Identifying the Causal Impact of Political Uncertainty on Asset Prices

by Wing Wah Tham
(Econometrics Institute, Erasmus School of Economics)

Abstract:

Governments play an important role through fiscal and monetary policies in determining and affecting the pace of economic activities, growth, employment, and inflation. Several recent theoretical papers show that political and policy uncertainty affects asset prices. However, an empirical study of this issue can be hampered by the endogeneity problem that asset prices and economic outcomes or uncertainty also affect political and policy outcomes. We overcome the problem by analyzing asset price dynamics caused by clearly exogenous changes in expectations about election outcomes related to political uncertainty (a hung parliament and a divided government) or political certainty (a majority government). More precisely, we use the changes in the odds for an uncertain government in the prediction market to explain movements in asset prices during election nights. We find that policy uncertainty has a substantial effect on asset prices, in the UK causes a depreciation of 120 bps in the British Pound and in the US a 1.4% decrease in equity markets and a 60-70bps increase in bond prices.