

Policy Uncertainty, Political Capital, and Firm Risk-Taking

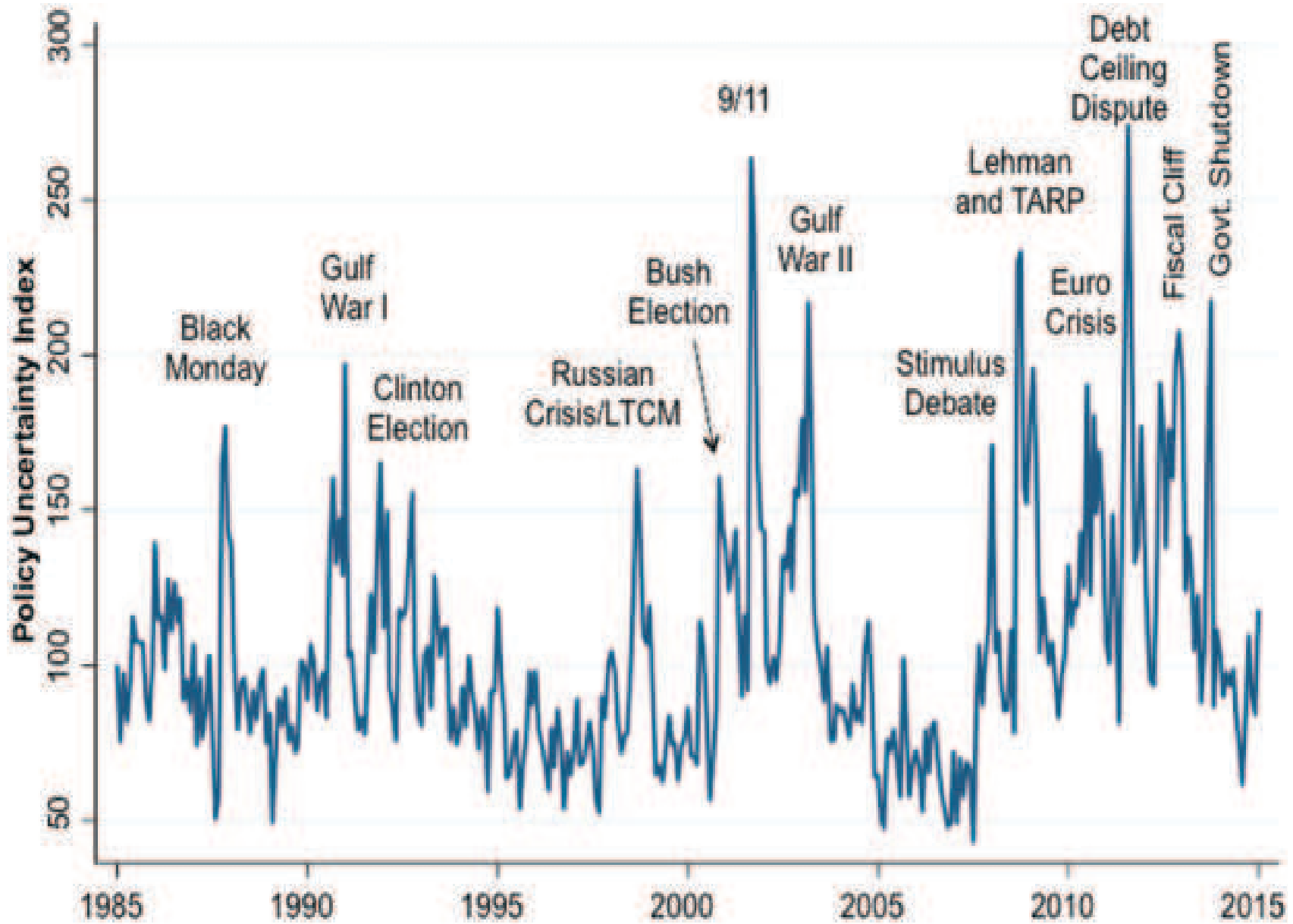
by Pat Akey and Stefan Lewellen

