



Foreign &
Commonwealth
Office

Measuring Economic Policy Uncertainty

*Comments for Money, Macro, Finance
Conference*

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Shamik Dhar, Chief Economist, Foreign and
Commonwealth Office



Outline

1. Summary of the approach
2. Conclusions – sensible and less so
3. The Ronseal test
4. ‘Policy’ and ‘Uncertainty’
5. Stories and fundamentals



Summary of the approach

Construct an index of 'policy uncertainty' using word count data

Micro: higher uncertainty raises stock price volatility and reduces investment and employment, notably in those firms most dependent on government

Macro: higher uncertainty leads to lower output, investment and employment, Explains significant proportion of post-2008 recession.

Sounds uncontroversial, but important to pick through what the research establishes and what it doesn't



Sensible conclusions (the authors)

- Uncertainty shocks reduce output, investment and employment
- Uncertainty reduces the impact and effectiveness of stabilization policy
- Government-facing firms struggle in the face of more uncertainty about the future scope of government
- Uncertainty has inhibited the global (and UK) recovery to some extent
- Uncertainty has had a material impact on monetary policy decisions in the US, UK and euro area



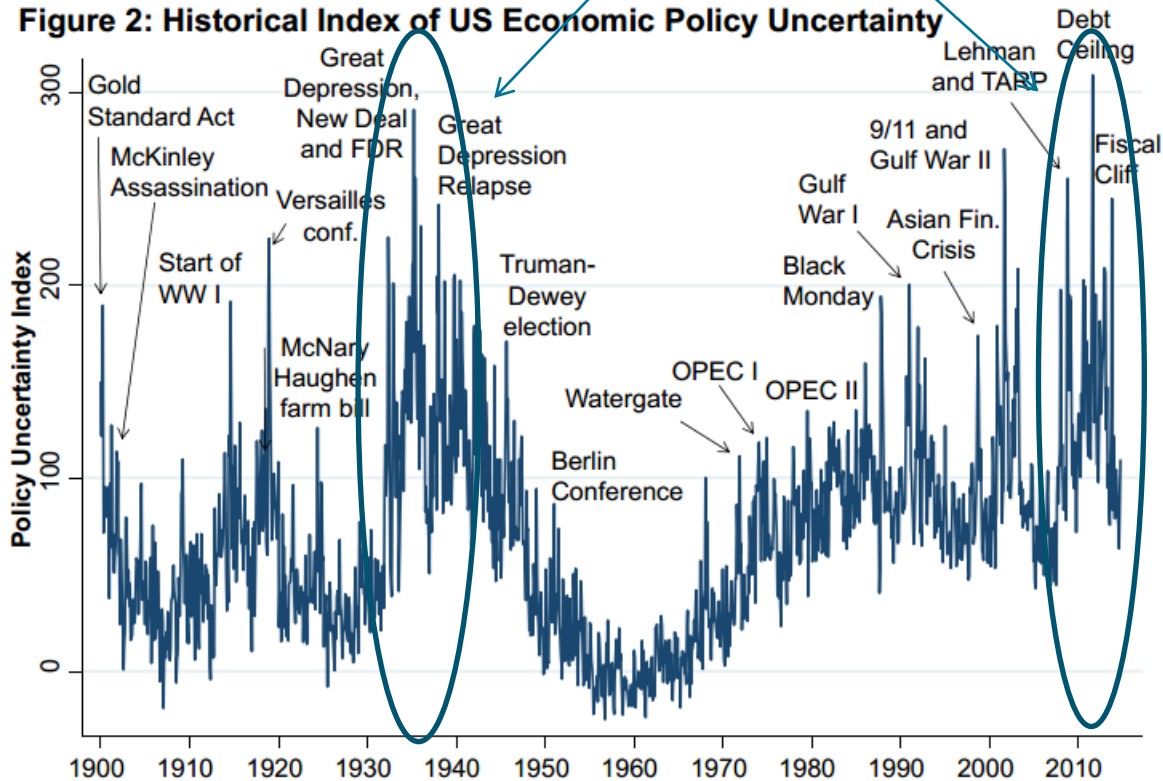
Less defensible conclusions (the blogs)

- Uncertainty doesn't matter a jot, it's all about austerity
- Policy uncertainty (ARRA, ACA) is the only thing that matters, fiscal tightening has been irrelevant
- Stricter adherence to rules for fiscal and monetary policy would have significantly alleviated the great recession
- We should now be following a Taylor rule, or something similar, in monetary policy



