



## Financial Crises and the Dangers of Economic Policy Uncertainty

By John H. Makin

*Economic uncertainty exists if the probability of outcomes cannot be estimated. Economic policy uncertainty exists when the probability of a given policy path cannot be estimated and the outcomes tied to alternative as-yet-unknown paths cannot be estimated either. Recovery from financial crises is so slow because they create sharply elevated economic policy uncertainty that policymakers often are unequipped to deal with or respond to poorly. Only when the Federal Reserve and lawmakers begin to take steps to reduce the uncertainty in the economic climate will the US economy begin to show signs of growth.*

Empirical research by Scott Baker, Nicholas Bloom, and Steven J. Davis has shown that the economic benefits of steps to reduce economic policy uncertainty would be substantial.<sup>1</sup> They have constructed a measure of economic policy uncertainty derived from a combination of factors, including the frequency of media references to economic policy uncertainty, the number of tax code preferences set to expire, and the degree of forecasters' disagreement over future inflation and government purchases. They then conducted a statistical analysis to measure the negative impact on employment and output arising from separate policy uncertainty shocks. They found the magnitude of policy uncertainty shocks (figure 1) arising between 2006 and 2011, the largest of which are linked to the post-Lehman Brothers financial crisis in the United States and Europe, to be sufficient to have cut private investment by 16 percent over three quarters, industrial production by 4 percent after 16 months, and employment by 2.3 million within two years.

The spike in policy uncertainty tied to the onset and aftermath of the 2008 financial crisis was unavoidable. That fact accounts in large part

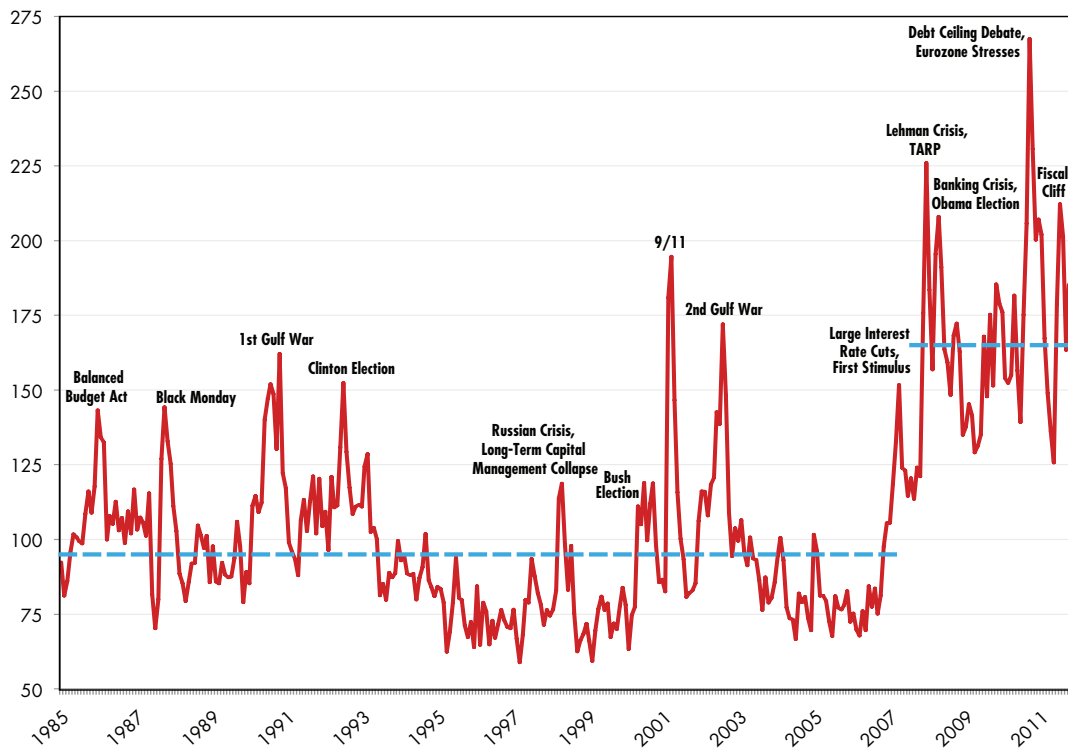
for the intensity of what has come to be known as the Great Recession in the United States. That said, since 2010, too many policy responses, including the debt ceiling debacle of mid-2011, the morass of indecipherable legislation in the Dodd-Frank Act, Obamacare, the latest quantitative easing experiment (QE3), and the fiscal cliff have all contributed to prolonging the recession, especially for American workers unable to find

### Key points in this Outlook:

- Economic policy uncertainty in the United States has built up since the 2008 financial crisis, hindering our economic growth.
- Uncertainty harms the economy by reducing consumers' level of spending on goods and services and lowering levels of investment and hiring by firms.
- Economic policymakers must focus not on experimental policy responses, but rather on reducing the high level of economic policy uncertainty by simplifying the tax system and avoiding new initiatives like the Federal Reserve's QE3.