Discussion

Pietro Veronesi

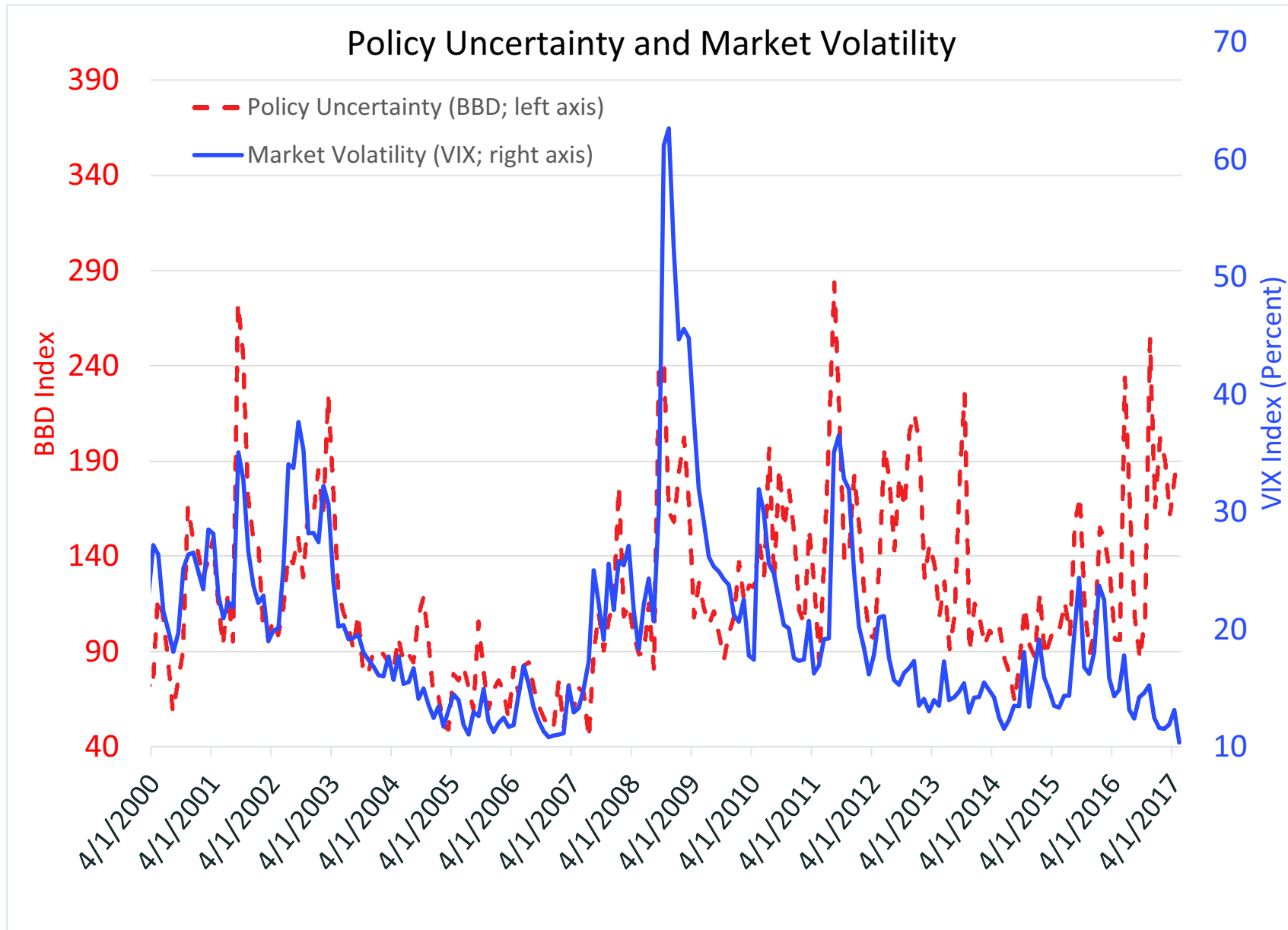
The University of Chicago Booth School of Business