Ronseal 1 - The US EPU index

Makes sense

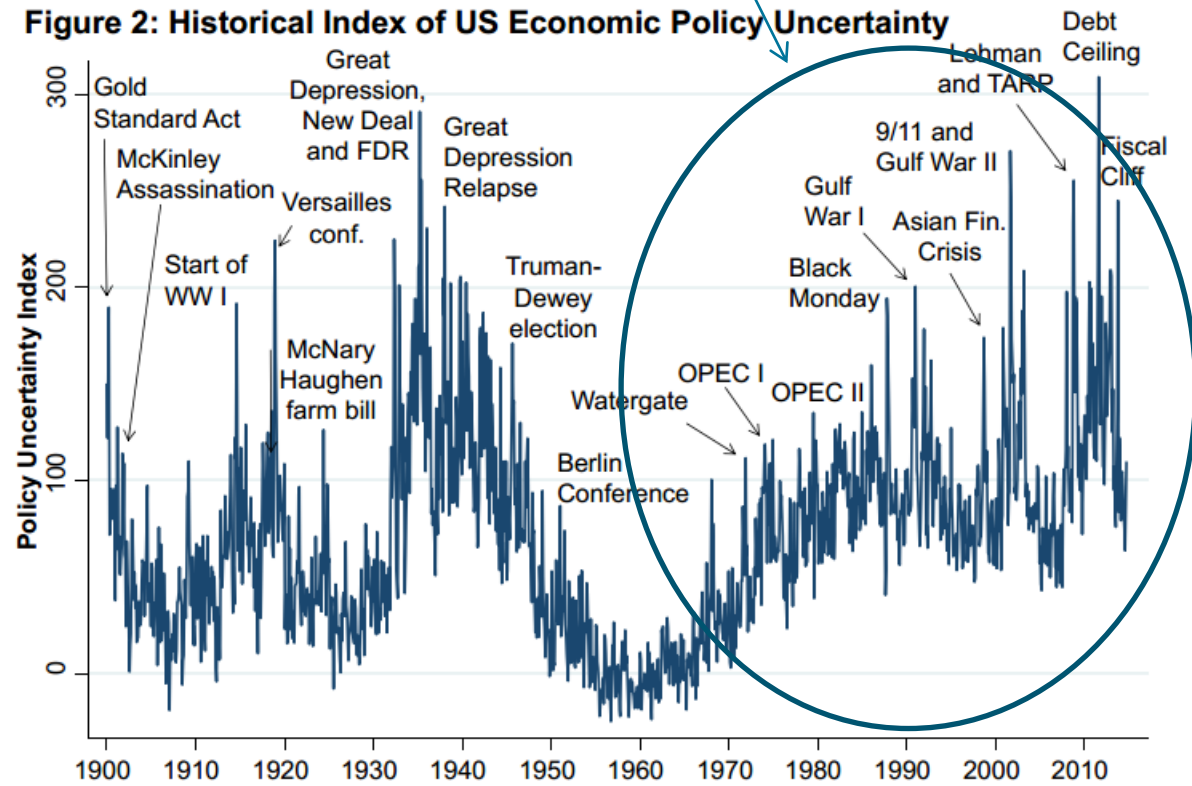


Notes: Index of Policy-Related Economic Uncertainty composed of quarterly news articles containing uncertain or uncertainty, economic or economy or business or commerce, and policy relevant terms (scaled by the smoothed total number of articles) in 6 newspapers (WP, BG, LAT, NYT, WSJ and CHT). Data normalized to 100 from 1900-2011.



Ronseal 1 - The US EPU index

Trend increase?

