How households respond to economic uncertainty:

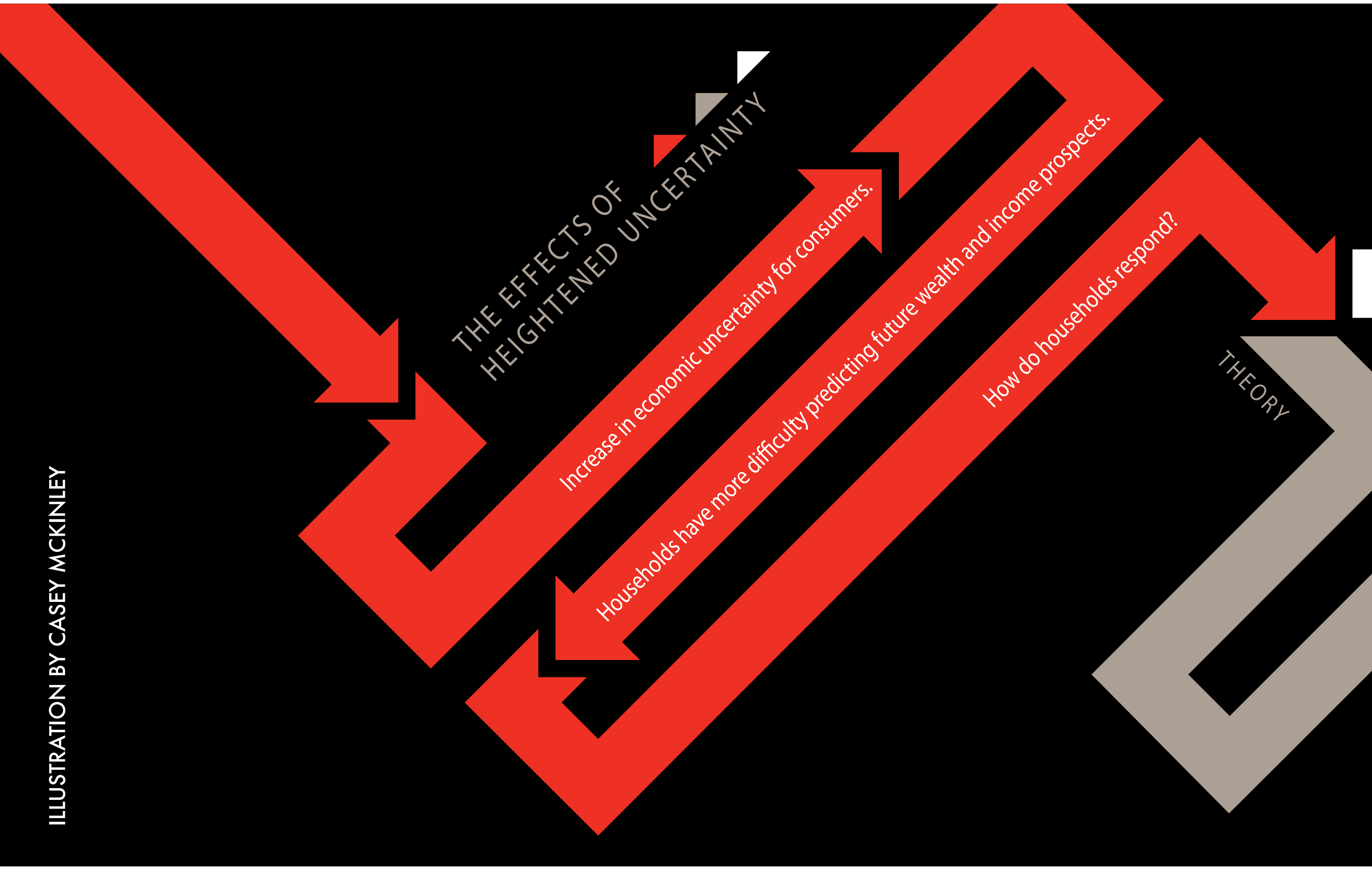


ILLUSTRATION BY CASEY MCKINLEY

Stock prices dip while headlines declare economic uncertainty.

Economic disruptions often coincide with heightened uncertainty for consumers, says Ed Knotek, a vice president and economist at the Federal Reserve Bank of Kansas City.

