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Is Policy Uncertainty Delaying the Recovery?

By Scott R. Baker, Nicholas Bloom and Steven J. Davis

Many commentators claim that policy uncertainty is holding back the recovery. In Europe and the US there is a sense that recent policy has been more volatile and unpredictable. But is that true? Scott R. Baker, Nicholas Bloom and Steven J. Davis have developed a measure of economic policy uncertainty, finding historic highs in recent years but that it is beginning to recede towards more normal levels.

The most striking thing about the recent volatility of global financial markets is that politicians are making the news. The actions of policy-makers and their statements about budgets, bailouts and regulatory reforms are driving the stock market gyrations.

This is not normal. Before the financial crisis of 2008, stock markets usually moved in response to economic news. Strong GDP and employment figures would send the markets soaring. Poor corporate earnings would send the markets crashing.

But today, all eyes are on the policy-makers. Unfortunately, they cannot agree, which is generating massive uncertainty. In fact, according to our new index, which charts the evolution of US economic policy uncertainty since 1985, it is now close to its all-time high (see Figure 1). This policy uncertainty is a key factor stalling the recovery and threatening a return to recession.

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About the Authors

Scott R. Baker is a fourth-year Ph.D. candidate in the Stanford Department of Economics. His research is concentrated on empirical labor and public economics, especially in the area of federal policy analysis and evaluation. Scott received B.A.'s in Economics and Political Science from the University of California, Berkeley.



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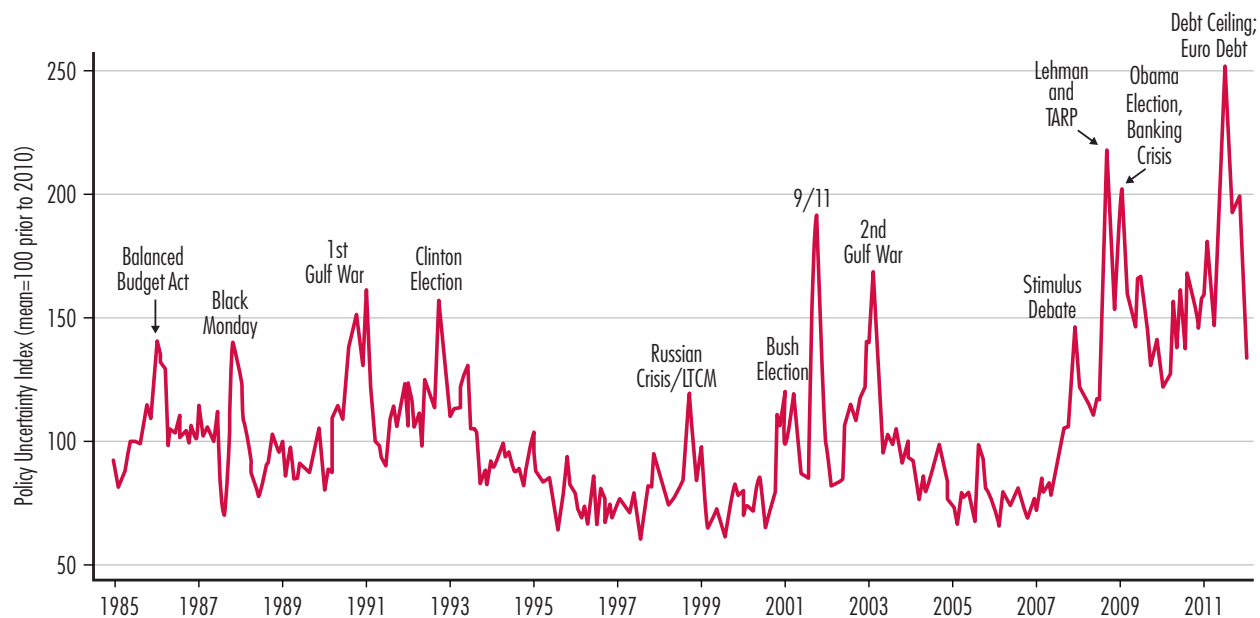


Steven J. Davis is the William H. Abbott Professor of International Business and Economics at the University of Chicago Booth School of Business. His research encompasses employment and wage behavior, worker mobility, job loss, the effects of labor market institutions, business dynamics, industrial organization, public policy, and other topics. Previously, he held positions at the National University of Singapore, Massachusetts Institute of Technology, the Milken Institute for Job and Capital Formation, the Federal Reserve Bank of Chicago, and the Hoover Institution at Stanford University.



