Uncertainty and Economic Activity: A Global Perspective

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Strong correlation between “uncertainty” and economic activity

During the crisis increase in uncertainty/volatility and contraction in activity

After the crisis, low volatility and a recovery of economic activity
Strong correlation between “uncertainty” and economic activity

- During the crisis increase in uncertainty/volatility and contraction in activity
- After the crisis, low volatility and a recovery of economic activity
In this paper

- **What do we do?** Quantify the relation between uncertainty and economic activity using a novel multi-country approach

- **How do we do it?**
  - Compute quarterly country-specific realized volatility measures (as a proxy for economic uncertainty) using daily returns of 109 asset prices worldwide
  - Set up a factor model for volatility and the business cycle in which both are driven by the same set of global common factors
  - Exploit the different cross-country correlation structure of volatility and GDP growth to identify the factors and the shocks

- **What do we find?** Show that conditional on global factors there is little correlation left between volatility and economic activity
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- **What do we find?** Show that conditional on global factors there is little correlation left between volatility and economic activity.
Outline

1. A simple factor model of volatility and macro dynamics
2. Results
Model used in the literature (abstracting from dynamics) to interpret correlation between $v_t$ and $\Delta y_t$

$$v_t = \alpha \Delta y_t + \varepsilon_t$$
$$\Delta y_t = \beta v_t + u_t$$
A standard model of volatility and economic activity

- Model used in the literature (abstracting from dynamics) to interpret correlation between $v_t$ and $\Delta y_t$
  
  \[ v_t = \alpha \Delta y_t + \varepsilon_t \]
  \[ \Delta y_t = \beta v_t + u_t \]

- Since the covariance matrix $\text{Cov}(v_t, \Delta y_t)$ provides only three moments, the system is not identified

- Identification of structural parameters and shocks is typically achieved with an exclusion restriction (ie $\alpha = 0$ or $\beta = 0$)
An alternative model based on common factors

- Assume that a small set of *unobserved* global factors characterize the evolution of the world economy.
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- Global factor $n_t$ affects both $v_t$ and $\Delta y_t$

\[
\begin{align*}
v_t &= \lambda n_t + \varepsilon_t \\
\Delta y_t &= \gamma n_t + u_t
\end{align*}
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An alternative model based on common factors

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- Again, identification of structural parameters and shocks cannot be achieved unless we impose an exclusion restriction, i.e. by assuming $\lambda = 0$ (or $\gamma = 0$)
An alternative model based on common factors: multi-country perspective

Replace model above with the following disaggregated system of equations:

\[ v_{it} = \lambda_{in} + \varepsilon_{it} \quad \text{for } i = 1, 2, \ldots, N \]
\[ \Delta y_{it} = \gamma_{in} + u_{it} \quad \text{for } i = 1, 2, \ldots, N \]

Global volatility (\(v_t\)) and world GDP growth (\(\Delta y_t\)) are aggregates over a large number of countries:

\[ v_t = \sum_{i=1}^{N} w_i v_{it}, \quad \Delta y_t = \sum_{i=1}^{N} w_i \Delta y_{it}, \]
Identifying assumptions

- **Assumption 1** Weights $\mathbf{w} = (w_1, w_2, \ldots, w_N)'$ are of order $1/N$

  $$||\mathbf{w}|| = O_p(N^{-\frac{1}{2}}), \quad \frac{w_i}{||\mathbf{w}||} = O_p(N^{-\frac{1}{2}}) \quad \forall i,$$

  - Ensures that the weights are not dominated by a few of the cross-section units
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- **Assumption 2** The volatility innovations ($\varepsilon_{it}$) are strongly correlated across countries, whilst the output innovations ($\mathbf{u}_{it}$) are weakly cross-correlated across countries.

  $$\lambda_{\text{max}}(\Sigma_\varepsilon) = O_p(N) \quad \text{and} \quad \lambda_{\text{max}}(\Sigma_\mathbf{u}) = O_p(1)$$

  - One cross-sectional unit plays dominant role in global financial markets but not in world activity
Identifying assumptions

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\|\mathbf{w}\| = O_p(N^{-\frac{1}{2}}), \quad \frac{w_i}{\|\mathbf{w}\|} = O_p(N^{-\frac{1}{2}}) \quad \forall i,
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- One cross-sectional unit plays dominant role in global financial markets but not in world activity

