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Aaron Popp* and Fang Zhang†

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Abstract

This paper studies the macroeconomic effects of uncertainty shocks with an emphasis on the interaction between elevated uncertainty and credit market conditions when the economy is in different regimes (recessions vs. non-recessions). We use a smooth-transition factor-augmented vector autoregression (ST-FAVAR) and a large monthly panel of U.S. macroeconomic and financial indicators in our estimation. Our findings are twofold. First, while an unanticipated increase in uncertainty has adverse effects on the real economy and financial markets, the effects are quantitatively larger during recessions. Second, the financial channel is important in the transmission of uncertainty shocks, with a greater role during recessions and in the short run.

JEL Classifications: E32, E37, E44, C32, C53

Keywords: uncertainty shocks, credit spread, recessions, smooth-transition vector autoregression, dynamic factor analysis

1 Introduction

Between 2007 and 2009, the U.S. economy experienced an elevation in uncertainty and one of the most tumultuous financial and economic periods since the Great Depression. It renewed interest

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