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Table 1
Policy Uncertainty has been at Historically High Levels



Notes: The index is composed of four series: monthly news articles containing the words “uncertain” or “uncertainty”, “economic” or “economy”, and policy relevant terms (scaled by the smoothed number of articles containing ‘today’); the number of tax laws expiring in coming years, and a composite of interquartile ranges for quarterly forecasts of federal government expenditures and 1-year CPI from the Philadelphia Fed Survey of Forecasters. Data at www.policyuncertainty.com

We construct our index of policy uncertainty by combining three types of information: the frequency of newspaper articles that reference economic uncertainty and the role of policy; the number of federal tax code provisions that are set to expire in coming years; and the extent of disagreement among economic forecasters about future inflation and future government spending on goods and services.

Our index shows sharp spikes in economic policy uncertainty

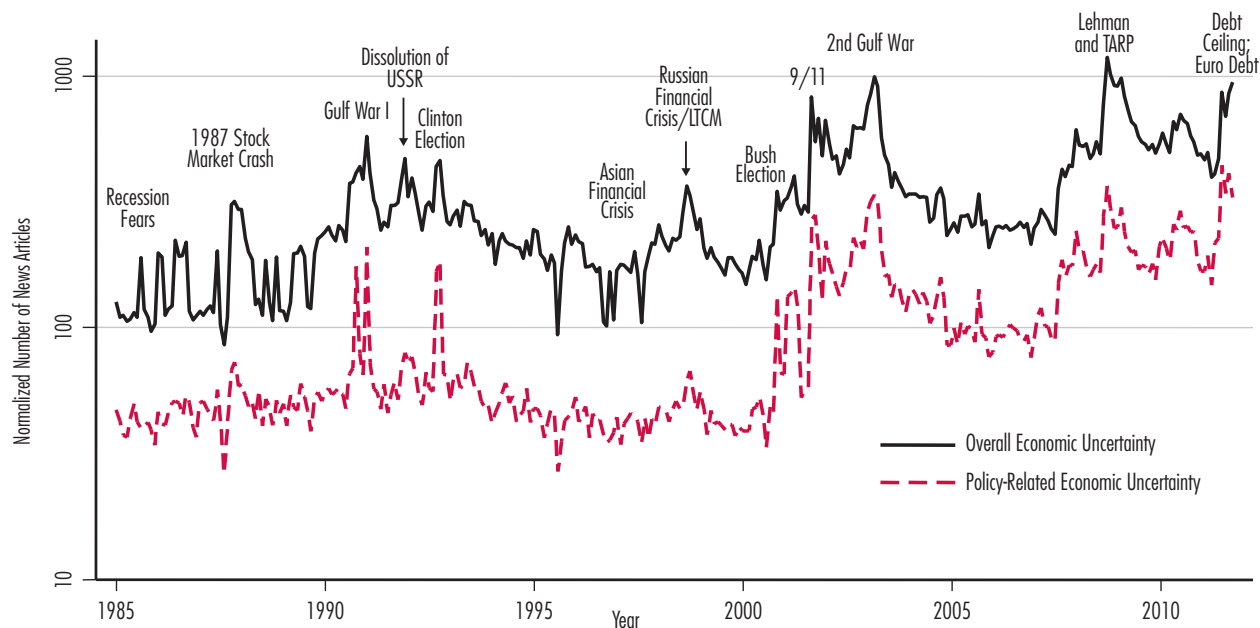
around major elections, wars and the 9/11 terrorist attacks. More recently, it spiked sharply after the Lehman bankruptcy in September 2008 and the passage of the TARP (Troubled Asset Relief Program) legislation shortly afterwards. It has remained high ever since, driven by continuing policy uncertainty around the 2010 mid-term elections, the debt ceiling dispute and the crisis of the eurozone.