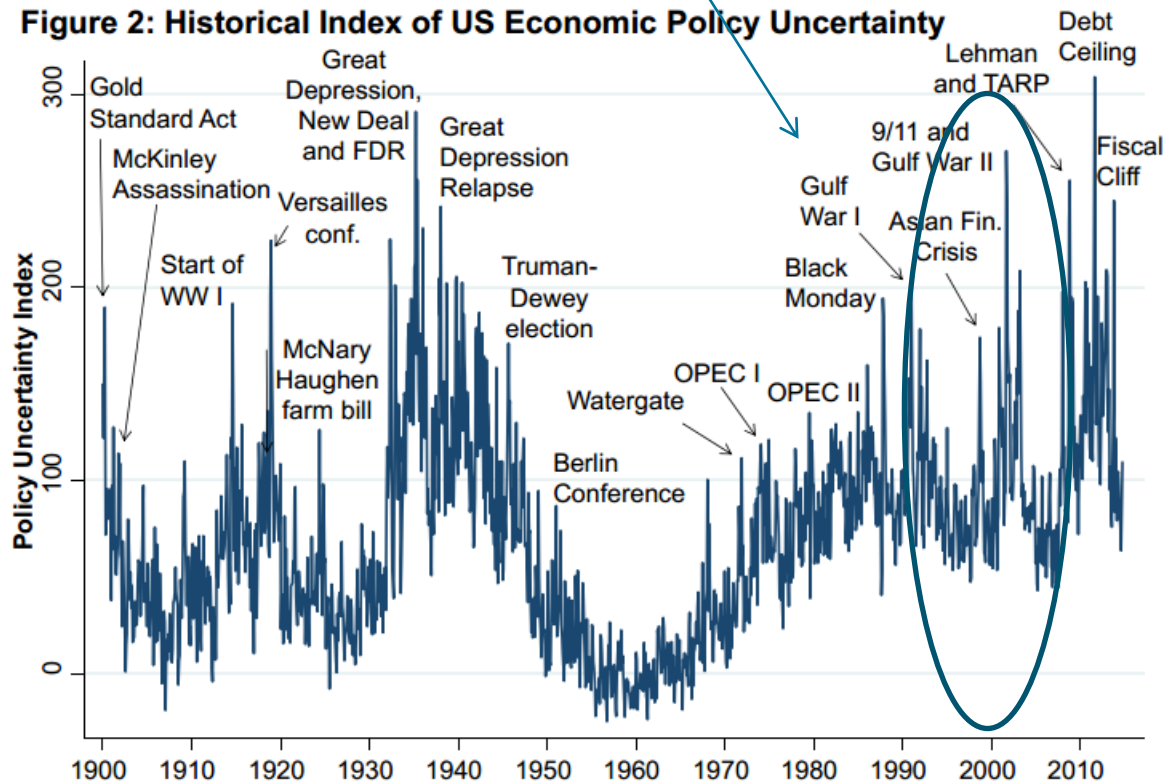


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Ronseal 1 - The US EPU index

