POLI 229 - Spring 2023
Thrusday 9:00AM-11:50AM
SSB #104

Political Risk and Asset Prices

Prof. Sebastian M. Saiegh
ssaiegh@ucsd.edu
Office Hours: Wednesday 10:00AM-12:00PM, SSB #370

Objectives

This course examines the relationship between *political* risk and the prices of claims to uncertain payments. Class sessions will be conducted as seminars led by the instructor. Often the instructor will present material based on the more difficult readings. The pace of this course will be fast. Each week, students are expected to study a topic in detail (items under *Study*), and read an related paper (items marked as *Read*). Both types of readings are **required**. All students should read them carefully and critically before class. *Recommended* comprises additional readings that provide a survey of each week's main topic. The mathematics will not be difficult. However, some basic knowledge of elementary calculus and of finance is recommended. Students are expected to write a short memo describing a political risk management strategy. This assignment accounts for 75 % of the final grade. Class participation accounts for the remaining 25 %.

Theories and Models

Each week we will try to address very complex issues using relatively simple models. In particular, we will attempt to engange in theoretical exercises of abstraction, ignoring many details in order to focus on the most important elements of the problem. With his inimitable fiction, Argentinean writer J. L. Borges illustrated in "Funes the Memorious" the importance of generalization and abstraction in thought and science:

"He had learned, without effort, English, French, Portuguese, Latin. I suspect, however, that he was not very capable of thinking. To think is to forget differences, to generalize, to abstract. In the over stocked world of Funes there was nothing but details, almost immediate details"

In a similar vein, Paul Krugman argues that the utility of modeling stems from useful simplification:

http://web.mit.edu/krugman/www/dishpan.html

On the other hand, as Henri Theil observed, "Models should be used, not believed" (cited in Paper Stones by Przeworski and Sprague). And, as these authors note, models "...are not simplified versions of a complex reality but instruments to be used in analyzing complex situations..." Moreover, there is no such thing as the right degree of abstraction for all analytic purposes. The proper degree of abstraction depends on the issue under consideration.

Course Policies

Academic Integrity. Students in this course are expected to comply with UCSD's Policy on Integrity of Scholarship. In particular, plagiarism is considered a dishonest practice and a serious academic offense. Hence, there will be a zero tolerance policy with respect to these practices: any student violating the obligation of academic integrity during the term will automatically fail the class. Copies of the current version of the UCSD Policy on Integrity of Scholarship, also commonly referred to as the Academic Dishonesty Policy, may be found on the Academic Senate webpage: http://www-senate.ucsd.edu/AcademicIntegrity/AcademicIntegrity.htm

Disabilities. If you have a disability that requires special testing accommodations or other classroom modifications, you need to notify both me and the Office for Students with Disabilities (OSD). You may be asked to provide documentation of your disability to determine the appropriateness of accommodations. To notify the OSD, call (858) 534-4382 to schedule an appointment.

Course Materials

All the readings for this course come from articles, as well as book chapters. They will either be available on the course's **Canvas** webpage, or can be accessed online through the UCSD Library System (Restricted to UCSD IP addresses).

Course Outline

Week 1: Introduction

Read: Webb, Alexander and Robert I. Webb. 2013. *Shock Markets: Trading Lessons for Volatile Times*. New Jersey: Pearson, Chs. 1, 2, 6.

https://learning.oreilly.com/library/view/shock-markets-trading/9780133345810/

Background: Wisniewski, Tomasz Piotr. 2016. "Is there a link between politics and stock returns? A literature survey," *International Review of Financial Analysis*, Vol. 47: 15-23.

Week 2: Preliminaries

Study: Varian, Hall R. 1992. *Microeconomic Analysis (Third Ed.)*. New Tork: Norton, Ch. 7.

Read: Persson, Torsten, and Guido Tabellini. 2000. *Political Economics*. Cambridge: MIT Press, Ch. 2.

Background: Drazen, Allan. 2000. *Political Economy*. New Jersey: Princeton University Press, Ch. 1.