- These assumptions are not contradicted by the time series evidence
Identification of the factor by aggregation

Consider the cross-country weighted averages of the disaggregated system

\[ v_t = \lambda n_t + \bar{\varepsilon}_t \]
\[ \Delta y_t = \gamma n_t + \bar{u}_t \]

where \( \bar{\varepsilon}_t = \tilde{w}' \varepsilon_t \) and \( \bar{u}_t = w' u_t \)
Identification of the factor by aggregation

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For \( N \) sufficiently large \( n_t \) can be identified from macro equation

\[ n_t = \gamma^{-1} \Delta y_t + \underbrace{\bar{u}_t}_{\text{\( O_p(N^{-1/2}) \)}} \]
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- For \( N \) sufficiently large \( n_t \) can be identified from macro equation

\[ n_t = \gamma^{-1} \Delta y_t + \bar{u}_t \quad O_p(N^{-1/2}) \]

- However, since the volatility shocks \( (\varepsilon_{it}) \) are strongly correlated across countries, \( n_t \) cannot be approximated by \( v_t \)
Implications: volatility equation

- Substitute $n_t$ into the volatility equation to get

$$v_{it} = \lambda_i \gamma^{-1} \Delta y_t + \bar{u}_t + \varepsilon_{it} =$$

$$= (\lambda_i \gamma^{-1}) \Delta y_t + \varepsilon_{it} + O_p \left( N^{-1/2} \right)$$

**Result**  OLS consistently estimate the impact of contemporaneous changes in global activity on country-specific volatility

**Result**  We can identify the volatility innovation $\varepsilon_{it}$
Outline

1. A simple factor model of volatility and macro dynamics
2. Results
Volatility equation estimation

- Realized volatility of equity prices $v_{it}^{eq}$ (robustness with other asset classes)
Volatility equation estimation

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- Model country-specific volatilities ($v_{it}$) allowing for dynamics

$$v_{it}^{eq} = \sum_{k=1}^{r} \Theta_{ik} v_{i,t-k}^{eq} + \sum_{k=0}^{s} \Psi_{ik} \Delta y_{t-k} + \varepsilon_{it}^{eq}$$

- Get volatility innovations $\hat{\varepsilon}_{it}^{eq}$

- Check validity of identifying assumption: strong cross-sectional dependence of volatility innovations $\hat{\varepsilon}_{it}^{eq}$

Results 12/18
Volatility equation estimation

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- Check validity of identifying assumption: strong cross-sectional dependence of volatility innovations $\hat{\varepsilon}_{it}^{eq}$
Pairwise correlation of volatility innovations: strong cross-sectional dependence

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Macro equation estimation

- Model country-specific GDP growth ($\Delta y_{it}$) as:

$$\Delta y_{it} = \sum_{k=1}^{p} \Phi_{ik} \Delta y_{i,t-k} + \sum_{k=0}^{q} \Lambda_{ik} \Delta y_{t-k} + u_{it}$$
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- Get macro innovations \(\hat{u}_{it}\)

- Check validity of identifying assumption: weak cross-sectional dependence of macro innovations \(\hat{u}_{it}\)
Pairwise correlation of GDP innovations: weak cross-sectional dependence

**Table: Pairwise Correlation Of The GDP Innovations**

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**Note.** Lag length determined with Akaike criterion with a max of 4 lags.
The impact of volatility innovations on economic activity

- Is there any relation left (after controlling for the global factor) between volatility and economic activity?
The impact of volatility innovations on economic activity

- Is there any relation left (after controlling for the global factor) between volatility and economic activity?

- If yes, we should observe a (negative) correlation between $\hat{u}_{it}$ and $\hat{\varepsilon}_{eq}^{it}$

- Estimate the following country-specific equations

$$\hat{u}_{it} = b_i \hat{\varepsilon}_{it}^{eq} + \eta_{it} \quad \text{for } i = 0, 1, ..., N$$
The impact of volatility innovations on economic activity

Table: The Relation Between GDP Innovations And Volatility Innovations

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Conclusions

- Quantify the relation between uncertainty and economic activity using a novel multi-country approach

- Exploit the different cross-country correlation structure of volatility and GDP growth to establish the direction of causation

- Much of the reduced form correlation between volatility and economic is driven by common (first moment) factors