Does US partisan conflict matter for the Euro area?

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HIGHLIGHTS

- We investigate how US partisan conflict affects the Euro area economy.
- We document a negative and significant effect on European industrial production.
- The effect is deeper and more persistent than a US policy uncertainty shock.
- US partisan conflict is a significant source for European variable fluctuations.

ARTICLE INFO

ABSTRACT

This paper highlights the international transmission of *political uncertainty* originated from a US partisan conflict shock, a newly identified shock that transmits a type of uncertainty beyond the economic *policy uncertainty* spillovers identified by Colombo (2013). Using the recently developed US Partisan Conflict Index (USPC) developed by Azzimonti (2014), we find that a one standard deviation USPC shock leads to a 0.2 percent decline in European industrial production. We also show that, compared with US policy uncertainty shocks, a shock to US partisan conflict creates deeper and more persistent spill-over effects to the Euro area.

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1. Introduction

As the world is more financially and economically integrated, domestic shocks from one country are increasingly likely to be transmitted across borders. Colombo (2013) showed that heightened economic policy uncertainty in the United States could have a detrimental impact on the European economy. Over the past decade, political conflict in the US has become much more severe. At the same time, evidence shows that Europeans believe that the US and US politics matter in global affairs.[2] Whether US

political uncertainty, which can stem from a partisan conflict shock, as opposed to US *policy uncertainty shocks*, which can be triggered by factors that are completely unrelated to political conflict, spill over to the rest of the world becomes an important question for economists and political scientists alike. As Azzimonti (2014) notes, an intensification of partisan conflict creates uncertainty about which policies politicians will choose. This is distinct from uncertainty over the *effects* of existing government policies, which is generated by economic policy uncertainty shocks.

There is a literature investigating the domestic impact of political shocks. Azzimonti (2015) proposes that a partisan conflict shock can cause a reduction in private investment by raising

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  [2] From 2003–2006, in every European Commission's Eurobarometer Survey, at least 70% of respondents believed that the US played either a positive or

negative role regarding growth of the world economy. Additionally, a 2009 survey conducted by the Wall Street Journal found that most Europeans felt that American political influence over the period 2004–2009 had been negative (http://www.wsj.com/articles/SB124534162608828017).
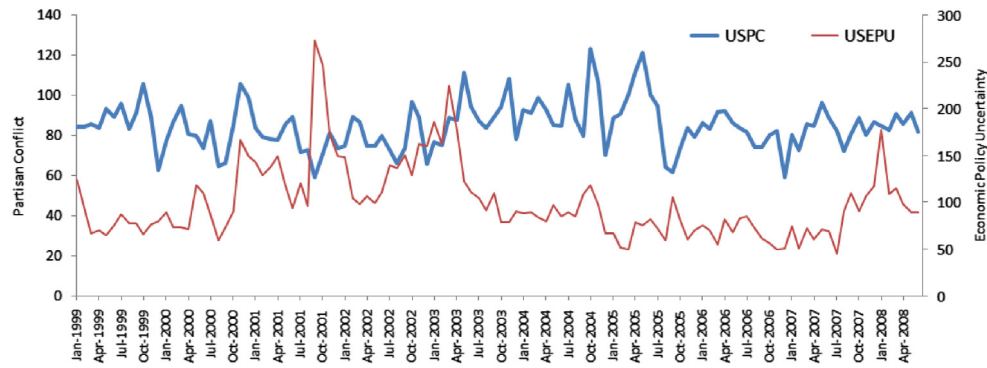

Fig. 1. US Partisan conflict index and economic policy uncertainty: 1999–2008. Note: The left axis measures the USPC index and the right axis measures the USEPU index.

uncertainty about government policy. Azzimonti and Talbert (2014) theorized that more frequent political turnover and a higher degree of political polarization will lead to more economic policy uncertainty. Using a news-based measure of economic policy uncertainty from Brogaard and Detzel (2015) for nineteen developed and developing countries, they show a positive correlation between own-country political polarization and economic policy uncertainty.

This paper hypothesizes further that more intense partisan conflict will have an economic impact not only in the US but also in the Euro area. As European economic agents have become more aware of the influence that US politics can have on the global economy, political gridlock in the US may prompt Europeans to postpone consumption because of a precautionary saving motive as well to defer investment due to the increase of the option-value of waiting (Bloom, 2009). Moreover, the US has a close trading relationship with the Euro region. As output and employment decline in the US after a political shock, European economies can suffer due to a decreased demand for their exports.

