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The Cyclicity of Political Connections: an Investigation into Changes in Reserve Requirements in China

“In this paper I will explore the cyclical nature of political connections by investigating market reactions to news of a unique and effective method of monetary contraction in China: the adjustment of reserve requirements. I illustrate that politically-connected firms, when the ultimate controller is either the central or the local government, demonstrate an additional negative cumulative abnormal return (CAR) when the reserve requirement is increased. There is also a lower level of real activity on the part of those connected firms during the tightening period. I argue that this impact is likely to be exerted through the bank-lending channel: specifically, banks are not willing to lend to connected firms due to the concern of either a higher probability of them defaulting, or a lower probability of a bailout from the government. This effect is less likely to result from other factors, such as changes in the value of collateral, decreases in investment opportunities, or government intervention in regard to banks.”

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