Straw Man Bites the Dust
By Steven J. Davis

Paul Krugman, in a recent *New York Times* article, attacks the view that policy uncertainty has impeded economic recovery. I respond here to some of Krugman’s remarks, especially as they relate to my work with Scott Baker and Nick Bloom on measuring policy uncertainty and assessing its effects.

Krugman observes, correctly, that our U.S. index of economic policy uncertainty (EPU) has returned to levels not seen since 2008. The recent plunge in the index comes on the heels of this January’s “Fiscal Cliff” resolution and the implementation, starting in March, of the federal spending “sequester.” These policy outcomes had been the subject of much contention, analysis, speculation, and uncertainty. They have large implications for federal spending and tax revenues, as well as large projected effects on macroeconomic outcomes, as analyzed by the Congressional Budget Office here, here, and here. So it is reassuring that our EPU index shows high levels of uncertainty about whether and how the Fiscal Cliff and sequester would be implemented, and the resolution of that uncertainty in early 2013.

Krugman makes the following argument: Because the U.S. “economy didn’t take off” after the recent plunge in our EPU index, policy uncertainty hasn’t been a problem. That is unpersuasive. Krugman puts up a straw man – that policy uncertainty is the sole or dominant driving force behind recent movements in
output and employment – and knocks it down. Having bested the straw man, he dismisses the idea that policy uncertainty matters.

Many factors affect the performance of the economy, and it is hard to isolate the effects of particular developments. One need not look far, however, to find plausible explanations for why the U.S. “economy didn’t take off” in recent months. The Fiscal Cliff tax hikes and sequester-imposed spending restraints are slowing GDP growth and lowering employment. State and local government budgets remain tight, eurozone problems continue to fester, and growth prospects in China and other major emerging-market economies appear to have slipped. Negative effects of the financial crisis, real estate bust, and worker displacements cast a long shadow. Slow U.S. growth in 2013 is no mystery.

Krugman criticizes our measure of policy uncertainty because it partly relies on the frequency of newspaper articles that reference policy-related economic uncertainty. In his New York Times column, he suggests that the EPU index surged in recent years because “economic policy uncertainty” became a Republican talking point. In a previous blog post, he suggests that the “Murdoch empire” might be responsible for pushing our EPU index to high levels in recent years.

Although not backed by any systematic evidence, these remarks touch on interesting issues related to our EPU index and other news-based indices of politically sensitive matters. Before I briefly remark on some of the issues, a small point: the phrase “economic policy uncertainty” is not enough to flag a newspaper article for inclusion in our index. Based on a human audit of a few thousand randomly sampled articles, my coauthors and I modified our list of policy-related
terms in November 2012, as discussed here and here, and “policy” did not make the cut. Since then, our website has featured the revised U.S. EPU index.

In addition to the news-based component, our EPU index has three other components. All of them show elevated levels from 2009 to 2012, as well as recent declines. The widest swings occur in our index component for federal tax code provisions scheduled to expire in coming years. These swings reflect the Fiscal Cliff resolution and earlier political battles over extending the Bush-era tax cuts. Our other two index components, one measuring disagreement among professional forecasters about expected future inflation and the other measuring disagreement about expected future government purchases, show smaller swings. The point is that other components of our index support the view that policy uncertainty was at high levels in recent years. Krugman seems to oscillate between viewing policy uncertainty as a propaganda campaign and viewing it as the fault of Republicans and Europeans.

Our working paper considers other evidence about movements in economic policy uncertainty over time. One of our investigations relies on the Beige Book report issued every six weeks by the Federal Reserve System. These reports summarize anecdotal information, gathered by regional Fed Banks in advance of FOMC meetings, about current economic conditions. The Beige Book yields a story about the evolution of policy uncertainty that is similar to the one told by the news-based component of our EPU index. In particular, the phrase “economic uncertainty” appears in the Beige Books with historically high frequency from 2010 to 2012, and the frequency drops sharply after January 2013. This pattern is even
more pronounced for Beige Book passages that attribute concerns about economic uncertainty to policy-related factors.

Are Republican talking points and Rupert Murdoch acolytes also driving the frequent expressions of concerns about policy-related economic uncertainty in the 2010-2012 Beige Books? Or do business people, market experts, and professional economists express concerns about economic uncertainty to the Fed when they actually have those concerns? Taking the straightforward interpretation, the Beige Book analysis reinforces the view that emerges from our EPU index, the news-based component in particular.

To be sure, there are serious questions about how accurately frequency counts of newspaper articles mirror an underlying economic reality. Political organizations, government officials, journalists, and pundits seek to influence perceptions about policy issues through newspapers and other popular media. It’s plausible that they succeed to some extent, and that newspapers slant their coverage in one direction or another. My coauthors and I find evidence of political slant in newspaper coverage of policy uncertainty. Positioning newspapers on a left-right ideological scale, using the measure developed by Matt Gentzkow and Jesse Shapiro, we find that right-wing papers play up policy uncertainty relative to left-wing papers when a Democrat holds the presidency, and vice versa when a Republican sits in the Oval Office. These media slant effects are modest in size for the set of mainstream newspapers that inform our index. More to the point, “left” and “right” versions of our news-based EPU index tell very similar stories about the evolution of policy-related uncertainty over time.
Krugman sees the frequency counts in our EPU index as reflecting a “phony fear factor,” a fiction foisted on newspaper readers to preserve the privileges and power structure of “captains of industry” and other wealthy elites. This is an interesting hypothesis, but it doesn’t fit the available evidence – certainly not in the extreme form advanced by Krugman. I also find it hard to picture the New York Times, for example, in the role of reliable right-wing stooge, faithfully echoing and amplifying Republican talking points. Still, there might be something to the notion that partisans and powerful interest groups influence the time-series behavior of our EPU index. Direct evidence on the matter would be interesting.

Many recent studies use our EPU index and other indicators to investigate the effects of policy uncertainty on investment, employment, output, and asset prices. In an analysis of firm-level panel data, my coauthors and I find that increases in policy uncertainty reduce investment and employment, more so at firms with greater exposure to government contract awards. At the macro level, positive shocks to our U.S. EPU index foreshadow declines in U.S. investment, output, and employment. An interesting analysis by researchers at the International Monetary Fund finds that policy uncertainty emanating from the United States and Europe depresses output in other regions of the world. The results in these and other studies also undermine Krugman’s contention that policy uncertainty is a phony factor. It’s either a real and important factor, or it proxies for an important factor that is otherwise missing in the standard measures considered by economists. Either way, the EPU indices are proving useful in research.
The question for policymakers is not whether “uncertainty is the problem,” as Krugman puts it. (Emphasis added.) One relevant question is whether instability in and lack of clarity about policy matters have played a role in the disappointing performance of the U.S. economy in recent years - and in Europe, for that matter. The evidence suggests they have. To quote from a short paper I wrote with Baker and Bloom in February 2012, the lesson is obvious: “If U.S. policymakers can deliver a policy environment characterized by greater certainty and stability, there will likely be a positive payoff in the form of improved macroeconomic performance.”

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