The BBD Index



Source: Baker, Bloom, and Davis, "Measuring Economic Policy Uncertainty" QJE, 2016

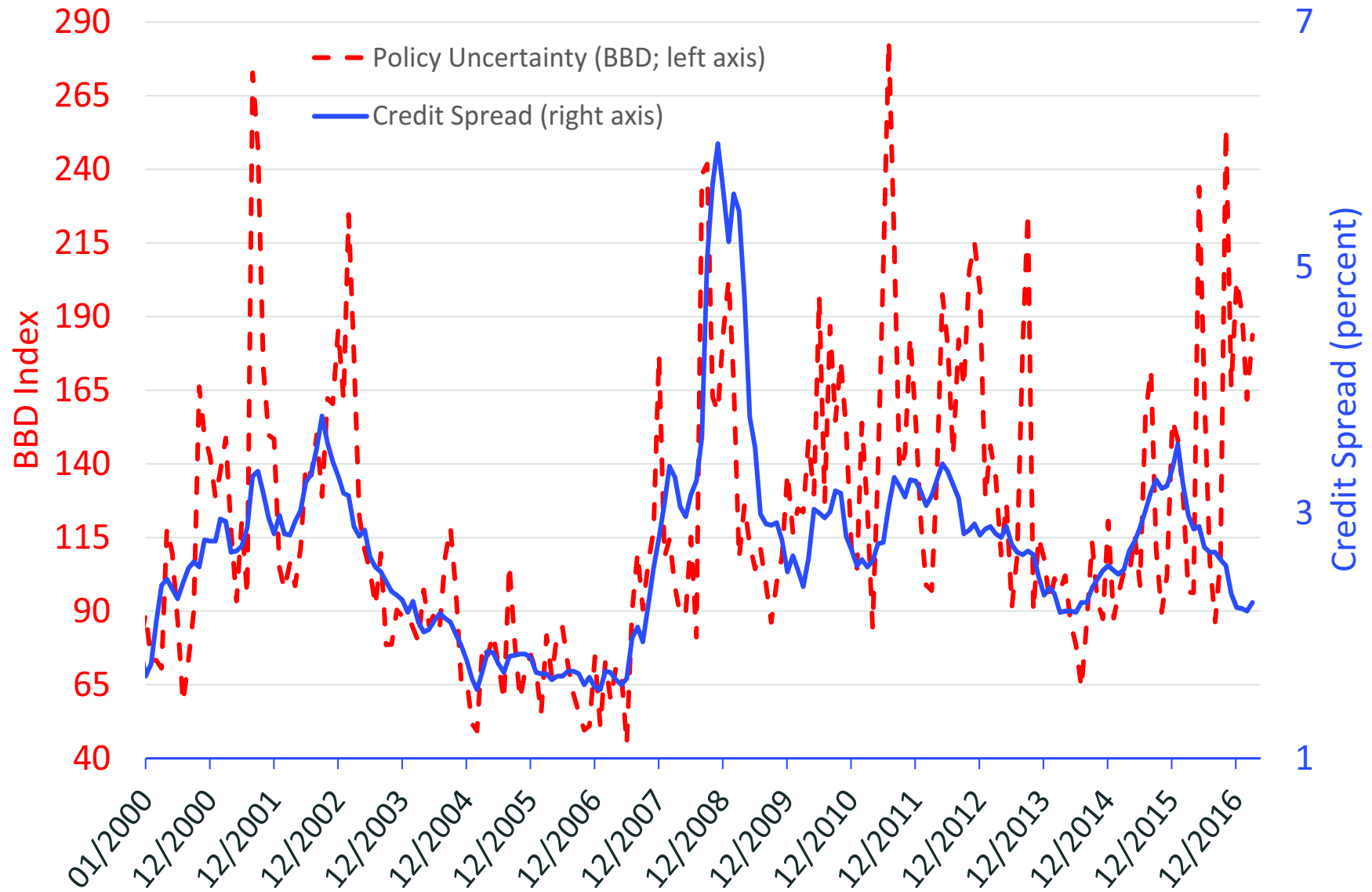
Implied volatility mostly tracks the BBD index (but not now)....



