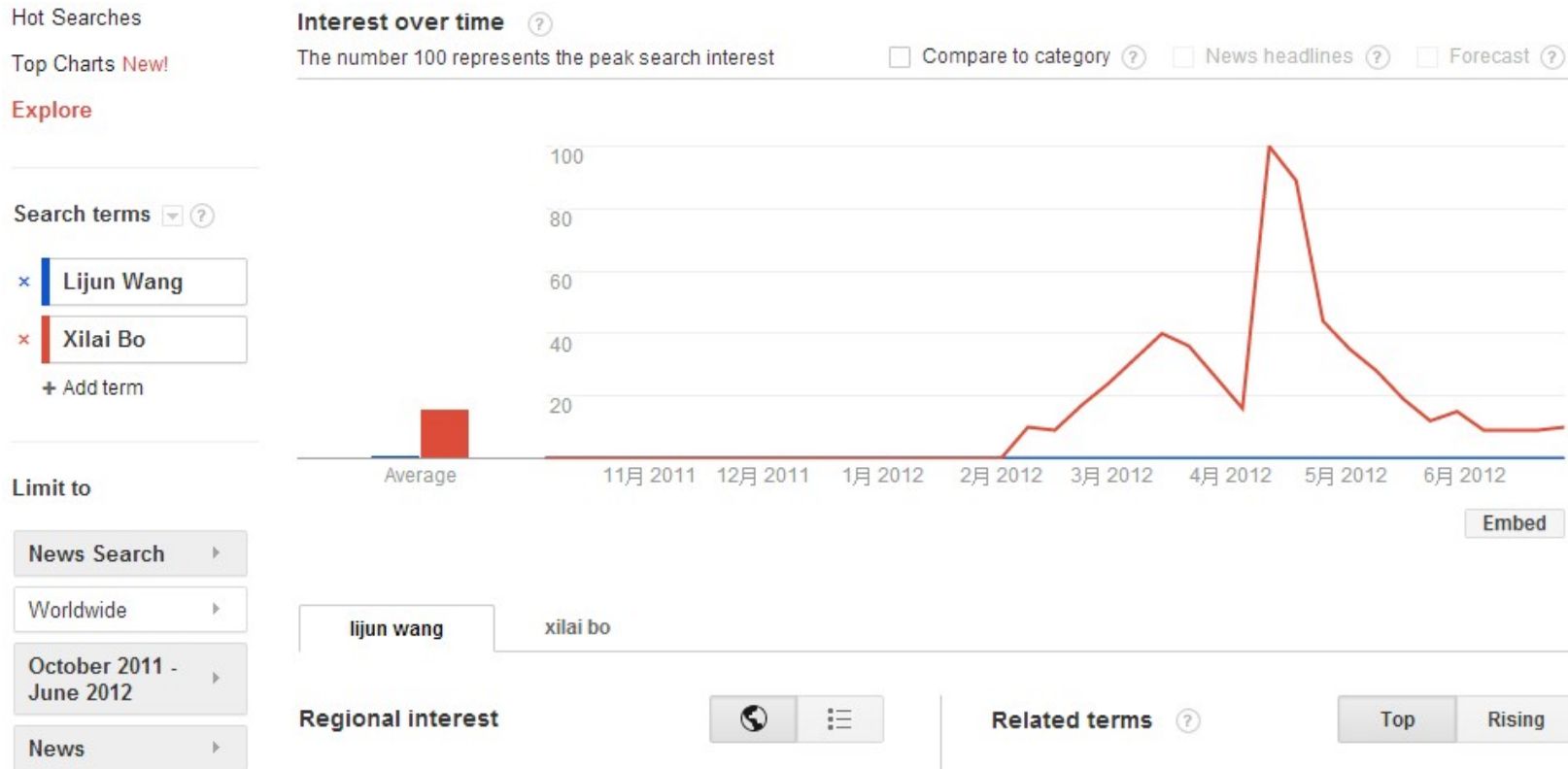


Figure 1 – continued

Panel B. News search intensity on “Wang Lijun” and “Bo Xilai” in English from Google: Oct 2011 to Jun 2012

