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Economic policy uncertainty and corporate investment: Evidence from China ☆

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ABSTRACT

This paper studies how economic policy uncertainty influences corporate investment for Chinese listed companies. We show that when the degree of economic policy uncertainty is higher, firms stand to lower their investment and vice versa. However, firms that have higher return on invested capital, use more internal finance and are not state-owned mitigate the negative effect of policy uncertainty on corporate investment. Moreover, firms in regions with higher degree of marketization are more sensitive to the economic policy uncertainty. The evidence illustrates that keeping the transparency and stability of the implementation of economic policies can improve corporate investment efficiency.

1. Introduction

This study examines the relationship between economic policy uncertainty and corporate investments at the firm level. The impact of uncertainty on investments has been studied before, but the results are not conclusive. Instead of idiosyncratic uncertainty, we are interested in the impact of economic policy uncertainty. Economic or political shocks can be an important source of uncertainty for firms as their costs, sales and profits will be greatly affected. In particular, corporate investment is usually costly and irreversible. Policy changes would affect the environment in which firms operate and hence their investment behaviors.

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Our study is mainly motivated by the importance of the influence of domestic policy uncertainty on economic activities. Besides political reasons, more often than not, policy uncertainty is closely related to unexpected changes that may alter the economic environment, which in turn will change the required return that firms used to discount their further cash flows. Therefore, it is of great interest to examine the impact of policy uncertainty on corporate investment decisions. We use Chinese data because China is still regarded as a transition economy moving away from planned economy to market-based economy. It is interesting to examine if the impact of economic policy uncertainty results in similar/different effect on corporate investment from that of market-based developed economy. The results may provide implications for other transition economies.

The extant literature documents empirical evidence that policy-related uncertainty can depress economic growth through a decrease in corporate investment. Aizenman and Marion (1993) are among the first to study the relationship between policy uncertainty and real per capita GDP for 46 developing countries from 1970 to 1985. They document that policy uncertainty can influence economic growth by investment. More recent studies find that the drop in corporate investment expenditures during the recent global financial crisis is attributable to the increasing uncertainty in policies (Baker et al., 2013; Gulen and Ion, 2013; Julio and Yook, 2012; Durnev, 2012).

To measure economic policy uncertainty, we resort to Baker et al. (2013), in which they develop a new index of economic policy uncertainty (EPU) for the US. Their EPU index has been tested to be a good proxy of real economic policy uncertainty. Following similar logic and methodologies, they then construct EPU indexes for Europe, Canada, China and India.[1] For our study, we adopt their China index to proxy the economic policy uncertainty.

Using a panel of Chinese publicly listed firms from 2003 to 2012, we examine impacts of economic policy uncertainty on corporate investment and find that such uncertainty indeed affects corporate investment in China in important ways. First, as a key factor, policy-related economic uncertainty can dampen corporate investment in general, which is consistent with prior evidence for developed economies. Second, firms with heterogeneous characteristics are found to respond differently in the face of policy uncertainty. Specifically, firms that enjoy higher return on invested capital, rely more on internal finance and are non-state-owned, are better positioned to mitigate the negative impact of uncertainty on corporate investments. Our results still hold when we apply a number of additional robustness tests. In particular, we consider potential endogeneity problem, use differenced variables, consider longer-lag effect in economic policy uncertainty, and an alternative proxy for economic policy uncertainty. To the extent that no study has yet investigated the relation between economic policy uncertainty and corporate investment for a transition economy, our findings contribute to the literature and offer meaningful insights to policy makers in these economies.

The rest of the paper proceeds as follows. The second section provides the relevant theoretical background in the literature and develops our main hypotheses. The third section describes our sample and variables. The fourth section presents the empirical results. The fifth section conducts robustness tests. We conclude in the last section.

2. Theoretical background and hypotheses development

The research on the relationship between corporate investment and uncertainty has been inconclusive. The classical theory of Knight (1921) emphasizes that entrepreneurs have the ability to recognize and seize investment opportunities in uncertainty and make profits through resource integration. Therefore, uncertainty is the very source of corporate profits. Furthermore, under the assumption of perfect competition, constant return to scale and symmetrical adjustment cost, economic models developed by Hartman (1972) and Abel (1983) suggest that a higher level of uncertainty will boost the expected profit margin of capital and thus increase investment. Abel and Blanchard (1986) provide empirical evidence for this assertion.

[1] For more details, refer to the policy uncertainty website developed by Baker, S.R., Bloom, N. and Davis, S.J. at www.policyuncertainty.com.