Discussion of:

”The impact of political convergence on financial integration”

by

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Summary with discussion

- Test how political parties / political convergence affects market integration in North America (U.S. and Canada).
  - Important elements to be defined:
    - Measure of political convergence: ideological closeness of two incumbent parties.
    - Measure of market integration: International CAPM (Mittoo (1992), Jorion and Schwartz (1986)).
    - Mechanism through which political parties/political convergence affects market integration: Changes in results of Hypothesis tests for domestic systematic risk.
- The parameters of the Asset Pricing Model are not estimated but inverted from the Hotelling Statistic.
- They find evidence that political convergence and American political parties affect market integration.
- By using the inversion technique they find stronger evidence of market integration than previous papers.

How to measure market integration/segmentation?

- The authors adopt one specific asset pricing model, namely a version of the international CAPM.
  - Can it really deliver a reliable measure of market integration?
  - Inverting from the Hotteling statistic to identify model parameters for the international CAPM doesn't imply that this model is the most appropriate way of measuring market integration...
- Incipient papers in this literature have adopted the international CAPM (Jorion and Schwartz, 1986) but Mittoo (1992) already advocates in favor of multiple models.
- A very interesting measure of market integration is provided by Chen and Knez (1995)
  - Their measure is independent of any asset pricing model.
  - It depends on the family of admissible stochastic discount factors for each market under consideration.
  - Based on the Hansen and Jagannathan (1991, 1992) distance.

What is the main contribution of the paper?

- Given that results are based on a unique APM, in my view the main contribution is methodological in econometrics.
- The inversion of the test statistic to obtain confidence interval for the APM parameters is very useful!
- Question: How much do you rely on the assumption that the error terms have normal distribution in the international CAPM model?
  - Apparently this is important to invert the Hotelling statistic from an F distribution.
  - Could either estimate the model or simply run a multiple regression with intercept of $R_i - R_f$ on $R_I - R_f$ and V_{D-I} to verify the normality assumption...
  - Wouldn't a bootstrap procedure applied to obtain the Wald test be a competitor to the inversion technique?

Testing political influence with a more flexible measure of market integration

- To derive their measure, Chen and Knez (1995) only rely on the Law of One Price (assets with the same future payoffs should have the same price).
- Therefore, for perfect market integration there should exist a SDF that is common to both markets.
- Measure of market integration is the minimum distance between the two sets of admissible stochastic discount factors.
- Could project returns using your political dummy variables and repeat the distance calculation.
- It is also possible to work with the version that guarantees no-arbitrage in both economies.

Other Comments

- Would be nice to have the international CAPM model fully derived in the text.
- Claim that "‘the article uncovers a political puzzle broader than the "‘Presidential Puzzle"’ (Santa-Clara and Valkanov (2003))"’.
  - The results in the paper are qualitative since they indicate changes in results of hypothesis tests rather than quantitative changes in returns.
  - The Presidential Puzzle above appears because they can not explain how changing presidency from Republican to Democratic increases realized returns in 9% per year!