Of course, policy uncertainty could be high simply because general economic uncertainty

is also high. To test this view, we use Google News listings to construct a broad index of economic uncertainty and a narrower index focused squarely on policy uncertainty.

Comparing these two indices reveals several episodes that involve large spikes in economic uncertainty but little or no jump in policy uncertainty (see Figure 2). Examples include the Asian financial crisis of 1997 and several bouts of recessionary fears in the second half of the 1980s. In short, the data

Table 2
Policy Uncertainty is an Increasingly Large Share of Overall Economic Uncertainty



Notes: The overall news-based economic uncertainty index is composed of monthly number of news articles containing “uncertain” or “uncertainty” as well as “economic” or “economy” (scaled by the smoothed number containing “today”).

refute the view that economic uncertainty necessarily breeds policy uncertainty.

So why is policy uncertainty so high now? To identify the drivers of policy uncertainty, we drill into the Google News listings and quantify the mix of factors at work. Several factors underlie the high levels of US policy uncertainty in 2010 and 2011, but monetary and tax issues predominate.

One clear example involves the Bush-era income tax cuts originally set to expire at the

end of 2010. Democrats and Republicans adopted opposing positions about whether to reverse these tax cuts. Rather than resolve the uncertainty in advance, Congress waited till the final hour before deciding to extend the tax cuts.

Other examples include recent moves in the Senate to increase tariffs on Chinese imports, which threaten to set off a trade war. And in Europe, the continuing debates over potential bailouts for countries and banks contribute to a

climate of policy uncertainty.

What makes policy uncertainty so harmful? When businesses are uncertain about taxes, healthcare costs and regulatory initiatives, they adopt a cautious stance. Because it is costly to make a hiring or investment mistake, many businesses naturally wait for calmer times to expand. If too many businesses wait to expand, the recovery never takes off. Weak investments in capital goods, product development and worker training also undermine longer-run growth.

Table 3
Policy Uncertainty now causes about Half of Stock Market Jumps



Notes: Number of jumps in the S&P 500 Index, defined as increases or decreases within one day greater than 2.5%. Determination of cause of increasing and decreasing jumps made from examination of New York Times coverage of the event on the following day.

We also see the effects of increased policy uncertainty on stock market volatility. To analyse this we categorized the factors causing daily S&P500 swings of more than 2.5% according to the next day's New York Times (see Figure 3). We find that not only have there been a large number of stock market jumps since 2008, but now almost half of these are caused by changes in government or central bank policy.

Lubos Pastor and Pietro Veronesi have recently documented how stocks have

recently exhibited much more co-movement and become tightly correlated with our policy uncertainty index. To the extent that these policy changes and increased policy uncertainty induce large swings in the market and more co-movement among individual stocks, they have the effect of increasing risk premia for firms, as it becomes more difficult to diversify stock holdings and insure against risk.

How much near-term improvement could we expect from a stable, certainty-enhancing