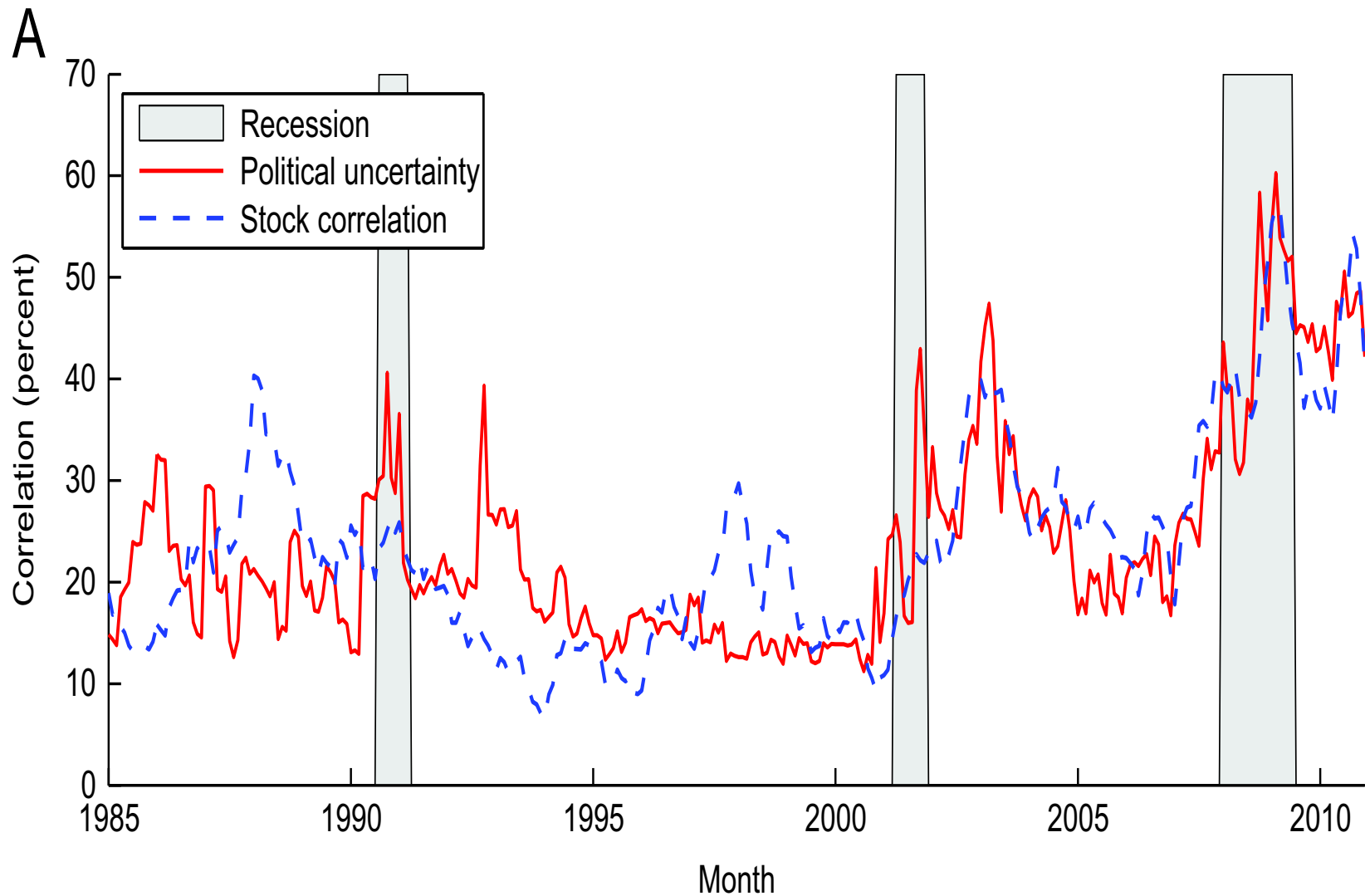
Source: Pastor and Veronesi, “Explaining the puzzle of high policy uncertainty and low market volatility” VOX, 2017

... and so do credit spreads (but not now)

Policy Uncertainty and Credit Spreads



The average correlation across stock returns also tracks the BBD index...



