

Policy Uncertainty, Investment, and the Cost of Capital

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Highlights

- Policy uncertainty weakens the sensitivity of investment to the cost of capital.
- Effect is stronger for firms that are more opaque.
- Effect is stronger for firms with high government dependency.
- Policy uncertainty distorts the fundamental investment-cost of capital relationship.

Abstract

We examine the effect of economic policy uncertainty on the relation between investment and the cost of capital. Using the news-based index developed by Baker, Bloom, and Davis (2016) for twenty-one countries, we find that the strength of the negative relation between investment and the cost of capital decreases during times of high economic policy uncertainty. An increase in policy uncertainty reduces the sensitivity of investment to the cost of capital most for firms operating in industries that depend strongly on government subsidies and government consumption as well as in countries with high state ownership. Consistent with the price informativeness channel, we find that an increase in policy uncertainty reduces the investment-cost of capital sensitivity for firms from more opaque countries, firms with low analyst coverage, firms with no credit rating, and small firms. We conclude that economic policy uncertainty distorts the fundamental relation between investment and the cost of capital.

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^e We thank two anonymous referees, Iftekhar Hasan (Editor), Narjess Boubakri, Joseph Clougherty, Ettore Croci, Simon Döring, Ralf Elsas, Michael Halling, Florian Heider, Emanuel Moench, Peyman Momtaz, Per Östberg, Tatjana Puhan, Christoph Schneider, Henning Schröder, and participants at the 2017 Paris Financial Management Conference, the 2018 Eastern Finance Association Conference, the 2018 Swiss Finance Association Conference, and the 2018 Financial Management (Europe) Conference for helpful comments. We appreciate the generous financial support from Canada's Social Sciences and Humanities Research Council.

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