



The Measurement and Impact of Uncertainty

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What is uncertainty?

- Geopolitical uncertainty
 - How do risk premia play out in various countries, regions?
 - Are there likely disruptions to trade flows? Is profitability of companies threatened?
 - Associated with diplomacy, war, normal international relations, informal political volatility (terrorism)
- Economic policy uncertainty
 - What are the trends and expected policies from national governments? How are they changing?
 - Associated with formal political volatility, including elections, referenda, change of government, etc.
- Institutional uncertainty
 - Are core institutions of the market economy threatened? How much so?
 - Reserved for largest political changes and “black swans” (Brexit, Obama and Trump, Orban)



Why does uncertainty matter?

- Financial markets thrive on predictability
 - Long-term, patient finance requires stability
 - Volatility is part of the game, but abnormal volatility upsets planning
- Economic and geopolitical policies can threaten profitability or worse
 - Rational versus irrational responses to news
- A neglected point: economic policy uncertainty may be a harbinger of institutional change
 - Institutions are rules of the game, policy uncertainty may mean the rules (or the game) is changing

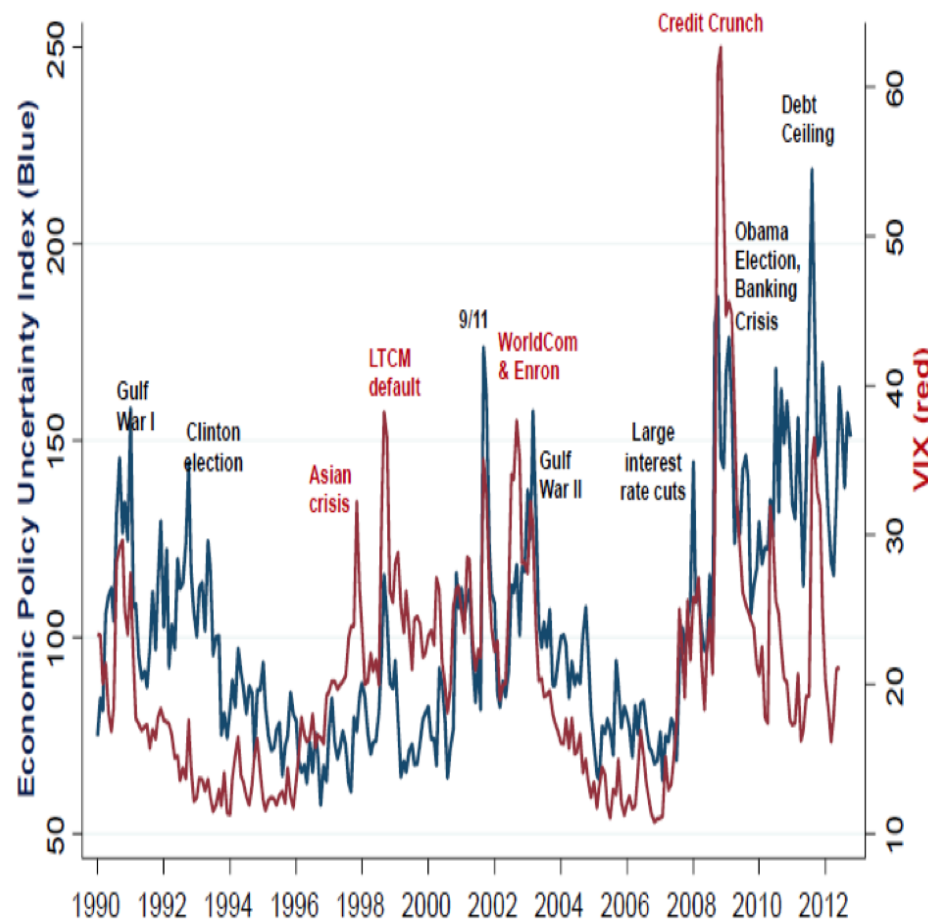


Quantifying uncertainty

With three types of uncertainty, need different metrics to quantify

- Geopolitical uncertainty
 - Standard macroeconomic indicators: Interest rates, exchange rates, volatility indices
- Economic policy uncertainty
 - News-based indices (Baker, Bloom, and Davis) and market reactions to the news
- Institutional uncertainty
 - Diversified indicators measuring institutions
 - Subjective indicators, such as indices of economic freedom, ICRG subjective indicators of rule of law/property rights, EBRD transition indicators
 - Objective indicators, such as contract-intensive money

U.S. Economic Policy Uncertainty and the VIX





Starting point for discussions

- Several types of uncertainty – which is most harmful?
- Is the world in a “high uncertainty” equilibrium that is set to continue?
- What could be the effect of continued volatility on financial markets worldwide?
 - Have they gotten better at pricing in uncertainty?