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The timing of uncertainty shocks in a small open economy

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The timing of uncertainty shocks in a small open economy

Hanna Armelius, Isaiah Hull and Hanna Stenbacka Köhler

December 2016
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The timing of uncertainty shocks in a small open economy

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Abstract

Foreign measures of uncertainty, such as the US EPU index, are often used as proxies for domestic uncertainty in small open economies. We construct an EPU index for Sweden and demonstrate that shocks to the domestic index yield different impulse response functions for GDP growth than shocks to the US index. In particular, a one standard deviation shock to the Swedish index delivers its maximum impact in the same quarter, lowering GDP growth by 0.2 percentage points. In contrast, a shock to the US index delivers its maximum impact with a one-quarter delay. Other foreign proxies, such as the EU and German indices, also generate effects that peak with a one-quarter delay. (JEL D80, E66, F41, F42)

Keywords: economic uncertainty, policy uncertainty, business cycles, small open economy
1 Introduction

Since the 2008 financial crisis, the world economy has been hit by a series of policy-related uncertainty shocks, such as the Eurozone debt crisis in 2011, the U.S. “fiscal cliff” episode in 2012, and the British referendum to leave the European Union (“Brexit”) in 2016. Disagreement remains over the extent to which such shocks affect the macroeconomy. While an earlier literature and recent empirical work suggest that uncertainty significantly affects output growth and other macrovariables, DSGE model analyses typically find smaller effects (Leland, 1968; Hartman, 1972; Abel, 1983; Bernanke, 1983; Bloom, 2009; Bachmann et al., 2013). Another line of literature suggests that the magnitude of the impact may depend critically on interactions with financial frictions (Cesa-Bianchi and Fernandez-Corugedo, 2014; Bonciani and van Roye, 2015).

Much of the work on uncertainty shocks concentrates on large economies, such as the US and UK. Only a few studies (e.g. Stockhammar and Österholm, 2016a; Stockhammar and Österholm, 2016b; Colombo, 2013) analyze the international transmission of uncertainty shocks to small open economies (SOEs) or measure the impact of domestic uncertainty on SOEs. We contribute to the literature by developing a Swedish economic policy uncertainty index (EPU), following the methods outlined in Baker et al. (2013). We then demonstrate how this index differs from foreign proxies, which are often used by SOE researchers, forecasters, and policymakers. In particular, we compute impulse response functions (IRFs) for shocks to Swedish, US, EU, and German EPU indices, and show that Swedish GDP growth responds faster to domestic EPU shocks than to foreign proxies. This provides support for the following two claims: 1) foreign proxies for uncertainty do not capture an important component of domestic uncertainty in SOEs; and 2) the domestic component of uncertainty may impact GDP growth faster than uncertainty that originates elsewhere. These findings have implications for both policy and forecasting in SOEs.
2 Methods

Sweden is a small open economy and is therefore affected by uncertainty abroad (Stockhammar and Österholm, 2016a,b). Even though policymakers often refer to uncertainty as an important factor that affects the economy, such a quantitative index has been missing for most SOEs, including Sweden. Although the US series can be used as a proxy, it does not capture uncertainty that originates domestically in Sweden, but is given little to no foreign media coverage. A Swedish EPU index could therefore potentially be of great use for understanding and analyzing GDP growth, trade, investment, and other economic relationships in Sweden.

In this paper, we follow the methodology developed by Baker et al. (2013) and construct a monthly EPU index for Sweden that measures uncertainty related to economic policy. Baker et al. (2013) compiled the original index by searching for articles that contained “economic” (E), “policy” (P), and “uncertainty” (U) in major newspapers. They then normalized the index to account for trends in word usage and newspaper composition. The robustness of this approach is demonstrated in Baker et al. (2016).

We constructed a Swedish EPU index by scraping the National Library of Sweden’s online newspaper archive. We queried the archive for Swedish keyphrases that correspond to their English equivalents of “economic,” “policy,” and “uncertainty.”1 The final index included articles from four of Sweden’s largest newspapers: Aftonbladet, Expressen, Dagens Industri, and Svenska Dagbladet. We standardized the data and then normalized by the total number of articles that contained keywords for the “economic” component of the index.

