Discussion of “Measuring Economic Policy Uncertainty” by Baker, Bloom, and Davis

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Very interesting and topical paper

Two contributions:

1. Construct an index of policy uncertainty
2. Look at how that index correlates with business cycle
Three related themes:

1. What is the index measuring?
2. What is the mechanism accounting for empirical relationship between index and economic activity?
3. How large are the effects?
Index composed of three parts:

1. News index
2. Upcoming tax code expirations
3. Forecast disagreement

In baseline index, news component gets largest weight

Disparate sources: both a strength and a weakness

- **Strength:** broadest possible coverage
- **Weakness:** very different kinds of policy – fiscal (tax code expirations) and monetary (CPI disagreement)
  - CPI disagreement may not even be related to policy: e.g. oil price shock uncertainty
Search over ten major newspapers for words in three separate categories: “uncertainty,” “economy,” and “policy”

Weighted to control for volume of news

Potential concern: more talk about policy when there is a need for policy – e.g. when economy is weak
  - Increasing volume of news about economy when economy is bad?
  - Perhaps weight “uncertainty” mentions by overall number of stories about economy to partially address this issue

Other concern: when journalists say “uncertainty,” do they mean the same thing economists do?
What do economists and journalists mean by an increase in “uncertainty”? 

Economists: mean-preserving spread

\[ \uparrow \text{var}(s_{t+j}), \quad \Delta E(s_{t+j}) = 0 \]

Journalists: down-side risk

\[ \uparrow \text{prob}(s_{t+j} < s) \]
What do Journalists Say?

- “... economic uncertainty as concerns about weak growth at home and abroad.” – Phil Izzo, *WSJ*

- “I’d define economic uncertainty as a force depressing output by deterring businesses and/or consumers from making investments or purchases because they feel there’s a high chance economic conditions will deteriorate or not improve enough in the future.” – Dylan Matthews, *Washington Post*

- “It [uncertainty] seems prevalent at turning points in the business cycle. If we’re headed into a recession, and the depth and severity of the recession is unknown, that’s going to generate a whole lot of uncertainty.” – Annie Lowrey, *NYT*
What is the Mechanism?

- IRFs are quite protracted: small impact effects, takes more than a year for peak negative effect
- Not consistent with conventional “wait and see” dynamics from real options intuition
- Explanations:
  - Uncertainty index picking up bad news / low confidence
  - Precautionary saving (Fernandez-Villaverde, et al, 2011) and nominal rigidities (Basu and Bundlick, 2011)
  - Search frictions: Schaal (2011)
BBD compute IRFs to a 112 point shock to uncertainty index (equal to rise in index from 2006-2011), find IP 4% lower

This is about 8 times the standard deviation of uncertainty innovations in the VAR

Largest realized uncertainty shock since 2006 is 66 points

Also many negative realizations of shocks since 2006

Uncertainty index reacts to other shocks in system via VAR coefficients (in particular IP and stock market innovations)
Variance Decomposition and Historical Decomposition

- **Conventional variance decomposition:**
  - Uncertainty shocks account for maximum of 14% of IP forecast error variance. Maximum of 5% if you include consumer confidence in VAR ordered first.
  - At 2 year horizon, when ordered first in system without confidence, 40% of forecast error variance of uncertainty index accounted for by other orthogonal “shocks”

- **Historical decomposition:**
  - Take VAR coefficients and realized orthogonal “shocks” and simulate out data with or without some of the “shocks”
  - Counterfactual simulation: simulate data post 2006 in which all realizations of uncertainty shocks are 0. All other “shocks” as identified in data
At trough, uncertainty accounts for about 2 percentage points of IP decline

Would have observed higher uncertainty without uncertainty shocks
Concluding Thoughts

- Nice paper: really important topic, produces an important new data series
- Concerns: interpreting series not straightforward, probably overstating economic impact of movements in series
- Agenda moving forward:
  - Exogenous variation in uncertainty series (e.g. Baker and Bloom, 2012)
  - Uncertainty as propagation mechanism for other shocks
  - Mechanisms other than physical adjustment frictions