Taking the Measure of Policy Uncertainty
In an ongoing series, scholars examine how turbulent policy may move, shake or paralyze the economy.

Between historic shocks to the economy, political intransigence and gridlock, and the growing size of government’s footprint, ordinary citizens and policymakers alike find it hard to know how best to move forward. Save or spend? Move into a new market, or hold off until the dust settles?

Economic theory suggests—and a mounting body of empirical evidence confirms—that elevated levels of uncertainty inhibit economic performance.

We may not be able to avoid uncertainty, but data and history point to some common sense ways we can limit its negative economic effects. This brief discusses a few of them.

The cost of uncertainty
Economists have long argued that uncertainty discourages firms from investing and hiring, affecting both the business cycle and stock market volatility. Recent studies are now adding empirical weight to theories and analytic models.

To understand its economic costs, we first need to measure the level of policy uncertainty. Economist Steven J. Davis at the University of Chicago Booth School of Business, along with Nicholas Bloom at Stanford University and Scott R. Baker at Northwestern University’s Kellogg School of Management, developed the Economic Policy Index to gauge levels of policy-related economic uncertainty over time. In another analysis of the link between policy uncertainty and economic activity, Baker, Bloom, and Davis analyzed large single-day swings of 2.5 percent or more in the S&P 500 equity market index. They found a much higher number of such large movements in the 2008–2012 period than any other period since World War II. They also found that mainstream newspapers such as the New York Times, Los Angeles Times and Wall Street Journal attributed a large share of these movements to policy-related events and developments.

To look at the effects of economic policy uncertainty on the ground, Davis and his colleagues looked at three kinds of outcomes—investment, employment, and option prices—for a few thousand firms with varying exposure to federal spending, as indicated by the revenue share of their federal contracts.

Each outcome was affected by policy-related uncertainty, as measured by their EPU index. When the EPU index went up, investment rates declined. Firms with greater exposure to government spending saw their investment rates fall more. For employment, the pattern was the same: the greater the exposure to government spending, the greater the slowdown in employment growth when policy uncertainty increased. Options, whose prices reflect uncertainty about firm-level equity returns, told a similar story. In the case of firms heavily exposed to government spending, implied volatility soared when policy uncertainty rose; for firms not exposed, implied volatility changed little.
STEPS WE CAN TAKE TO REDUCE UNCERTAINTY

Policy-related uncertainty may naturally follow on the heels of negative economic shocks, but there are things we can do to reduce that uncertainty and mitigate its effects now, and in the future.

Use automatic stabilizers.
Automatic stabilizers—unemployment insurance spending that goes up when employment falls, for example—offer some advantages over discretionary measures. The fiscal equivalent of an “advance directive,” they kick-in quickly in real time as economic fundamentals change. They don’t need to wait for a legislative act. And while every distribution of federal dollars involves some political infighting, a policy response developed in advance of actual need is more likely to be evaluated primarily on its economic rather than political merits. Finally, those bearing the brunt of the shock—wage earners and businesses—aren’t left wondering when or if some help is on the way.

Take some of the politicking out of policymaking.
A Congress that indiscriminately exercises its right to debate, amend, and delay can produce excessive tug-of-war policymaking that comes with the cost of heightened uncertainty. Asking Congress to skip the dickering and bind itself to a simple up or down vote, as it already does with military base closures and fast-track trade authority, could minimize the drama—and cost—of indecision.

Get some buy-in across the political aisle.
If the Affordable Care Act has taught us anything, it’s this: A party in power can push through a major policy initiative in the teeth of strong political opposition, but it probably shouldn’t. A better strategy is to secure some support across the political aisle, even at the cost of compromise. Persistent attacks on the Affordable Care Act continue to generate uncertainty about its political durability and raise doubts about what the healthcare delivery landscape will look like in the U.S. for many years to come.

Don’t let the dogs out.
Policymakers have learned to be wary of unleashing dogs that bite, such as the protectionist Smoot-Hawley tariffs that inadvertently extended the Great Depression by drying up global trade in the 1930s. Trade suffered in the financial crisis of 2008–09 but did not collapse, thanks in part to the complex web of general, multilateral, and bilateral trade agreements that made it harder and more costly for countries to raise tariff barriers or turn populist anti-trade sentiment to political advantage.

WHAT IS THE EPU INDEX?
The Economic Policy Uncertainty Index is essentially a series of snapshots of economic policy uncertainty over time. It uses digital newspaper archives to quantify newspaper coverage of policy-related economic uncertainty. To this it adds two more ingredients: the number of federal tax code provisions set to expire in future years, and the level of disagreement among economic forecasters about future inflation and future government spending.

The developers of the index find that an increase in the EPU index foreshadows a decline in economic growth and employment in the following months.

Researchers and analysts from the public and private sector are using the index to examine the relationship of policy uncertainty to market fluctuations, business investment, hiring activity and other economic indicators. An International Monetary Fund working paper published in April 2014, for example, used EPU index data for India and found evidence that economic policy uncertainty played an important role in the recent slowdown of investment in that country.

Data sets, research papers, and a complete discussion of EPU index methodology can be found at www.policyuncertainty.com.

ABOUT THIS RESEARCH
The Gary Becker Milton Friedman Institute for Research in Economics advances inquiry that illuminates our choices, our economy, our society, and our future. It supports research initiatives touching on key economic and policy questions. This brief, produced with the generous support of the MacArthur Foundation, is the first in a series exploring the effects of uncertainty.

To view the accompanying video or learn more about the project, visit bfi.uchicago.edu/policyuncertainty.