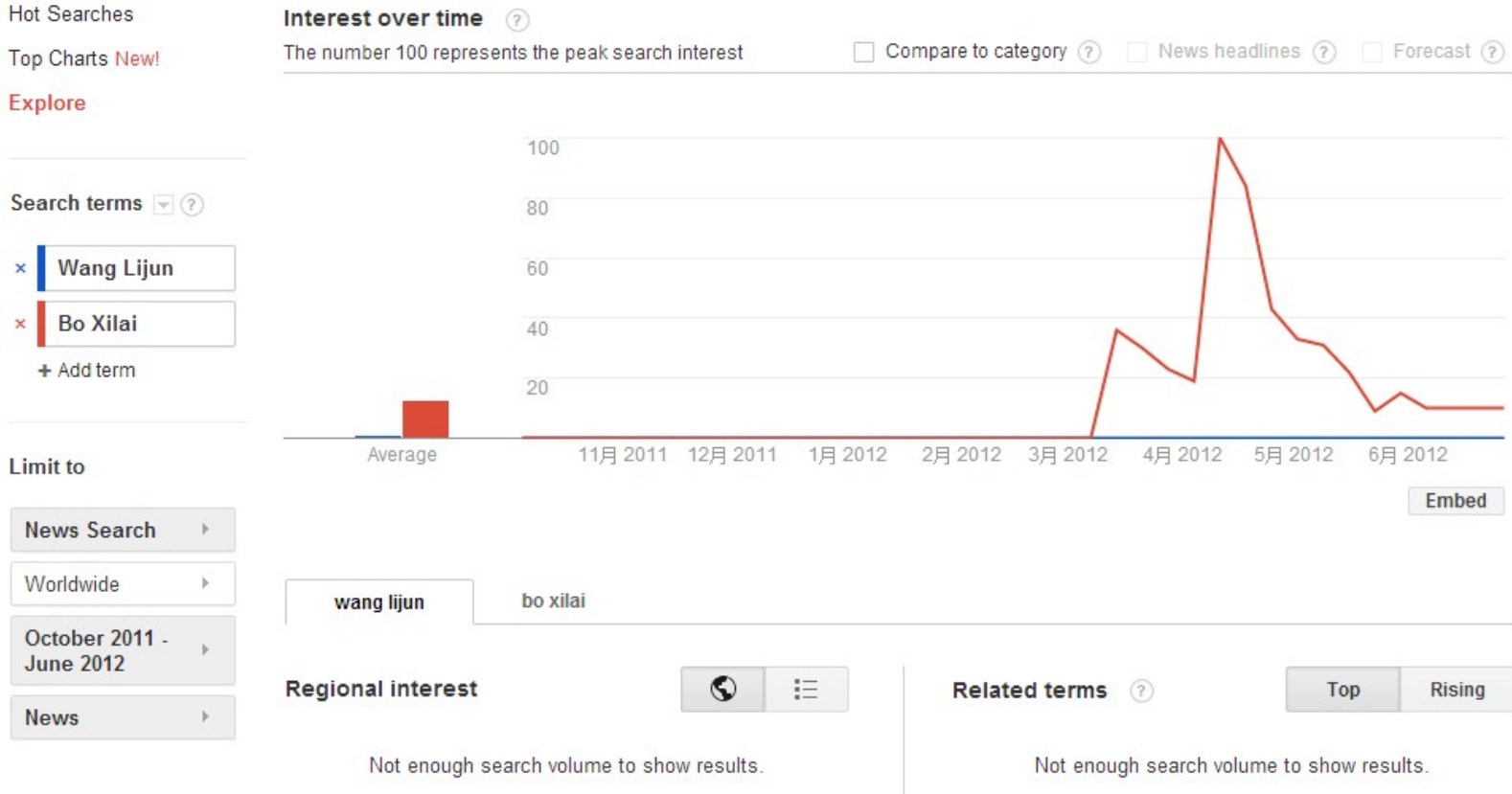


Figure 1 – continued

Panel C. News search intensity on “Lijun Wang” and “Xilai Bo” in Chinese over time from Google: Oct 2011 to Jun 2012