Week 3: Representation

Study: Besley, Timothy. 2006. *Principled agents?*. New York: Oxford University Press, Chapter 3.

Read: Przeworski, Adam. 2003. *States and Markets*. New York: Cambridge University Press, Ch. 4.

Background: Dal Bó, Ernesto, and Frederico Finan. 2018. "Progress and perspectives in the study of political selection," *Annual Review of Economics*, 10: 541-575.

Week 4: Political Business Cycles

Study: Lohmann, Susanne. 1998. "Rationalizing the Political Business Cycle: A Workhorse Model," *Economics & Politics*, Vol. 10: 1-17.

Read: Keech, William R. 2013. *Economic Politics in the United States.* New York: Cambridge University Press, Chs. 2-4.

Background: Dubois, Eric. 2016. " Political business cycles 40 years after Nordhaus," *Public Choice*, 166: 235-259.

Week 5: Partisan PBC

Study: Alesina, Alberto, and Howard Rosenthal. 1995. Partisan Politics, Divided Government, and the Economy. New York: Cambridge Univ. Press, Ch. 7.

Read: Pástor, Ľuboš, and Pietro Veronesi. 2020. "Political cycles and stock returns," *Journal of Political Economy*, 128: 4011-4045.

Background: Franzese, Jr., Robert J. 2002. "Electoral and Partisan Cycles in Economic Policies and Outcomes," *Annual Review of Political Science*, 5: 369-421.

Week 6: Investment Under Uncertainty

Study: Cukierman, Alex. 1980. "The Effects of Uncertainty on Investment under Risk Neutrality with Endogenous Information," *Journal of Political Economy*, Vol. 88: 462-475.

Read: Carnahan, Daniel, and Sebastian Saiegh. 20201 'Electoral uncertainty and financial volatility: Evidence from two-round presidential races in emerging markets," *Economics & Politics*, Vol. 33: 109-132.

Background: Bernanke, Ben S. 1983. "Irreversibility, Uncertainty, and Cyclical Investment," *Quarterly Journal of Economics*, Vol. 98: 85-106.

Week 7: Asset Pricing Theory

Study: Cochran, John H. 2005. *Asset Pricing (Revised Edition).* Princeton: Princeton University Press, Ch. 1.

Read: Carnahan, Daniel, and Sebastian Saiegh. 2021. "Political Shocks and Asset Prices: Evidence from Argentina," *Political Science Research and Methods*, 1-18. doi:10.1017/psrm.2021.58

Background: Dai, Lili and Bohui Zhang. 2019. "Political Uncertainty and Finance: A Survey," *Asia-Pacific Journal of Financial Studies*, Vol. 48: 307-333.

Week 8: Factor Pricing Models

Study: Cochran, John H. 2005. *Asset Pricing (Revised Edition)*. Princeton: Princeton University Press, Ch. 9.

Read: Cox, Gary, and Sebastian Saiegh. 2022. "Suffrage Reform and Financial Volatility: Reconsidering the Great Reform Act," *Journal of Historical Political Economy*, 2: 415–447.

Background: Ferrara, Federico Maria, and Thomas Sattler. 2018. "The political economy of financial markets," *Oxford Research Encyclopedias*,

https://doi.org/10.1093/acrefore/9780190228637.013.628

Week 9: Option Pricing

Study: Cochran, John H. 2005. *Asset Pricing (Revised Edition)*. Princeton: Princeton University Press, Ch. 17.

Read: Saiegh, Sebastian. 2023. "Fear and Loathing on Wall Street: Electoral Risk Hedging in the United States (1996-2020)," unpublished manuscript, Department of Political Science, UCSD.

Background: Zhou, Ping and John Shon. 2013. *Option Strategies for Earnings Announcements*. New Jersey: Pearson, Chs. 2, 6, 7.

https://learning.oreilly.com/library/view/option-strategies-for/9780132947411/

Week 10: Political Risk Management

Students' presentations.