A Machine Learning Approach to Identifying Different Types of Uncertainty

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Abstract

We implement natural language processing techniques to extract uncertainty measures from Federal Reserve Beige Books between 1970 and 2018. Business and economic related uncertainty is associated with future weakness in output, higher unemployment, and elevated term premia. On the other hand, political and government uncertainty, while high during recent times, has no statistically significant impact on the economy.

Keywords: Natural Language Processing, VAR, Federal Reserve Beige Books

JEL classification: C8, E52, D80

1. Introduction

Uncertainty plays a significant role in shaping investment decisions, household spending patterns, and labor market outcomes, with the potential for large cross-border spillover effects (e.g., Klößner and Sekkel 2014). Unfortunately, very few concepts are simultaneously as important and as difficult to measure, leading to significant efforts to quantify uncertainty through survey-based measures of disagreement among professional forecasters (e.g., Bachmann et al. 2013); option-implied measures of volatility around future asset prices (e.g., VIX); and news-based measures of reported uncertainty (e.g., Baker et al. 2016).

2. Measuring Uncertainty

We develop a natural language processing model (combining a trained support vector machine classifier, deterministic algorithms, and manually created graph pattern rules) using Amenity Analytics’s text mining engine to extract uncertainty measures from Federal Reserve Beige Books, published between 1970 and 2018.$^2$

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$^2$We utilize the same software as in Boudoukh et al. (2016). There is also a growing literature capitalizing on computational linguistics algorithms to analyze FOMC transcripts and other forms of central bank communication (e.g., Hansen et al. 2017).
Our proposed measure counts every time the concept of “uncertainty” is mentioned in the text. Importantly, our model recognizes negation links that separate instances of uncertainty reduction from negative mentions of uncertainty in the economy. For example, the sentence “there is uncertainty in the economy” would increase the count by one. If it instead read, “there is not uncertainty in the economy,” it would reduce the count by one. This capability is unique in the literature, as common algorithms treat words as features, and search for set combinations in text without being able to account for context. Moreover, the multi-functional extraction capabilities of the engine, also allow us to extract slotted terms in addition to sentiment, such that we not only identify the word “uncertainty” in a sentence, but we are also able to contextually classify the type of uncertainty being extracted. Figure 1 shows a sentence with slots around the two areas identified: “domestic” and “politics” that relate to “uncertainty.”

Figure 1: Example of Identified Uncertainty from January 18, 2017 Beige Book, p. A-2

The outlook among contacts was cautiously optimistic, with significant [uncertainty] related to [domestic politics]

We define the uncertainty count for each Beige Book \( i = 1, 2, ..., I \), as the difference between the negative and positive uncertainty mentions divided by the word count for each Beige Book, to control for the tendency of documents to become lengthier over time:

\[
v_i = \left( \frac{\text{(number of negative uncertainty extractions in Beige Book } i) - \text{(number of positive uncertainty extractions in Beige Book } i)}{\text{(word count in Beige Book } i)} \right) \times 10,000. \quad (1)
\]

The aggregate quarterly measure of uncertainty is the sum of the scaled count of each Beige Book in a given quarter, \( t \),

\[
U_t = 100 + \sum_{i \in \text{quarter } t} v_i. \quad (2)
\]

3. Quantifying Different Types of Uncertainty

Beyond the main index of uncertainty, we use equations 1 and 2 to distinguish among 13 different areas of uncertainty. We apply principal component analysis and find that the areas can be classified into two broader categories (see figure 2).

The areas in groups 1 and 4 both contribute heavily to the second principal component (> |0.5|). We combine these groups (e.g., “fiscal,” “regulation,” etc.) into Politics & Government (P&G) Uncertainty. In contrast, groups 2 and 3 are mostly explained by the first component and combined into Business & Economics (B&E) Uncertainty. Importantly, given the low factor contribution of the components (0.22 and 0.13), we identify these two categories to be quite different, suggesting that uncertainty differs by type and
a simple word count would miss this important distinction.3

Figure 2: Contribution of Components

Notes: Components 1 and 2 are extracted by principal component analysis on all 13 measures of uncertainty extracted from the Beige Books.

Figure 3 depicts the overall index of Uncertainty and its two categories over time. Our uncertainty measure is broadly similar to the economic policy uncertainty measure of Baker et al. (2016) during the 1985-2018 period (0.68 correlation). Moreover, P&G Uncertainty correlates highly (0.55–0.66) with similar measures, such as tax expiration and categorical uncertainty on taxes, fiscal policy, government spending, health care, and entitlement programs.