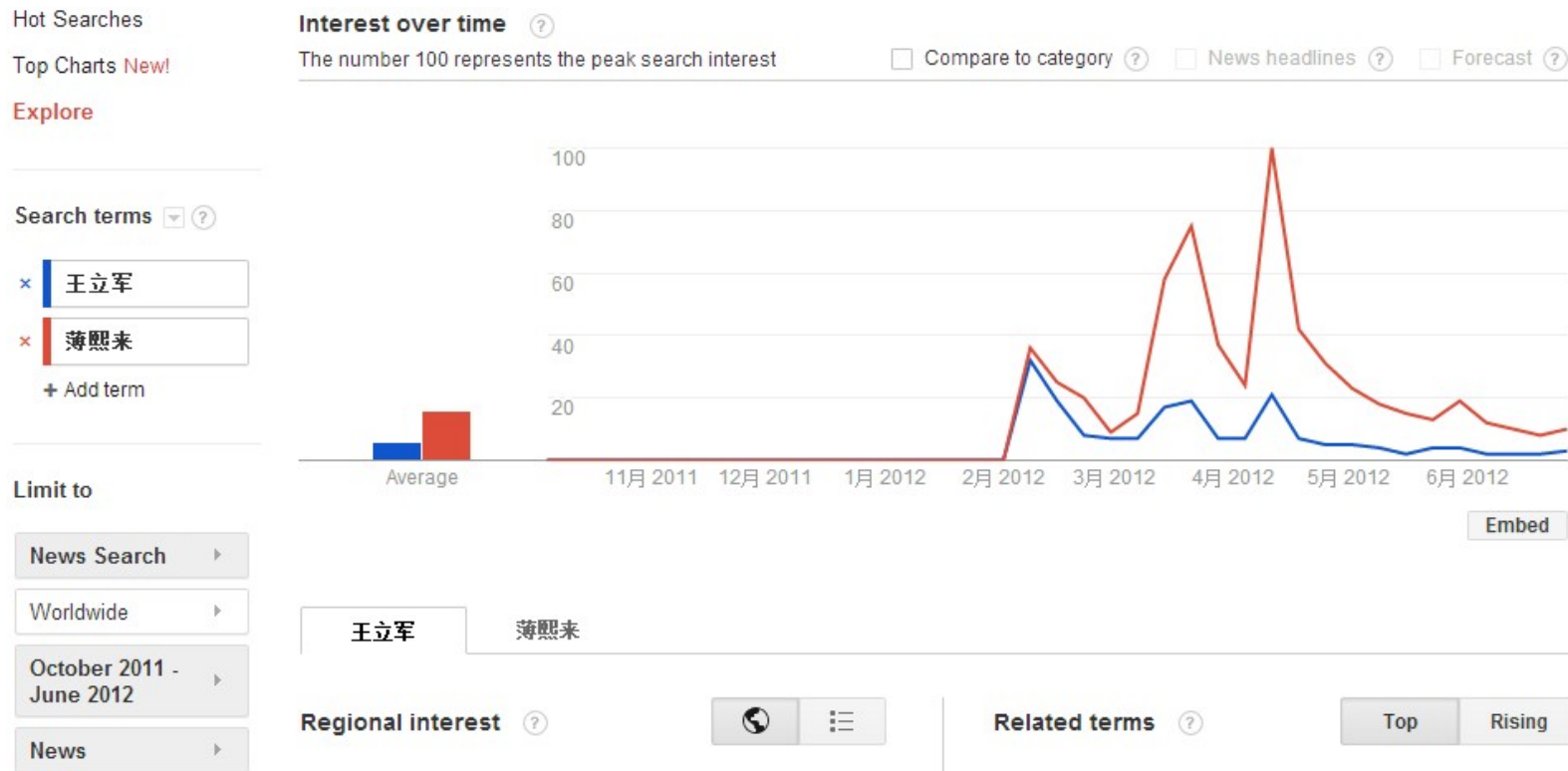


Figure 1 – continued

Panel D. Search intensity and media coverage on “Lijun Wang” and “Xilai Bo” in Chinese from Baidu: Oct 2011 to Jun 2012

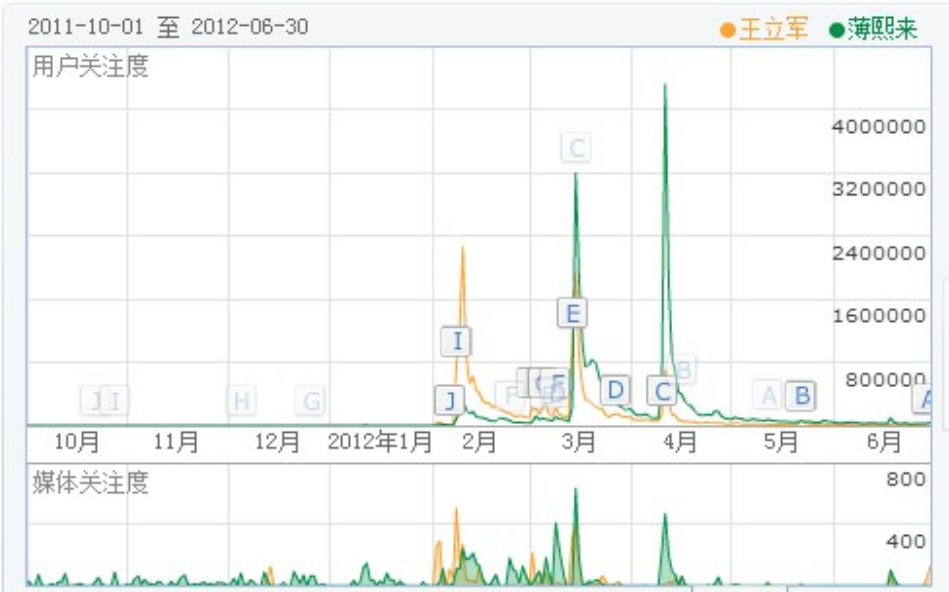


Figure 2. Baidu searching results for revolution in Chinese