(Source: Pastor and Veronesi, “Political Uncertainty and Risk Premia” JFE, 2013)

... and implied volatility is higher around elections

$$\text{IVD} = \text{IV}(\text{that spans event}) - \text{Average IV (that does not span event)}$$

Mean implied volatility differences

	Weak minus strong economy			
All	<i>MKT</i>	<i>GDP</i>	<i>FST</i>	<i>CLI</i>

Panel A: All political events

Mean	1.43	2.57	1.94	2.22	3.00
	(4.43)	(3.79)	(3.34)	(3.78)	(4.61)

Panel B: Elections only

Mean	1.63	2.63	1.73	2.51	2.36
	(3.13)	(2.73)	(1.78)	(2.34)	(2.39)

Panel C: Summits only

Mean	1.42	2.68	2.13	2.40	3.25
	(3.76)	(3.27)	(3.17)	(3.56)	(4.30)

(Source: Kelly, Pastor, and Veronesi “The Price of Political Uncertainty” JF 2016)

In sum...

- Lots of evidence that **political uncertainty is a systematic risk factor** as predicted by the theoretical models of Pastor and Veronesi (2012, 2013)
- I now show that indeed Akey and Lewellen empirical results are perfectly consistent with our theoretical framework

Election interpretation of Pastor and Veronesi (2012, 2013)

- Finite horizon economy $[0, T]$ with a continuum of firms $i \in [0, 1]$ and utility maximizing investors.
- Government policies differentially impact firms' average profitability:

$$ROA_{it} = \underbrace{\mu}_{\text{growth}} + \underbrace{b_i}_{\text{policy sensitivity } (\geq 0)} \times \underbrace{g_t}_{\text{policy impact}} + \underbrace{\epsilon_{it}}_{\text{idio shock}} + \underbrace{\epsilon_t}_{\text{sys shock}}$$

