

CAUSALITY BETWEEN US ECONOMIC POLICY AND EQUITY MARKET UNCERTAINTIES: EVIDENCE FROM LINEAR AND NONLINEAR TESTS

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This paper examines the causal relationship between economic policy uncertainty (*EPU*) and equity market uncertainty (*EMU*) in the US. We use daily data on the newly developed indexes by Baker et al. (2013a) covering 1985:01:01 to 2013:06:14. Results from the linear causality tests indicate strong bidirectional causality. However, the parameters stability tests show strong evidence of short-run parameter instability, thus invalidating any conclusion from the full sample linear estimations. Therefore we turn to nonlinear tests and observe a stronger predictive power from *EMU* to *EPU* than from *EPU* to *EMU*. Using sub-sample bootstrap rolling window causality tests to fully account for the existence of structural breaks, we find evidence that *EPU* can help predict the movements in *EMU* only around 1993, 2004 and, 2006. However, we find strong evidence that *EMU* can help predict the movements in *EPU* throughout the sample period barring around 1998, 2003 and 2005.

JEL classification codes: C32, E61, G12, G18

Key words: economic policy uncertainty, equity market uncertainty, Granger causality

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I. Introduction

Over the past thirty years, a number of researches have focused on the effect of economic policy uncertainty on macroeconomic variables: economic growth, inflation, investment and employment (Bernanke 1983; Rodrik 1991; Bloom 2009; Bachmann et al. 2013; Jones and Olson 2013, among others). The general consensus is that policy uncertainty has a negative effect on economic growth and investment but a less clear-cut effect on inflation. The recent global financial crisis with the accompanying volatility in the equity market has kindled a protracted and high-profile debate over the role of key economic policies. This has primarily surrounded the European debt crisis and the US fiscal cliff and debt ceiling concerns, but also includes debate over such other policies as healthcare and financial services regulation (Fishman et al. 2012). It is believed that the recent increasing focus on economic policy uncertainty undoubtedly suggests the role it plays in economic growth and the equity market (Fishman et al. 2012).

Further, many investors argue that recent equity volatility levels are as much about policy as economics and corporate earnings. According to Li et al. (2013), “stock markets usually move swiftly and sharply in response to policy changes. Tax cuts, monetary easing or financial deregulation would send the stock markets soaring. On the contrary, quantitative easing withdrawal would send the stock markets crashing.” However, Li et al. (2013) note that the extent to which the stock market would be impacted by policy changes (whether good or bad) depends on the certainty about such policy changes. Taylor (2010) and Hoshi (2011) suggest that high policy uncertainty in relation to the resolution of large bankrupt financial institutions has worsened or prolonged the recent financial crisis in the United States. Hatzius et al. (2012) argue that the economy’s poor performance has been caused by an exogenous increase in US policy uncertainty.

This study intends to contribute towards the study of the effects of economic policy uncertainty, focusing on its effect on the US equity market performance. Specifically, we examine the causal link between two interesting new indexes, the US economic policy uncertainty index and the equity market uncertainty index developed by Baker et al. (2013a). We consider both the direction and magnitude of the causal and reverse causal effects. The choice for the US is justified because it is the only country with these indexes. A number of studies have investigated the relationship between economic policy uncertainty and equity market uncertainty

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