John H. Makin (jmakin@aei.org) is a resident scholar at AEI.

FIGURE 1  
INDEX OF US ECONOMIC POLICY UNCERTAINTY



NOTE: Dashed lines indicate average uncertainty over the periods of 1985–2008 and 2008–2012.  
SOURCE: Scott Baker, Nicholas Bloom, and Steven J. Davis, [www.policyuncertainty.com](http://www.policyuncertainty.com).

jobs. In addition, Europe’s indecisiveness has precluded articulation of a clear path toward recapitalization of its ailing banks. Economic policymakers should begin to reduce uncertainty surrounding their responses to the financial crises in America and Europe; I will offer some suggestions for how to do this later in this *Outlook*.

### What Uncertainty Does

It is important for policymakers to understand why policy uncertainty harms the economy. Uncertainty causes households and firms to delay decisions until the uncertainty is resolved or at least substantially diminished. Symptoms of responses to elevated uncertainty include reduced levels of spending on goods and services by households and reduced levels of investment and hiring by firms. Firms and households may respond to higher uncertainty by accumulating larger precautionary cash balances, both as a way to deal with a wider range of unexpected contingencies and as a way to have ready resources to employ once uncertainty is removed. Cash

provides optionality, which becomes more valuable as the world becomes more uncertain.

The desire to increase optionality in states of elevated uncertainty complicates policymakers’ work after an event like a financial crisis that increases uncertainty about the value of future real assets. Holders of these assets sell them for cash, whose future value is least sensitive to the state of the world, save for value changes related to uncertainty about the prospective rate of inflation. In a sense, a rush into cash that reflects less spending preordains a fall in inflation that could become self-reinforcing after a financial crisis since falling inflation, or deflation, boosts the real return of holding cash. This is why central banks need to supply extra liquidity after a crisis to avoid a dangerous self-reinforcing deflation that further exacerbates the run into cash.

### Responses to Financial Crises

A financial crisis, like that of 2008, sharply elevates uncertainty about the future path of the economy.

Economic policy, especially monetary and fiscal policy, is meant to reduce uncertainty by providing liquidity (monetary policy) and demand (fiscal policy and monetary policy) to stabilize the economy when households and firms are sharply cutting outlays in the face of sharply elevated uncertainty. However, as Frank Knight observed in *Risk, Uncertainty, and Profit*:

The use of resources in reducing uncertainty is an operation attended with the greatest uncertainty of all. If we are uncertain as to the results of ordinary business operations, we are doubly so as to the results of expenditures along any of the lines enumerated looking to the increase of knowledge and control.<sup>2</sup>

A shock as substantial as the 2008 financial crisis presented policymakers with a sudden disaster for which obvious solutions did not exist. The Fed and the Treasury proposed the Troubled Asset Relief Program (TARP) shortly after the September 2008 Lehman collapse to help recapitalize banks. Congress at first rejected this proposal as a bailout for those who caused the crisis. Resulting intensification of the crisis, abetted by a jump in uncertainty tied to rejecting the TARP proposal, caused Congress to relent and pass TARP.

Early 2009 brought what turned out to be a poorly designed fiscal stimulus package that both underestimated the severity of the crisis and misapprehended its nature. The large transfers to government employees and hastily devised public works projects were far from optimal responses to the large wealth losses in the midst of elevated uncertainty that occurred late in 2008 and early 2009. Business-as-usual, temporary measures like the Cash for Clunkers incentive program were initiated abruptly and then revoked, sometimes just as abruptly, compounding the uncertainty attached to such ad hoc policy. Payroll tax cuts and extensions of unemployment benefits were considered, rejected, and then later enacted a year at a time only after the economy was losing the temporary momentum it had gained and then lost in the wake of stop-and-go fiscal stimulus measures.