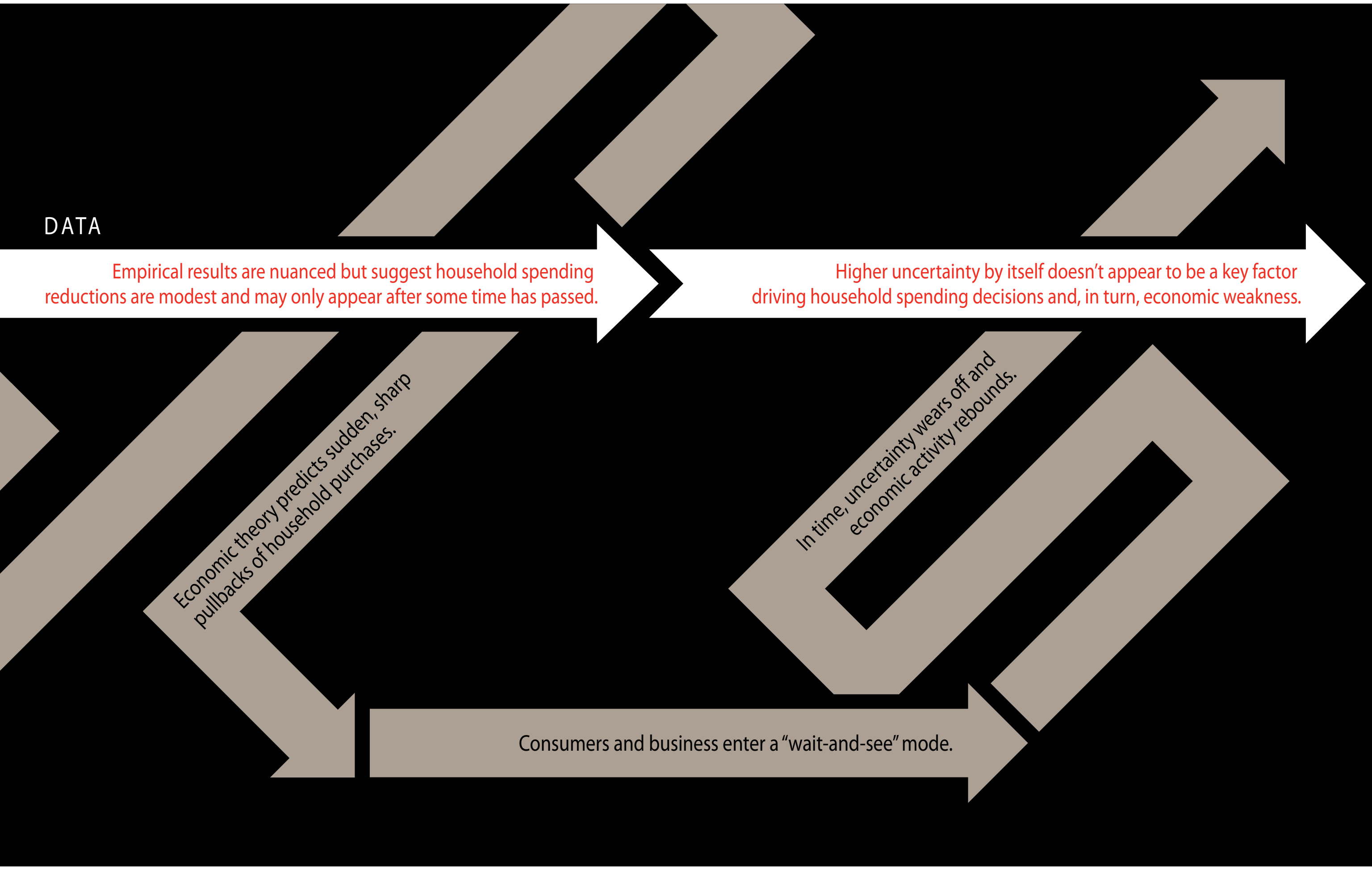
This raises the question: Is uncertainty a primary cause of economic weakness, or is uncertainty a consequence of a variety of other factors?

Knotek and Shujaat Khan, a research associate, recently examined this issue in more detail. They focused on how households respond to sudden, unexpected events that raise the possibility of extreme future outcomes for wealth and income, both good and bad. In other words, they considered household responses to movements in uncertainty—uncertainty shocks.

Knotek and Khan considered two ways to measure uncertainty. One is based on the monthly appearance of the words "uncertainty" or "uncertain" in *New York Times* articles that also contain references to the economy. The second measure is from monthly stock market volatility.

A written record can provide one measure of intangible uncertainty, capturing both the nation's and Wall Street's sentiments on the

Theory versus data



economy, says Khan. Highly volatile stock price movements may also be associated with more uncertain times, as investor sentiment rapidly shifts between positive and negative outlooks.

Economic theory predicts that household purchases would decline immediately following an increase in uncertainty as consumers take a "wait-and-see" approach before making costly purchases, especially those that aren't easily undone, like buying a home or car.

In the data, however, Knotek and Khan find that uncertainty shocks tend to curtail household spending modestly. In some cases, households do not appear to react quickly to increases in uncertainty. In addition, uncertainty shocks can explain only a small portion of fluctuations in household spending.

Above is a breakdown of household responses to uncertainty based on theory and based on data.

FURTHER RESOURCES

"HOW DOES HEIGHTENED UNCERTAINTY AFFECT ECONOMIC ACTIVITY?"
By Edward S. Knotek II and Shujaat Khan
KansasCityFed.org/research