The Effect of Economic Policy Uncertainty on Investment

Thomas Seiler, Stockholm School of Economics

Abstract

Exploiting textual information for a large panel of U.S. firms, I study the sensitivity of corporate investment rates to economic policy uncertainty. I find that a doubling of economic policy uncertainty reduces capital expenditure by 25%, but R&D does not respond to policy uncertainty when controlling for industry-specific shocks. Firms might have little reason to delay R&D projects when policy uncertainty idiosyncratically increases because this makes them lose the race for new discoveries against their competitors. Investigating the channels through which policy uncertainty affects investment, I find the sensitivity of investment to policy uncertainty is significantly amplified for firms that are likely to be financially constrained ex-ante. Thus, the key to understanding the relation between investment and policy uncertainty lies in the interaction of policy uncertainty with financial frictions.