Figure 1 shows the Swedish EPU index, starting in 1980. Notice that the

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1We use the Swedish words “ekonomi” and “ekonomisk” for economic; “riksbank,” “centralbank,” “regering,” “departement,” and “reglering” for policy; and “osäker” and “oro” for uncertainty. We also included all keywords that contained the aforementioned words as roots.
index value increases during the Nordic Banking crisis in the early 1990s, and has a local peak in the fall of 1998 when the Stockholm stock exchange experienced its biggest fall since 1900, coinciding with the Russian financial crisis. It also increases around the IT bubble crash and 9/11 terrorist attacks in the early 2000s; and around the global financial crisis in 2008. It had another local peak during the European sovereign debt crisis in 2011 and has remained elevated since then, as has the EU index.

3 Results

We first analyze the relationship between the Swedish EPU index and Swedish GDP growth using a bivariate VAR. We later add more variables in a subsequent exercise to demonstrate the validity of the index. Since the domestic index also contains uncertainty originating in the US, EU, and Germany,
we use a specification that includes only one EPU index per VAR to avoid building in a high degree of multicollinearity.

The system is identified following the standard recursive ordering procedure with the EPU index ordered first.\textsuperscript{2} The appropriate lag-length for the VAR is chosen to be four lags, using the Akaike information criterion. The data spans the period from 1981:Q2 to 2016:Q2. GDP enters as a growth rate, while the EPU index is included in levels. In Figure 2, the Swedish EPU is shown together with Swedish GDP growth. Casual observation suggests a negative relationship between the two variables.

Figure 2: Swedish GDP Growth (Q/Q\%) and Swedish EPU Index

![Figure 2: Swedish GDP Growth (Q/Q\%) and Swedish EPU Index](image)

Figure 3 shows how Swedish GDP growth responds to a one standard deviation EPU index shock, along with the associated 95\% confidence interval. The impulse response functions were calculated using a Cholesky decomposition.

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\textsuperscript{2}We have also tried ordering the EPU second in the VAR, which generates similar but not identical results.
Figure 3: Impulse Response Functions for Swedish GDP Growth

Notes. Each IRF is computed for a separate bivariate VAR that includes Swedish GDP growth and the EPU index referenced in the plot’s title. We use quarterly data and a sample period of 1981:Q2 to 2016:Q2. Quarters are shown on the horizontal axis. Percentage points are shown on the vertical axis.

Notice that GDP growth in Sweden drops by 0.2 percentage points in the same quarter as the one standard deviation shock to the Swedish EPU. The effect then dissipates over the following four quarters. We also find a significant response to a US index shock, but it arrives with a one-quarter delay. EU and German EPU shocks also have a maximum impact after two quarters.

We also repeat the same exercise for the Netherlands, which is the other non-Anglosphere SOE in Europe with an EPU index. The results, shown in Figure 4, are nearly identical: a one standard deviation shock to the Dutch
EPU index has its largest impact on Dutch GDP growth in the same quarter; however, a shock to the US index takes two additional quarters to have its maximum impact on Dutch GDP.

Figure 4: Impulse Response Functions for Dutch GDP Growth

![Impulse Response Functions for Dutch GDP Growth](image)

Notes. Each IRF is computed for a separate bivariate VAR that includes Dutch GDP growth and the EPU index referenced in the plot’s title. We use quarterly data and a sample period of 2003:Q1-2016:Q1. Quarters are shown on the horizontal axis. Percentage points are shown on the vertical axis.

We next consider a larger VAR to verify that shocks to the Swedish EPU index generate the expected IRFs. Since Swedish newspapers provide a substantial amount of coverage for the US, EU, and Germany, we expect the Swedish EPU index to contain much of the information embodied in the other indices. For that reason, we abstain from including foreign EPU indices in the VAR. We add household saving, investment, the repo rate, and unemployment. Finally, we order the EPU first in the VAR.