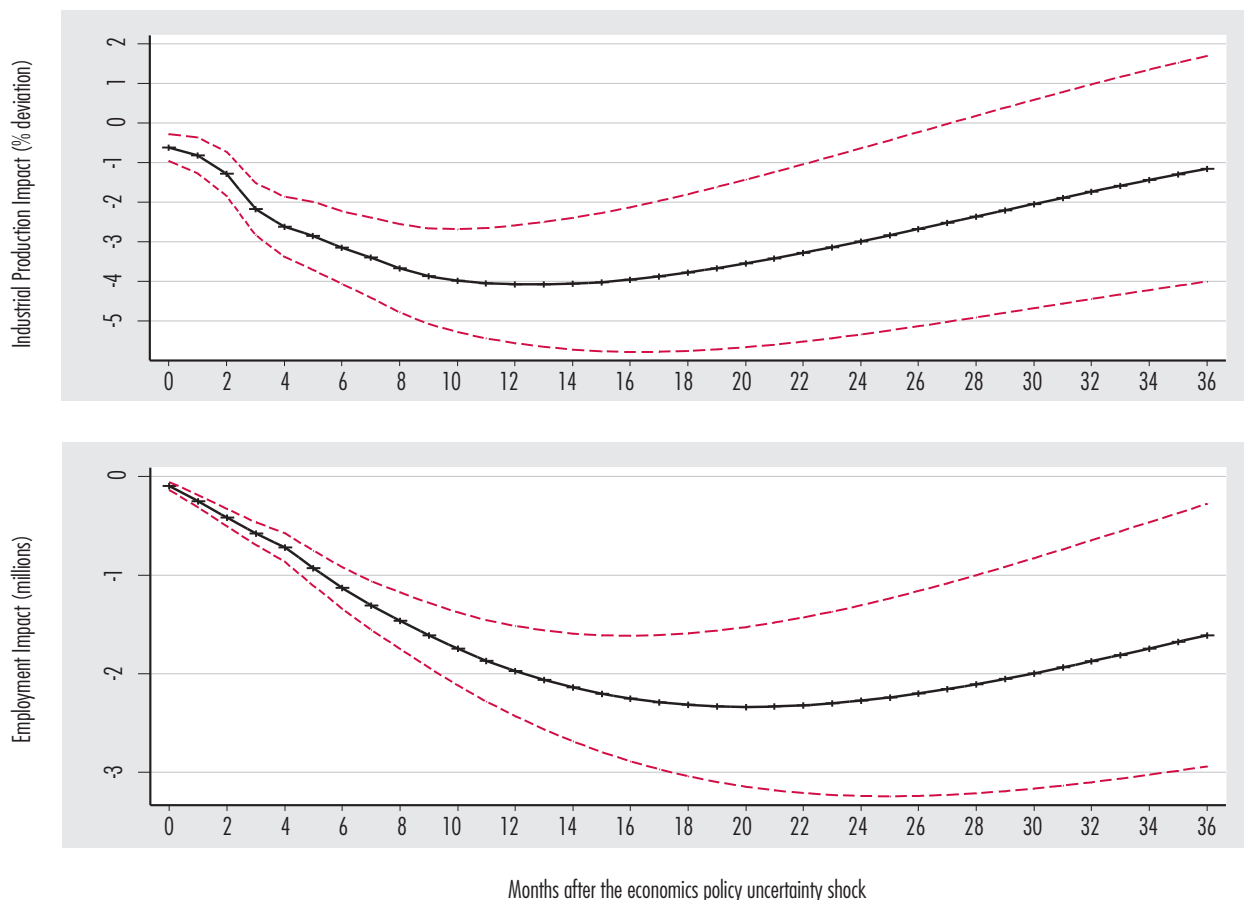
policy regime? We use techniques developed by Christopher Sims, one of the two 2011 Nobel laureates in economics, to estimate the effects of economic policy uncertainty.

The results for the United States suggest that restoring 2006 (pre-crisis) levels of policy uncertainty could increase industrial production by 4% and employment by 2.3 million jobs over about 18 months (see Figure 4). That would not be enough to create a booming

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Table 4

Industrial Production falls by about 4% and Employment falls by about 2 million Following an Increase in Uncertainty



Notes: Impulse Response Functions for Industrial Production and employment to an 112 unit increase in the policy-related uncertainty index (the increase from 2008 to 2010). Estimated using a monthly Vector Autor Regression on data from 1985 to 2011.

economy, but it would be a big step in the right direction.

The first months of 2012 have seen steps in this direction, with lower levels of uncertainty surrounding federal policies, tax measures, and European macroeconomic policies. We find that our measure has fallen to its

lowest level since 2009, hinting that the historic levels of economic policy uncertainty have subsided for now. With a longer period of more subdued uncertainty, the nascent economic recovery may find stronger legs.

This article summarises 'Measuring Economic

Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven Davis (<http://www.policyuncertainty.com>).

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