

Chapter 15

Economic Policy Uncertainty in Banking: A Literature Review

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ABSTRACT

This chapter is a survey of the most important research in the economic policy uncertainty literature. Economic policy uncertainty, although still under-researched relative to mainstream topics in economics and finance, has recently received increased scholarly attention. Through synthesizing common themes in the literature, the chapter highlights the progress made so far and suggests some avenues for future research that allow future researchers to position their research and differentiate themselves from other studies in the literature. The chapter finds that economic policy uncertainty affects banks through a reduction in credit supply and loan re-pricing. High economic policy uncertainty compels bank managers to discretionary distortion of bank financial reporting in ways that help them to mitigate the depressing effect of economic policy uncertainty on banks' financial statements.

INTRODUCTION

The purpose of this chapter is to review the existing literature on economic policy uncertainty (EPU) and synthesize the insights it provides. I begin by defining the term “economic policy uncertainty”. After this, I present a summary of what we know in the literature, then I discuss how it relates to banking. I end the chapter with a summary of what we do not know about economic policy uncertainty. Hopefully, this will help to set the agenda for future research. The articles selected for this concise review were chosen after applying a high research quality threshold which allows us to focus only on the relevant, recent and high-quality research articles in the literature.

Economic policy uncertainty is defined as uncertainty regarding economic policies such monetary policy, fiscal policy, and regulatory policies, and it derives mainly from whether existing policies will change in the future (Baker et al. 2016; Danisman et al., 2021). EPU describes the unknown impact of

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new policies on the economy and the private sector (Ng et al. 2020). On the other hand, policy uncertainty is defined as uncertainty about government policies. Economic policy uncertainty is a hot topic in the finance literature, even though ‘policy uncertainty’ is not a new topic. Economic policy uncertainty has been discussed in the past few decades. For example, Hassett and Metcalf (1999) examine the effect of uncertain tax policy on investment decisions and find that uncertain tax policies that follow a jump process have detrimental effects on investments. Hermes and Lensink (2001) show that policy uncertainty, measured by the uncertainty of budget deficits, tax payments, government consumption and inflation rate, leads to higher capital flight. Chen and Funke (2003) analyse the impact of policy uncertainty on foreign direct investment strategies, and show that political uncertainty is detrimental to foreign direct investment decisions. These studies suggest that policy uncertainty has detrimental economic consequences.

Economic policy uncertainty derives from whether existing economic policy will change in the future or what impact a newly introduced economic policy will have on the private sector. Precisely, economic policy uncertainty refers to uncertainty regarding fiscal, monetary, or regulatory policy. One important aspect of economic policy uncertainty is economic policy uncertainty. Understanding the implication of economic policy uncertainty for the financial and economic system is important because it can give an idea of how uncertainty about government’s economic policies affect firms, households, and individuals. The major sources of economic policy uncertainty, according to Baker et al (2016), are: (i) newspaper-based reports on the economy, (ii) tax code expirations, (iii) disagreement over CPI forecasts, and (iv) disagreement over government purchases forecasts. Many recent studies have used these sources as reliable indicators of economic policy uncertainty (see., Bhagat and Obreja, 2013; Brogaard and Detzel, 2015; Gulen and Ion, 2016; Kim and Kung, 2017; Nguyen and Phan, 2017). Other sources of economic policy uncertainty, which are less commonly used in the literature, are increased political polarization, change in governments following elections, budget deficits, trade wars, etc.

Few studies conduct a survey on economic policy uncertainty. For example, Hassett and Sullivan (2016), in their survey, show that new empirical measures of uncertainty have emerged which allows economists to assess the impact of uncertainty in various aspects of the economy. Also, Castelnovo et al. (2017), in a survey, show the interaction between uncertainty and financial frictions. Al-Thaqeb and Algharabali (2019) conduct a review of studies that use the economic policy uncertainty index (EPU) of Baker et al (2016) as a key factor in measuring uncertainty. They also reviewed the impact of EPU on financial markets, macro and micro level, stock markets, corporate behavior, and risk management. But the study did not focus on banks. Dai and Zhang (2019) conduct a survey on the impact of political uncertainty on financial markets from the perspective of asset prices, corporate policies, households and the economy. Taken together, these review studies did not focus on the banking sector. The current study is different from prior review studies in that it focuses on EPU in the banking sector. This study reviews the literature that examine the impact of EPU on the banking sector and offer some suggestions for future research.

Also, this study contributes to the recent literature on economic policy uncertainty. Economic policy uncertainty is an increasingly common macroeconomic phenomenon, and earlier studies have focused more on its economic implications while recent studies examine how economic policy uncertainty affects corporate decisions (e.g. Baker et al., 2014; Baker et al, 2016; Kim and Kung, 2017, Nguyen and Phan, 2017). This chapter complements the recent literature by providing a concise review of the recent literature in order to set the agenda for future research. A review of the recent literature has not emerged in the recent literature with particular focus on economic policy uncertainty in banking. To the best of my knowledge, this chapter is the first to review the recent literature on economic policy uncertainty.

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