Figure 5 shows the impulse responses generated from a one standard deviation shock to the Swedish EPU. In line with the existing literature, we find that an increase in uncertainty tends to 1) increase household saving; 2) decrease the repo rate; and 3) increase unemployment. We also find a statistically insignificant, but persistently negative investment response, which provides support for the hypothesis advanced in Bloom (2009). Overall, these
Figure 5: Impulse Response Functions for Augmented VAR

Notes. Each IRF is computed for the same VAR, which includes household saving, investment, the repo rate, unemployment, and the Swedish EPU. We use quarterly data and a sample period of 1993:Q1-2016:Q1. Quarters are shown on the horizontal axis.

results suggest that the index developed in this paper captures economic policy uncertainty well in Sweden.

4 Conclusion

Following the approach in Baker et al. (2013), we construct a Swedish EPU index. Such indices remain rare for SOEs in Europe. Employing a series of VARs, we find that a one standard deviation shock to the Swedish EPU index reduces Swedish GDP growth by 0.2 percentage points in the same quarter. Shocks to the US, EU, and German indices all arrive slower, achieving a
maximum impact on Swedish GDP growth with a one-quarter delay. We demonstrate external validity by showing that the same result holds for the Netherlands. Our results indicate that researchers, forecasters, and policy-makers in SOEs may benefit from constructing domestic EPU indices, rather than relying on foreign proxies.

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<table>
<thead>
<tr>
<th>Title</th>
<th>Authors</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimation of an Adaptive Stock Market Model with Heterogeneous Agents</td>
<td>Henrik Amilon</td>
<td>2005:177</td>
</tr>
<tr>
<td>Some Further Evidence on Interest-Rate Smoothing: The Role of Measurement Errors in the Output Gap</td>
<td>Mikael Apel and Per Jansson</td>
<td>2005:178</td>
</tr>
<tr>
<td>Bayesian Estimation of an Open Economy DSGE Model with Incomplete Pass-Through</td>
<td>Malin Adolfson, Stefan Laséen, Jesper Lindé and Mattias Villani</td>
<td>2005:179</td>
</tr>
<tr>
<td>Are Constant Interest Rate Forecasts Modest Interventions? Evidence from an Estimated Open Economy DSGE Model of the Euro Area</td>
<td>Malin Adolfson, Stefan Laséen, Jesper Lindé and Mattias Villani</td>
<td>2005:180</td>
</tr>
<tr>
<td>Inference in Vector Autoregressive Models with an Informative Prior on the Steady State</td>
<td>Mattias Villani</td>
<td>2005:181</td>
</tr>
<tr>
<td>Bank Mergers, Competition and Liquidity</td>
<td>Elena Carletti, Philipp Hartmann and Giancarlo Spagnolo</td>
<td>2005:182</td>
</tr>
<tr>
<td>Exploring Interactions between Real Activity and the Financial Stance</td>
<td>Tor Jacobson, Jesper Lindé and Kasper Roszbach</td>
<td>2005:184</td>
</tr>
<tr>
<td>Two-Sided Network Effects, Bank Interchange Fees, and the Allocation of Fixed Costs</td>
<td>Mats A. Bergman</td>
<td>2005:185</td>
</tr>
<tr>
<td>Real Exchange Rate and Consumption Fluctuations following Trade Liberalization</td>
<td>Kristian Jönsson</td>
<td>2005:187</td>
</tr>
<tr>
<td>Bayesian Inference of General Linear Restrictions on the Cointegration Space</td>
<td>Mattias Villani</td>
<td>2005:189</td>
</tr>
<tr>
<td>Forecasting Performance of an Open Economy Dynamic Stochastic General Equilibrium Model</td>
<td>Malin Adolfson, Stefan Laséen, Jesper Lindé and Mattias Villani</td>
<td>2005:190</td>
</tr>
<tr>
<td>Forecast Combination and Model Averaging using Predictive Measures</td>
<td>Jana Eklund and Sune Karlsson</td>
<td>2005:191</td>
</tr>
<tr>
<td>A Simultaneous Model of the Swedish Krona, the US Dollar and the Euro</td>
<td>Hans Lindblad and Peter Sellin</td>
<td>2006:193</td>
</tr>
<tr>
<td>Efficient Bayesian Inference for Multiple Change-Point and Mixture Innovation Models</td>
<td>Paolo Giordani and Robert Kohn</td>
<td>2006:196</td>
</tr>
<tr>
<td>Derivation and Estimation of a New Keynesian Phillips Curve in a Small Open Economy</td>
<td>Karolina Holmberg</td>
<td>2006:197</td>
</tr>
<tr>
<td>Monetary Policy and Staggered Wage Bargaining when Prices are Sticky</td>
<td>Mikael Carlsson and Andreas Westermark</td>
<td>2006:199</td>
</tr>
<tr>
<td>The Swedish External Position and the Krona</td>
<td>Philip R. Lane</td>
<td>2006:200</td>
</tr>
</tbody>
</table>
Price Setting Transactions and the Role of Denominating Currency in FX Markets
by Richard Friberg and Fredrik Wilander
2007:201

