How certain are we about the role of uncertainty in the economy?

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Abstract

Although the causes and consequences of uncertainty in the US economy have attracted a strong research interest over the past decade, the literature still lacks a consensus on several aspects. To name two matters of debate, it is unclear whether uncertainty shocks are a source or the result of recessions and whether uncertainty shocks have adverse (or even stimulating) effects on the economy. We find that ambiguous results in these regards can be traced back to the selection of an appropriate identification strategy in structural vector autoregressive (SVAR) models. As a potential solution, we propose an easy-to-employ identification approach that utilizes tools of independent component analysis (ICA). In addition, ICA-based identification allows straightforward model augmentation as an elegant means to reconsider the results of some prominent studies that point to realized volatility as the actual trigger of economic slowdowns rather than uncertainty shocks. Moreover, we assess the transmission channels of different types of uncertainty shocks (macroeconomic vs. financial) to the real economy. Overall, we find that all considered uncertainty types are exogenous to business cycle fluctuations and cause economic slowdowns. Our results show that realized volatility is the result of economic and financial turbulence, not the cause. Moreover, while financial uncertainty is transmitted to the real economy solely through financial market frictions, macroeconomic uncertainty is channeled through both a tightening of financial market conditions and wait-and-see effects.

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