Political Ties and the Global Financial Cycle

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Research Question

- Global Financial Cycle (GFCy)
  - Asset returns driven by compensation for non-diversifiable risk
  - A common global factor: GFCy, esp. US financial conditions Rey (2015); Miranda-Agrippino and Rey (2020, 2022)
  - The sensitivity of stock prices to GFCy vary across countries

- Political fragmentation
  - Russo-Ukrainian conflict, Brexit, US-China trade war ...
  - Political ties could bind nations closer: buffer shocks or increase co-movement?

→ Will political ties with US affect the strength of GFCy?

✓ A short answer:

Empirical Analysis

- Baseline
  \[ \text{Return}_{t+1} = \alpha_0 + \beta_1 \text{PotTies}_{t+1} + \beta_2 \text{GFCy}_{t+1} + \beta_3 \text{PotTies}_{t+1} \times \text{GFCy}_{t+1} + \delta \text{Control}_{t+1} + \theta + \epsilon_{t+1} \]
  - GFCy: exogenous to country
  - Lag term of political ties mitigate concerns on reverse causality
  - Country and year FE confounding factors
  - If \( \beta_2 < 0 \): stronger political ties associated with a larger spillover from GFCy
  - Standard error clustered at country level

Key Features

- Political ties with US matter a lot for amplifying GFCy to developing countries
- Unique to the political ties with US, political ties with EU and China insignificant
- Horse race between political ties and other determinants, magnitude = liberalizing capital account or increasing FX flexibility

Addressing Endogeneity

- IV approach and 2SLS: IV for political ties: D(SecondTerm) \times Population
- Matching between countries with low and high political ties

Channels

- Globalization: for non-OECD: political ties with US ↑, external assets and liabilities ↑↑, trade ↑
- Reduced information asymmetry: mitigated effect of geographical distance for bilateral holdings of securities and direct investment
- Sentiment transmission: larger forecast revisions and sentiment from GFCy

Conclusions

- Stronger political ties with US: sensitivities of stock returns to GFCy ↑
- More pronounced effect for non-OECD countries
  - GFCy ↓ 1 sd, countries whose political ties with US ↑ 1 sd (e.g., China and Argentina), stock return fall by 3.4 - 4.4 pp more
  - Causal interpretation based on IV, matching, LP
- Deepening trade and financial linkages, and information and sentiment flows could be possible channels

Measurement

  - Calculate bilateral voting similarities relative to how US voted
  - S2UN-imp: three-category (Yes-No-Abstain), US deemed important
  - Alternatives: S2UN-imp (Yes-No); S3UN & S2UN; State Visits; US Aid
  - More similar voting patterns, stronger political ties

- GFCy
  - VIX: market’s expectation of volatility based on prices of options on S&P 500 index
  - EBP: aggregate bond credit spreads net of expected defaults (Gilchrist and Zakrajsek, 2012; Gilchrist et al., 2023)
  - Alternatives: GZ spread, EPU, Global factor (Miranda-Agrippino and Rey 2020): overlap with stock market index

- Stock Market Return: Datastream

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