Policy Forum: Uncertainty and the Business Cycle – Some New Findings

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Uncertainty has been a pretty hot topic among academics and economists working in policy circles since the global financial crisis. I believe we now know a lot more about its effects on the business cycle for a variety of countries than we used to know before the crisis. Uncertainty tends to be recessionary; it exerts stronger effects when the economy is already experiencing difficulties from an aggregate standpoint, or when financial markets operate less smoothly; it tends to harm macroeconomic policies' effectiveness.

In spite of the impressive amount of knowledge cumulated so far, gaps in the literature are still present. First, we do not know much on how long term rates respond to uncertainty shocks. While dynamic stochastic general equilibrium models approximated at a third order offer predictions on how the term structure responds to uncertainty shocks, the literature has basically not produced yet many model free reduced-form type of regressions on the link between uncertainty and the long rates. This is a big whole, given the relevance on long rates for consumption and investment decisions. Second, we need to sharpen our understanding on monetary policy risk management. Uncertainty is clearly relevant from a policy standpoint. But do policymakers systematically monitor uncertainty? And, as a related question, do they disagree on the economic outlook, and if so, does this influence their decisions? Third, we need proxies for uncertainty for a broader set of countries than the G7 ones. How does uncertainty evolve in a country as New Zealand as opposed to, say the United States?

This special issue addresses all these questions. The first paper, "Yield Curve and Financial Uncertainty: Evidence Based on US Data", estimates the response of the US yield curve to a jump in financial uncertainty. I address this question by conducting a local projections analysis with US monthly data, period: 1962-2018. I find both ends of the yield curve to respond negatively and significantly. The response of the short end of the yield curve is stronger than that of the long end, i.e., a financial uncertainty shock causes a temporary steepening of the yield curve. This result is consistent, among other interpretations, with medium-term expectations of a recovery in real activity after a financial uncertainty shock.

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Turning to the impact of uncertainty on policy decisions, Natalia Ponomareva, Jeffrey Sheena, and Ben Zhe Wang construct a novel measure of uncertainty using expert monetary policy recommendation data for Australia. Their results suggest that the Reserve Bank of Australia tends to lower the cash rate when expert uncertainty is high. This result, which is robust to using other uncertainty measures, point to the possibility of a risk management-type of approach by the Australian monetary policymakers.

Last but not least, Trung Duc Tran, Tugrul Vehbi, and Benjamin Wong construct two novel uncertainty indices for New Zealand by exploiting two separate data-rich environments. The first index follows a data-rich approach to construct an estimate of uncertainty based on a large New Zealand macro dataset. The second index is built up by using freely accessible and real time Google Trends data to provide a real-time and freely-accessible measure of uncertainty. Both indices do a reasonable job measuring uncertainty in New Zealand. VAR evidence documents significant impacts of uncertainty shocks on GDP in New Zealand.

All three pieces of this special issue represent high quality research that should prove useful for both academics and economists working in policy circles. I have certainly learnt a lot out of my reading of them. I wish our readers to enjoy these articles as much as I did.

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