Puny Great Moderation

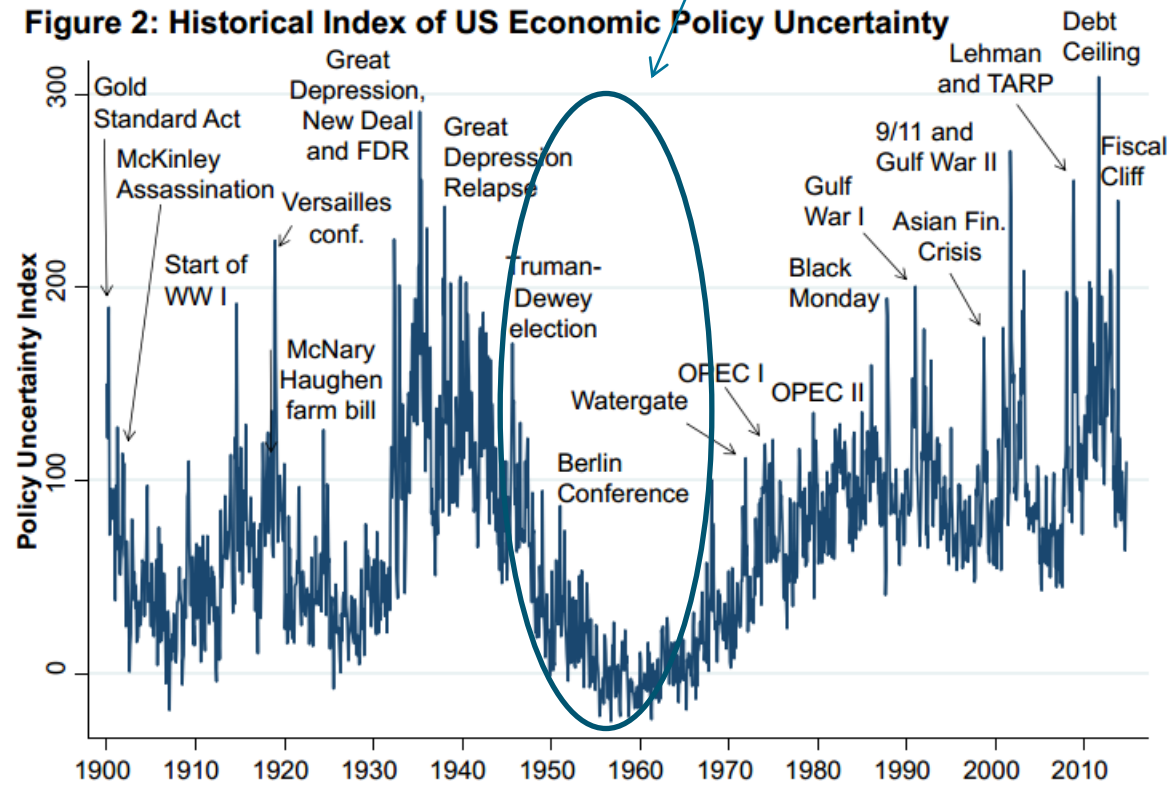


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Ronseal 1 - The US EPU index

Maybe but...?

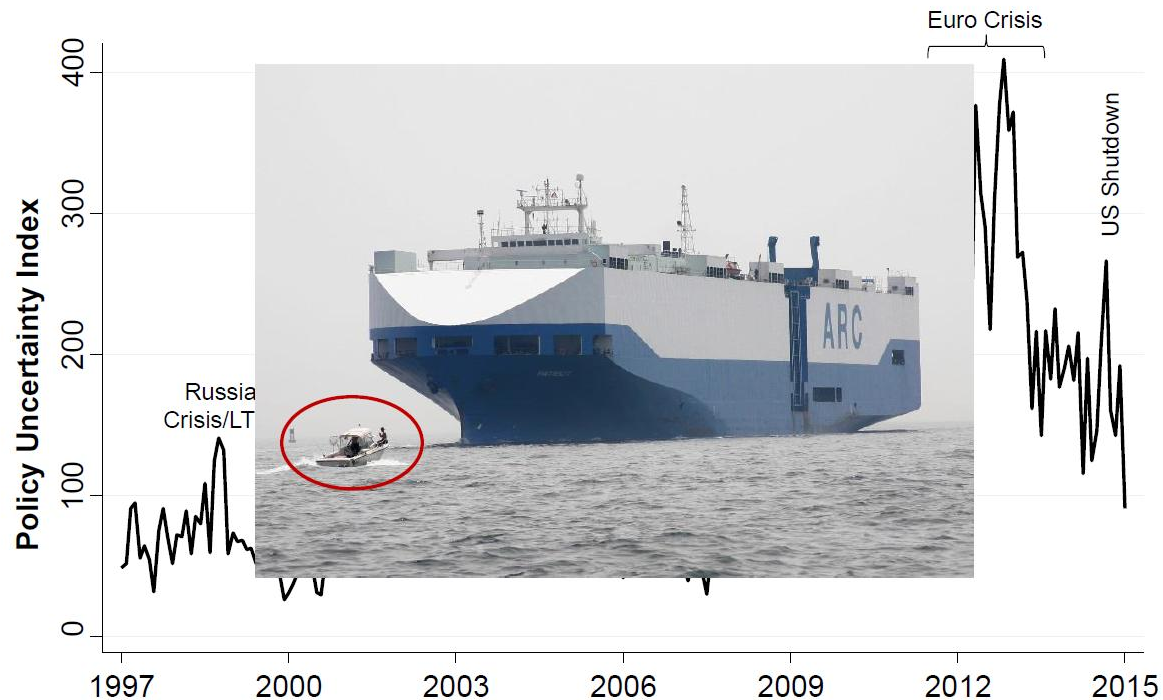


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Ronseal 2: the UK index

UK Policy Uncertainty Index – note many of the policy events are international (why G20 is helpful)

