THE GLOBAL ECONOMY

A World of Doubts

It was 2013, and the decision in China hardly raised any eyebrows in the global investment community—at least at first. Concerned about rogue financing, the government said it would crack down on so-called "shadow banking" firms, which are financial institutions that operate with little or no regulation. Too much bad lending, China's leaders said, could mean a repeat of 2008.

Which appeared to make sense, except that over time, the move exposed a major weakness in China: its inability to attract enough investment and to switch to a US-style consumer-led economy at the same time. The crackdown would squeeze lending too much, and China's economy slowed. But most importantly, it created new doubts about the nation's policies—and ultimately a dramatic exodus of international investment.

All of which raises a curious question: How do you anticipate and measure investor confidence on a large scale? Watching the business news cycles or gyrating stock market, it would be easy to assume confidence tracks geopolitical sentiment closely, shifting on every bit of news from the White House or on Brexit spewing out of the UK Parliament. But it doesn't work that way. It works much slower and differently.

A group of enterprising academics have figured this out and developed a robust measure of doubt about policy matters. It's known as the Economic Policy Uncertainty Index, invented by Scott Baker, Nicholas Bloom and Steve Davis, professors at Northwestern University, Stanford University and the University of Chicago, respectively. They do this by tracking newspaper stories on only economic policy uncertainty—not any political issues—and then create a story-count index. It may sound simple, but it's remarkable how well it is followed and how accurate it can be.

"This index captures shifts in sentiment surrounding policy uncertainty in a way that provides CEOs with a forward look at risks along the political and economic spectrum," says Joe Brusuelas, chief economist at the professional service firm RSM in New York. In other words, the index is like a huge telescope that allows business leaders to look into the future and see trouble before it actually happens. That matters, because a rise in the index spells trouble ahead for companies. The economists who developed the index say,

BY SIMON CONSTABLE

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A group of enterprising academics have developed a remarkable index of economic policy uncertainty.

"An increase in economic policy uncertainty as measured by our index foreshadows a decline in economic growth and employment in the following months."

So where are the doubts today? You might expect investment concerns over the US to be rising given all the White House drama, but according to the latest results, the US uncertainty index is now only a little worse than its long-term average. More importantly, it is nowhere near its worst-ever level, which occurred in August 2011 during the US debt-ceiling showdown.

But for its part, China has fallen off a cliff. Earlier this year, the policy-uncertainty index for the country hit its worst-ever level. And though it has improved more recently, it remains elevated by historical standards. Certainly, the shadow-banking move didn't help. "They have a critical capital-flight problem," says Gordon Chang, a senior fellow at the London Center for Policy Research in New York and an expert on China. "It was a loss of confidence in the economy and the political system." In the simplest terms, people are getting their money out of China while they can because they are worried.

The surprises don't stop there. Canada, which normally exudes stability, also saw uncertainty climb, hitting its worst-ever level last year on concerns of a US-Canada trade war. (As that issue faded, the index improved.) Meanwhile, Russia, a poster child for geopolitical antagonism, has an uncertainty reading nowhere near its worst. That's likely because while Russia is on the minds of many, it hasn't actually made major provocative moves lately. Think of it like a boy who once tracked mud across the priceless oriental rug but who hasn't done so in months. While the boy or Russia stays in check, the uncertainty steadily drops.

Naturally, the doubt meter moved where expected. For instance, the UK hit a record level of uncertainty (seven times its normal level) when the country chose to exit the European Union last year. As you would expect, when the dust settled, uncertainty dropped close to normal levels. France shows a similar story. The index there hit a record reading in April on the possibility that far-right leader Marine Le Pen might win the country's presidency. In the election, she lost and the uncertainty quickly subsided.

Corporate leaders, of course, get ahead by anticipating the unknown and operating in an uncertain environment. That's what they get paid to do. To paraphrase former US Defense Secretary Donald Rumsfeld, you do business in the environment that you have, not the one you desire. When the business landscape looks foggy, it's best to find a way to see through the mist. "When a country's policy uncertainty jumps on a sustained basis, it brings into question whether one should allocate any capital there," says Brusuelas. ●