The geography of asset holdings: Evidence from Sweden
by Nicolas Coeurdacier and Philippe Martin
2007:202

Evaluating An Estimated New Keynesian Small Open Economy Model
by Malin Adolfsson, Stefan Lasèèn, Jesper Lindé and Mattias Villani
2007:203

The Use of Cash and the Size of the Shadow Economy in Sweden
by Gabriela Guiubourg and Björn Segendörf
2007:204

Bank supervision Russian style: Evidence of conflicts between micro- and macro-prudential concerns
by Sophie Claey s and Koen Schoors
2007:205

Optimal Monetary Policy under Downward Nominal Wage Rigidity
by Mikael Carlsson and Andreas Westermark
2007:206

Financial Structure, Managerial Compensation and Monitoring
by Vittoria Cerasi and Sonja Daltung
2007:207

Financial Frictions, Investment and Tobin’s q
by Guido Lorenzoni and Karl Walentin
2007:208

Sticky Information vs Sticky Prices: A Horse Race in a DSGE Framework
by Mathias Trabandt
2007:209

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by Sophie Claey s and Christa Hainz
2007:210

Nonparametric Regression Density Estimation Using Smoothly Varying Normal Mixtures
by Mattias Villani, Robert Kohn and Paolo Giordani
2007:211

The Costs of Paying – Private and Social Costs of Cash and Card
by Mats Bergman, Gabriella Guiubourg and Björn Segendörf
2007:212

Using a New Open Economy Macroeconomics model to make real nominal exchange rate forecasts
by Peter Sellin
2007:213

Introducing Financial Frictions and Unemployment into a Small Open Economy Model
by Lawrence J. Christiano, Mathias Trabandt and Karl Walentin
2007:214

Earnings Inequality and the Equity Premium
by Karl Walentin
2007:215

Bayesian forecast combination for VAR models
by Michael K. Andersson and Sune Karlsson
2007:216

Do Central Banks React to House Prices?
by Daria Finocchiaro and Virginia Queijo von Heideken
2007:217

The Riksbank’s Forecasting Performance
by Michael K. Andersson, Gustav Karlsson and Josef Svensson
2007:218

Macroeconomic Impact on Expected Default Frequency
by Per Asberg and Hovick Shahnazarian
2008:219

Monetary Policy Regimes and the Volatility of Long-Term Interest Rates
by Virginia Queijo von Heideken
2008:220

Governing the Governors: A Clinical Study of Central Banks
by Lars Frisell, Kasper Roszbach and Giancarlo Spagnolo
2008:221

The Monetary Policy Decision-Making Process and the Term Structure of Interest Rates
by Hans Dillén
2008:222

How Important are Financial Frictions in the U S and the Euro Area
by Virginia Queijo von Heideken
2008:223

Block Kalman filtering for large-scale DSGE models
by Ingvar Strid and Karl Walentin
2008:224

Optimal Monetary Policy in an Operational Medium-Sized DSGE Model
by Malin Adolfsson, Stefan Lasèèn, Jesper Lindé and Lars E. O. Svensson
2008:225

