

RESEARCH SUMMARY

Does Uncertainty over Economic Policy Harm Trade, Foreign Investment, and Prosperity?

Over the past quarter century, foreign direct investment has grown almost sixfold and has proportionately contributed to economic growth and wage increases. In a new study from the Mercatus Center at George Mason University, “[Does Uncertainty over Economic Policy Harm Trade, Foreign Investment, and Prosperity?](#),” economics professor Robert Krol presents evidence that increased uncertainty about economic policy is a deterrent to such investment and affects economic growth negatively as potential investors put off investment decisions. The effect of increased policy uncertainty on export and import growth is similarly negative. Lack of policy clarity can undermine efforts to render the business environment conducive to faster economic growth.

KEY FINDINGS

Foreign Direct Investment

Increased policy uncertainty has a delayed but significant negative effect on investment flows into the United States.

- Increased economic policy uncertainty has a negative effect on foreign direct investment after five quarters. Increased uncertainty also makes such investment more volatile.
- Increased trade policy uncertainty affects foreign direct investment negatively after four quarters.

Trade

Increased policy uncertainty has a delayed and negative effect on trade flows.

- Increased economic policy uncertainty has a persistent and negative effect on both exports and imports.
- Increased trade policy uncertainty has a negative but insignificant effect on imports and exports.

DEFINING POLICY UNCERTAINTY

- Policy uncertainty is measured using an index constructed on a computer-based search of 10 leading newspapers for articles that use combinations of words like “uncertainty” and policy terms like “deficit.”
- Economic policy uncertainty encompasses uncertainty with respect to regulation, taxes, monetary policy, and trade policy.

- Trade policy uncertainty includes uncertainty in the relationship with a trade partner or a block of economies, as public officials make public comments on the status of bilateral or multilateral agreements.

HOW POLICY UNCERTAINTY WORKS

- Reducing uncertainty with respect to trade policy can be accomplished by entering into trade agreements. Conversely, signals that trade agreements might be reconsidered increase policy uncertainty and increase the riskiness of entering that market. Businesses will likely prefer to wait to trade or invest until the uncertainty is reduced.
- Lower imports and lower levels of investment limit capital formation, lowering standards of living in the United States.