The Relationship between the Economic Policy Uncertainty Index and Stock Prices: A Study on Developing Countries

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Abstract

Political decision-making and implementation processes inherently contain many uncertainties that can affect macroeconomic variables, financial markets and company behavior. To examine the economic and financial effects of these uncertainties, Baker, Bloom, and Davis (2013, 2016) developed the economic policy uncertainty (EPU) index. The development of the index has increased the interest in its impact on financial markets and stocks, and research on the subject has accelerated. This research provides new evidence for the relationship between EPU and stock prices from the perspective of developing countries. In the research, monthly data of 4 countries (Brazil, China, India and Russia) in the category of developing countries for the period 2010-2020 were used. In this context, the Covid-19 period is also included in the research, and the relationship between the EPU index and stock prices has been examined, including the Covid-19 period. EPU index series Baker et al. (2013, 2016) and available at www.policyuncertainty.com. In the research, the stock prices of the countries were obtained from Yahoo Finance. In accordance with the purpose of the study, cross-section dependency tests (Breusch-Pagan LM, Pesaran Scale LM, and Pesaran CD), Pesaran panel unit root test, Westerlund cointegration test and Dumitrescu-Hurlin causality test were used. The results obtained from the research show that the EPU index has a negative effect on stock returns in developing countries. The increase in the EPU index affects the stock returns negatively. On the other hand, in some countries no relationship was found between EPU and stock returns, while in some countries a weak relationship was found. The results obtained from the research provide important outputs for policy makers and researchers. First of all, policy makers should take measures to eliminate uncertainties and make necessary arrangements in order to reduce the risks in the stock market. In future studies, the researchers may reveal new evidence by examining the relationships between the EPU and portfolio returns.