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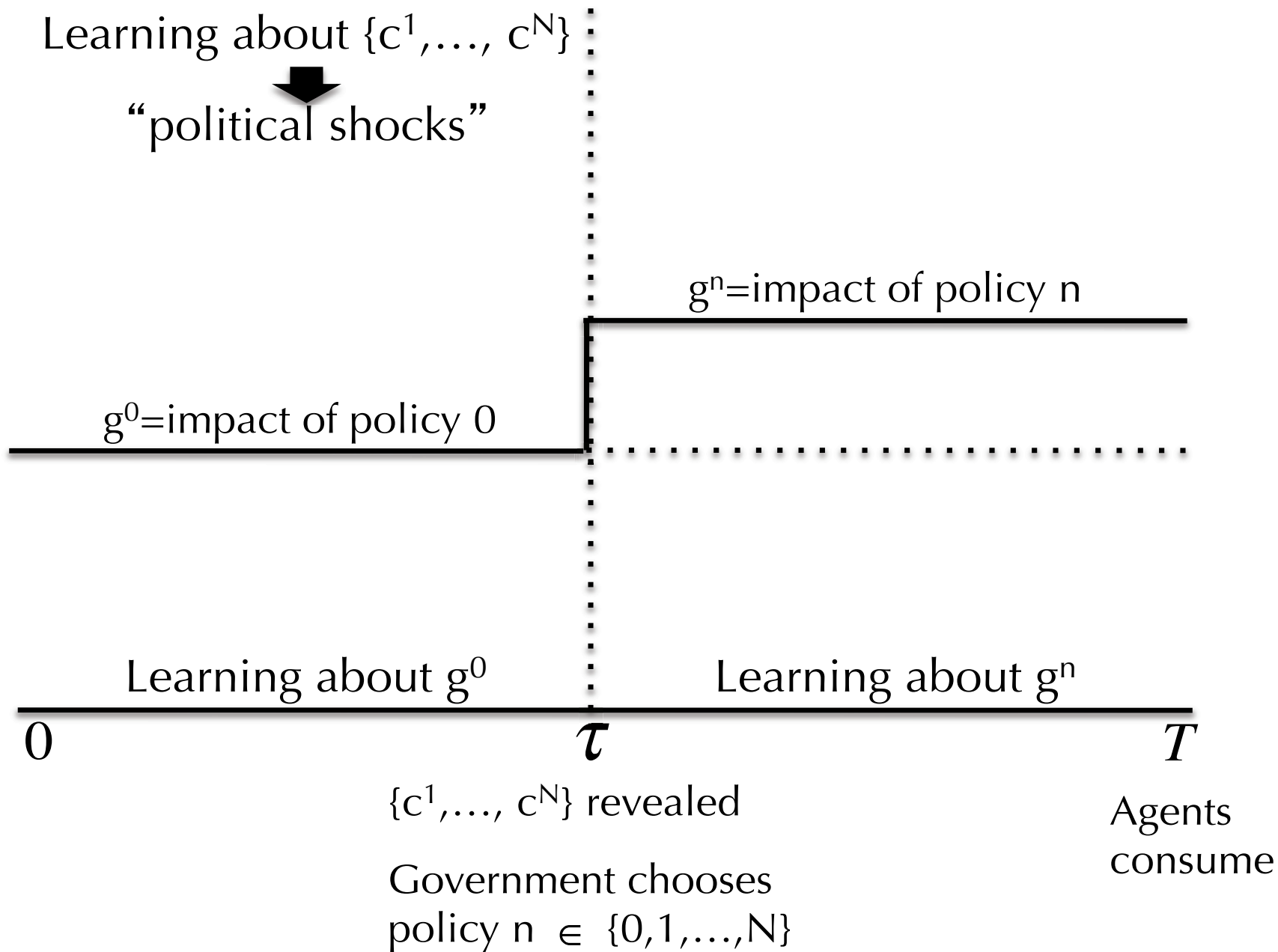
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- Agents choose new government for economic and non-economic motives:

$$\max_{n \in \{0, 1, \dots, N\}} \mathbf{E}_\tau \left[C^n \frac{W_T^{1-\gamma}}{1-\gamma} \mid \text{policy } n \right]$$



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1. Policy (or politician) n wins iff it maximizes

$$s^n = E[g^n] - \frac{a(\gamma - 1)}{2}V[g^n] - b \times \log(C^n)$$

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⇒ Political contributions ⇒ ↓ C^n ⇒ ↑ chance (high- $E[g_n]$, low- $V[g^n]$) wins

– Political contributions = voting by firms

– Individual firm pays little but the sum of contributions (votes) matters

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- These results are across firms and not within firm.
 - Extend model to time varying b_{it} to generate within-firm variation
 - Logic is the same

Political Connections?

- Model offers an interpretation of empirical results in which “political connections” just reflect the implicit “voting” of firms through campaign contributions.
- There is no obvious “pay back” so long politician commits to policy
 - This is also consistent with the paper’s results that show that usual “payback” channels do not seem at work here.
- The elected politicians implement policies in the interest of specific (lucky) firm as they were “voted” in to do so.

Additional Comments and Conclusion

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- There is a relevant asset pricing literature on the cross-section of policy risk
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- Overall, the paper contains interesting empirical results that help (me, at least) bridge the gap between
 - asset pricing (e.g. the market price of political uncertainty); and
 - corporate finance (e.g. political connections).
- More work at the intersection of AP and CF would be welcome!