Firm Default and Aggregate Fluctuations
by Tor Jacobson, Rikard Kindell, Jesper Lindé and Kasper Roszbach
2008:226
Firm-Level Evidence of Shifts in the Supply of Credit
by Karolina Holmberg

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by Karolina Holmberg

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by MATIAS QUIROZ, MATTIAS VILLANI AND ROBERT KOHN
2015:306

SPEEDING UP MCMC BY DELAYED ACCEPTANCE AND DATA SUBSAMPLING
by MATIAS QUIROZ
2015:307

Modeling financial sector joint tail risk in the euro area
by André Lucas, Bernd Schwaab and Xin Zhang
2015:308

Score Driven Exponentially Weighted Moving Averages and Value-at-Risk Forecasting
by André Lucas and Xin Zhang
2015:309

On the Theoretical Efficacy of Quantitative Easing at the Zero Lower Bound
by Paola Boel and Christopher J. Waller
2015:310

Optimal Inflation with Corporate Taxation and Financial Constraints
by Daria Finocchiaro, Giovanni Lombardo, Caterina Mendicino and Philippe Weil
2015:311

Fire Sale Bank Recapitalizations
by Christoph Bertsch and Mike Mariathasan
2015:312

Since you’re so rich, you must be really smart: Talent and the Finance Wage Premium
by Michael Böhm, Daniel Metzger and Per Strömberg
2015:313

Debt, equity and the equity price puzzle
by Daria Finocchiaro and Caterina Mendicino
2015:314

Trade Credit: Contract-Level Evidence Contradicts Current Theories
by Tore Ellingsen, Tor Jacobson and Erik von Schedvin
2016:315

Double Liability in a Branch Banking System: Historical Evidence from Canada
by Anna Grodecka and Antonis Kotidis
2016:316

Subprime Borrowers, Securitization and the Transmission of Business Cycles
by Anna Grodecka
2016:317

Real-Time Forecasting for Monetary Policy Analysis: The Case of Sveriges Riksbank
by Jens Iversen, Stefan Laseén, Henrik Lundvall and Ulf Söderström
2016:318

Fed Liftoff and Subprime Loan Interest Rates: Evidence from the Peer-to-Peer Lending
by Christoph Bertsch, Isaiah Hull and Xin Zhang
2016:319

Curbing Shocks to Corporate Liquidity: The Role of Trade Credit
by Niklas Amberg, Tor Jacobson, Erik von Schedvin and Robert Townsend
2016:320

Firms’ Strategic Choice of Loan Delinquencies
by Paola Morales-Acevedo
2016:321

Fiscal Consolidation Under Imperfect Credibility
by Matthieu Lemoine and Jesper Lindé
2016:322

Challenges for Central Banks’ Macroe Models
by Jesper Lindé, Frank Smets and Rafael Wouters
2016:323

The interest rate effects of government bond purchases away from the lower bound
by Rafael B. De Rezende
2016:324

COVENANT-LIGHT CONTRACTS AND CREDITOR COORDINATION
by Bo Becker and Victoria Ivashina
2016:325

Endogenous Separations, Wage Rigidities and Employment Volatility
by Mikael Carlsson and Andreas Westermark
2016:326

Renovatio Monetae: Gesell Taxes in Practice
by Roger Svensson and Andreas Westermark
2016:327

Adjusting for Information Content when Comparing Forecast Performance
by Michael K. Andersson, Ted Aranki and André Reslow
2016:328

Economic Scarcity and Consumers’ Credit Choice
by Marieke Bos, Chloé Le Coq and Peter van Santen
2016:329

Uncertain pension income and household saving
by Peter van Santen
2016:330

Money, Credit and Banking and the Cost of Financial Activity
by Paola Boel and Gabriele Camera
2016:331

Oil prices in a real-business-cycle model with precautionary demand for oil
by Conny Olovsson
2016:332
Financial Literacy Externalities

by Michael Halasso, Thomas Jansson and Yigitcan Karabulut