## Monetary Policy Uncertainty

The Fed had to contend with uncertainty surrounding extemporaneous policy measures once it pushed interest

rates to zero early in 2009. Quantitative easing was controversial and experimental, with some opining that it would lead to hyperinflation while others, seeing it as too limited in scope, predicted deflation. The Fed had to feel its way from QE1 in 2009 to QE2 in 2010, with the latter partly driven by signs of emerging deflation. The

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Fed implemented Operation Twist, aimed toward lowering long-term rates, in September 2011 and QE3 in August 2012, introducing yet another experimental phase of monetary policy that included targeting unemployment and committing the Fed to leave stimulus in place longer than usual after the economy had recovered. The Fed hinted strongly at a greater tolerance for higher inflation. At the least, its target level for inflation became more uncertain.

As the Fed struggled with its own post-crisis extemporaneous monetary policy, uncertainty was further elevated by two additional policy measures. The Dodd-Frank legislation designed after the crisis to further regulate the financial system introduced massive uncertainty surrounding bank operations that remains very much in place today. Much of the intent of the legislation has yet to be fleshed out with operational interpretations.

Second, Congress raised uncertainty, as already noted, by constantly bickering about whether and when to extend tax cuts and other stimulus measures. In mid-2011, it threatened not to extend the debt ceiling, managing to lose a AAA rating for US Treasury debt. As if this was not enough, Congress legislated a huge collection of tax and spending and measures that expire simultaneously on December 31, 2012, creating a so-called "fiscal cliff." If they are not modified, the measures expiring will subtract 4 percentage points from the tepid 1.5 percent growth rate now in place, throwing the US economy decisively into recession in early 2013.

Since the expiration date follows a presidential election and coincides with a lame-duck Congress, uncertainty has surged concerning what action the government might or might not take to mitigate the fiscal cliff. Add to this the recession in Europe and a rapidly slowing Chinese economy, and it is little wonder JPMorgan reports that global business equipment spending looks set to have declined at a 4 percent annual rate during the third quarter. It is hard to imagine a pickup in the fourth quarter, given the looming fiscal cliff and uncertainty about the policies the next administration and Congress will follow.

## Crises and Uncertainty

Economic crises elevate economic policy uncertainty because they occur infrequently and unexpectedly. Policy-makers do not know how to react because in most cases they have spent precrisis months denying that a crisis is coming. Onset of a crisis forces rapidly formed policies and actions that, at least in hindsight, are far from optimal.

The substantial wealth losses for households and financial institutions that have followed the crisis have prolonged its negative impact, save for well-managed firms that have been able to sharply reduce costs and boost profits at the expense of labor. Policy uncertainty, especially tied to the new health care legislation, makes it difficult for firms to estimate the cost of adding to labor, so they tend to substitute capital as a means to enhance productive capacity.

We have had four years of extemporized monetary policy—some of it well-executed but now being pushed into a highly experimental phase—and ad-hoc fiscal measures financed with low-interest debt that Congress and both presidential candidates say has to stop growing. Economic uncertainty is choking the economy simply because there is no clear path toward the next steps for monetary or fiscal policy, let alone the morass of regulatory changes embodied in Dodd-Frank and Obamacare.

To say that the effect of economic outcomes will occur in 2013 and beyond cannot be estimated in November 2012 is something of an understatement. If uncertainty is

not substantially reduced by early 2013, there is little doubt that an uncertainty-induced global recession will occur. Whoever is elected president must understand this and induce Congress to follow a path to lower tax rates paid for by a simpler, less uncertain tax code. Beyond that, the United States must move to steady expenditure reduction and a stable, predictable path to a smaller debt-to-GDP ratio. The Fed needs to commit to low and stable inflation and abandon its flirtation with higher inflation aimed at helping to improve labor markets. Let lowered policy uncertainty and a simplified tax system that boosts growth help labor.

The most effective economic stimulant in 2013 would be reducing the high level of economic policy uncertainty that has built up since the 2008 financial crisis. Less social engineering with the tax system, less complex regulation for the financial system, less government management of health care, and monetary policy aimed at price stability would help lift the US economy back toward 3–4 percent growth by 2014.

## Notes

1. Scott R. Baker, Nicholas Bloom, and Steven J. Davis, “Measuring Economic Policy Uncertainty,” June 4, 2012, <http://policyuncertainty.com/media/BakerBloomDavis.pdf>.
2. Frank H. Knight, *Risk, Uncertainty, and Profit* (Boston: Houghton Mifflin, 1921), 159–60.