We investigate the question of interest by building on Azzimonti (2015). Using Azzimonti's novel Partisan Conflict Index (USPC), and after controlling for economic policy uncertainty and macroeconomic indicators, we show that a one standard deviation shock to USPC is associated with a 0.2% decline in European industrial production and the negative effect lasts for up to eighteen months. Furthermore, we find that the effect of a partisan conflict shock on the Euro area is deeper and more persistent than policy uncertainty shocks identified by Colombo (2013). These results thus extend a growing literature showing how political disagreements can have real economic consequences both domestically and internationally.

The remainder of the paper is organized as follows. Section 2 focuses on the data and the empirical model. Section 3 discusses the results and Section 4 concludes.

2. The empirical model

The effects of a partisan conflict shock are estimated through the following vector autoregression (VAR) model:

$$B(L)y_t = d + \epsilon_t$$

where y_t represents a vector of endogenous variables, d is a vector of constant terms and ϵ_t are the reduced-form residuals, fulfilling $E(\epsilon_t) = 0$ and $E(\epsilon_t\epsilon_t') = \Sigma$. $B(L)$ is given by $= I + B_1L + B_2L^2 + \cdots + B_NL^N$, where N is the lag length of the VAR model.

The following variables are included in the VAR model: the US partisan conflict index ($USPC_t$), the US consumer price index ($USCPI_t$), the US industrial production index ($USIP_t$), the federal funds rate ($USFFR_t$), the US economic policy uncertainty index ($USEPU_t$), the consumer price index for the Euro area ($EAHCPI_t$),

the European industrial production index ($EAIP_t$), the three-month interest rate for the Euro area (EAR_t) and the European economic policy uncertainty index ($EAEPU_t$).

We follow Colombo (2013) and employ monthly data from 1999M1 to 2008M6 in our estimation. Our sample's starting date is based on the creation of the Euro area and the chosen end date helps ensure that we avoid any non-linearities that might be a result of the financial crisis. $USPC_t$ refers to the news-based Partisan Conflict Index (USPC) developed by Azzimonti (2014).[3] We proxy for $USEPU_t$ and $EAEPU_t$ using the news-based components of the economic policy uncertainty (EPU) indexes developed by Baker et al. (2015).

Fig. 1 displays the USPC Index and the news-based USEPU index and shows that uncertainty over economic policy can be high during periods of political calm and vice versa.[4] Azzimonti (2014, 2015) suggests that during periods of high partisan conflict, where meaningful policy is unlikely to be passed, investors and consumers will expect the policy status quo to persist, making economic policy uncertainty low. Furthermore, she shows that the USPC index is mainly driven by political factors whereas the EPU index can be affected by financial shocks and monetary policy.

All variables, except for the federal funds rate and the European interest rate, are expressed in log values. The industrial production indexes and consumer price indexes for both the US and the Euro area are detrended with a linear time trend.[5] In the baseline specification, we assume the following ordering:

$$y_t = [USPC_t, USCPI_t, USIP_t, USFFR_t, USEPU_t, EAHCPI_t,$$
$$EAIP_t, EAR_t, EAEPU_t].$$

The model is estimated with Bayesian methods using four lags. To recover the structural shocks from the residuals, we follow a standard Cholesky decomposition approach. In line with Colombo (2013), we order the US block before the European block and order policy uncertainty last within each block.

We also assume that USPC does not respond to lagged values of other US and European variables by imposing tight zero-mean priors to shrink the coefficients of the relevant parameters to zero. The rationale is that increased political conflict likely originates during election periods or is due to increased political polarization.[6]

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[3] This is available at https://www.philadelphiafed.org/research-and-data/real-time-center/partisan-conflict-index/.

[4] The unconditional correlation between the two indexes is −0.17.

[5] Data sources: Federal Reserve Bank of St. Louis, European Central Bank, and the Economic Policy Uncertainty website, http://www.policyuncertainty.com/.

[6] As robustness checks, we also consider: (i) relaxing the exogeneity assumption on the USPC index (ii) different lag length specifications; (iii) introducing additional variables to the VAR, i.e. S&P 500 Index, Euro Stoxx 50 Index, nominal exchange rate, and consumer sentiment index; and (iv) different orderings within each country-specific block. None of these change the results significantly. These results are available in Appendix A.