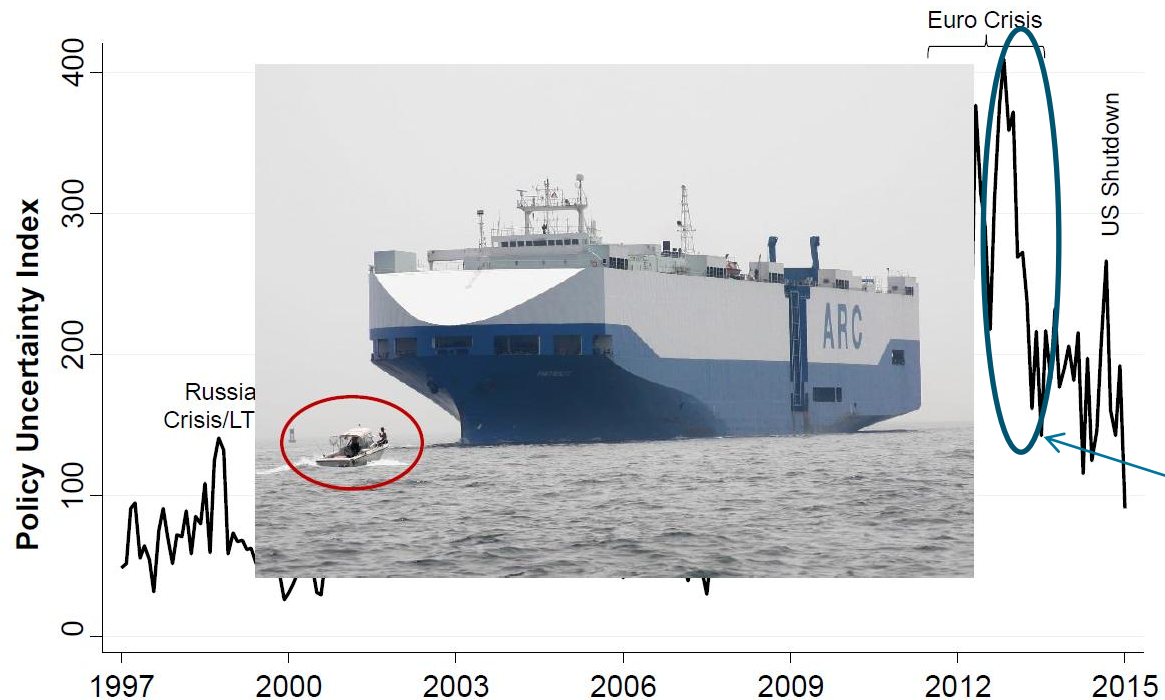


Source: www.policyuncertainty.com. Data from 2 UK newspapers (Times and Financial Times)



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Ronseal: the verdict

Index (at least the ones I could see) looks pretty sensible

Some concerns, but room for debate

Bigger issue – ‘policy’ and ‘uncertainty’



'Policy'

One interpretation: Obama administration focus on ARRA and healthcare increased uncertainty about future deficits, reducing private spending.

Another interpretation: we're going through a huge recession that I didn't see coming and the papers tell me it's got something to do with deficit. I'm not sure what's going on but I'm scared, so I'm not going spend on that IT upgrade, I'm going to pay off my debts and hoard some cash

Does this research truly identify which of these is true? If not, we should be wary about drawing strong policy conclusions



'Uncertainty'

Economists - 'increase in mean-preserving spread'. Real options, precautionary saving, credit spreads

That's not common usage though, MS synonyms include: 'doubt', 'hesitation', 'ambiguity', 'vagueness', 'improbability'. And it's MS antonym is 'confidence'

I suspect in newspapers, common discourse it's a synonym for 'fear'. Note correlation with VIX – a.k.a 'the fear index'

Would other word searches, more associated with first, not second moments, result in similar looking indices? E.g. 'crisis, meltdown, fear, panic, pessimism'.



To sum up

Strong evidence for animal spirits being an important contributor to recessions and recoveries

But whether this is true ‘uncertainty’ (increase mean-preserving spread) is less clear (despite statistical controls)

US debate since 2008 – huge focus on fiscal situation. A popular view: ‘large deficits are bad news and cause depressions’. ARRA and ACA dangerous.

Not sure if we’re identifying impact of policy uncertainty (second moment) or of impact of that debate on average expectations/demand (first moment)



Keynesian species: Chapter 12 vs. Book 1

Part 1-ers emphasize sticky prices and fundamentals (fiscal tightening) over animal spirits/uncertainty (Chapter 12)

Nick's research reminds me how powerful the ARRA/ACA debate has been in the US, and by implication how political debate can shape expectations

A plea to economists: listen to the anthropologists. Stories are important and shape economic outcomes.

Expectations – uncertainty or fear - are fundamental and not necessarily irrational.