Politics and Finance

(10 students)

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Project description:

The goal of the project is to analyze interactions between financial and political markets. The questions of primary interest are about the effects of political institutions or political events on financial outcomes. Financial outcomes affected by political interventions can be either confined to specific firms or affect the whole market. In the first case, political connections of certain firms can affect their asset prices (Fisman, 2001; Goriaev and Sonin, 2005) or access to credit (Khwaja and Mian, 2005; Bertrand et al, 2004). In the latter case special interests in the economy can affect regulation of banking (Krozner and Strahan, 1999), security markets (Rajan and Zingales, 2003), takeover restrictions (Holmstrom and Kaplan, 2001), bankruptcy regulation (Nunez and Rosenthal, 2004) etc. Special attention will be devoted to issues of general development of financial markets, political determinants of which were highlighted in Rajan and Zingales (2003).

How political institutions affect financial regulations? How political connections affect firm-level performance? What drives financial development? How financial crises change composition of special interest groups in power? These are examples of questions which can be answered within this project.

Brief (but not full) review of relevant literature could be found in Pagano and Volpin (2001) and Haber and Perotti (2007). A short list of references is provided below. More detailed list of references can be found in the syllabus for Politics and Finance class, to be taught by Ruben Enikolopov and Maria Petrova in the 2nd module in 2008-2009 NES academic year. Please feel free to e-mail us for the syllabus.

Methodology:

To analyze problems of politics and finance, students can use different methodology, depending on their own preferences. Both empirical and theoretical projects are welcome. Theoretically, the main approach is to use game theoretical models and models of standard policy choice to generate testable predictions for policy choice and/or behavior of individual firms under certain political conditions. The expected result is fully developed applied theory models.

Empirically, several different methodologies could be used. One is event study analysis to analyze effects of particular political events on stock prices. Another is to compare the effect of political and regulatory interventions on the behavior of different firms. Finally, one can do cross-country analysis for macro-level variables, using either standard cross-country comparison or Rajan-Zingales (1998) methodology for the comparison of different industries within countries.

Potential research topics:

1. (Theoretical) Modeling the choice of obstacles for financial development in class-based political economy models. Classes might include labor, capital, and land, or labor, big capital and small capital, or labor, capital, and entrepreneurs, or high-skilled labor, low-skilled labor, and capital.
2. (Theoretical) Modeling relationship between income inequality and financial development. There are two potential mechanisms for the effect of financial development which work in the opposite directions: financial development can increase inequality by giving each entrepreneur his marginal product, while it can decrease inequality by reducing the impact of privileged incumbents on policy outcomes.
3. (Theoretical) Modeling entrepreneurship and demand for financial development in a model of allocation of talents with multiple equilibria.
4. (Empirical) Tests of some prediction of class-based political economy models of policy choice (e.g. with respect to financial development) using data from US Census of 19th century.
5. (Empirical) Estimating the effect of political connections for Russian firms.
6. (Empirical) Income inequality and access to finance. What do cross-country regressions say?
7. (Empirical) Does political vulnerability/political connections of Russian firms affect their investment decisions?
8. (Empirical) Does political vulnerability/political connections of Russian firms affect their foreign listing decision?

References:

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- Khwaja, Asim Ijaz and Atif Mian (2005) “Do Lenders Favor Politically Connected Firms? Rent provision in an Emerging Financial Market” *Quarterly Journal of Economics*, 120(4): 1371-1411.
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