4. Assessing the Impact of Different Types of Uncertainty on the Economy

In order to explore the impact of uncertainty on the real economy, we specify a quarterly vector autoregressive (VAR) framework, similar to Baker et al. (2016), from 1970-Q2 to 2017-Q4. We let uncertainty be followed by the unemployment rate and (log) GDP, as well as the federal funds rate and the (log) S&P 500 Index, in order to control for business-cycle and general financial conditions.4

3This result is consistent with work by Larsen (2017), who finds that various types of uncertainty from news paper articles in Norway have different effects on the economy.

4In order to account for potential endogeneity, Richter and Throckmorton (2017) for example, develop a structural model to study the effects of uncertainty.
Notes: The stacked bars show the proportion of each category relative to the overall index, which might not necessarily add up to 100% since one mention of uncertainty could be counted towards both categories at the same time. Similarly, if uncertainty is not classified into any category, the total will be less than 100%.

The first column in figure 4 shows the response to a shock to Uncertainty, while the second and third columns, show the responses to a shock to B&E and P&G Uncertainty, respectively. A one standard deviation increase in Uncertainty is about 2.8 points. To provide some context, this magnitude is roughly equal to the increase from the average level of uncertainty in 2005-2006 to 2007-2008. Notoriously, the uncertainty index has muted effects; but when divided into categories, it is clear that B&E Uncertainty is associated with economically and statistically significant changes in the economy; whereas P&G Uncertainty is not.

A one standard deviation shock to B&E Uncertainty increases the unemployment rate by 0.3%.\(^5\) This effect is statistically significant at the 90 percent confidence level and quite persistent, lasting for over 3 years. A shock to B&E Uncertainty is also associated with a decline in economic activity of about 1.8%.\(^6\)

\(^5\)This magnitude is consistent with the response of the unemployment rate to different uncertainty shocks previously found in the literature: 0.05 p.p. (Bundick et al., 2017); 0.08% (Creal and Wu, 2017); 0.15% (Castelnuovo and Tran, 2017); 0.2 p.p. (Leduc and Liu, 2012); 0.25%-0.4% (Mumtaz, 2018).

\(^6\)In their quarterly VAR specification, Baker et al. (2016) found uncertainty to lower GDP by 1.2%. Others have identified a decline in industrial production with similar magnitudes: 0.25% (Husted et al., 2017); 0.4% (Bundick et al., 2017); 1% (Choi, 2013); 1.2% (Baker et al., 2016); 1% during expansions and 2% during recessions (Caggiano et al., 2017).
Figure 4: Impulse Responses to Uncertainty, B&E Uncertainty, and P&G Uncertainty Shocks

Notes: The first column shows the response of a shock to Uncertainty to the unemployment rate, GDP, the Federal Funds Rate, and S&P 500. The second and third columns show the same impulses for a shock to B&E and P&G Uncertainty, respectively. Impulse responses are estimated with the corresponding 90% confidence intervals with 10,000 Bootstrap iterations from a VAR of order 3. For data sources, details on the main specification, and robustness checks, refer to the Online Appendix.

The impact of B&E Uncertainty shocks are in line with the effects of other publicly available measures of uncertainty, such as the financial and macroeconomic uncertainty indices from Jurado et al. (2015); the historical economic policy uncertainty index from Baker et al. (2016); and the financial uncertainty index from Chuli et al. (2017).

The main results are robust to altering the order of the variables so that uncertainty is first, in the middle, or last; allowing for different lags as specified by several information criteria rules; including different variables to control for general optimism/pessimism in financial markets; incorporating the shadow rate to account for the stance of monetary policy during the zero lower bound period; first-differencing variables; excluding the
unemployment rate; considering non-farm payroll employment; and removing the zero lower bound period.

In all cases, the same results hold: B&E Uncertainty has stronger, more persistent, and statistically significant effects on the real economy, whereas P&G Uncertainty does not.\footnote{A potential explanation is that P&G Uncertainty captured in the Beige Books is not associated with changes in the real economy because it reflects uncertainty that is perhaps already priced in the economy or agents don’t believe these documents provide special insight into fiscal policy.}

Bundick et al. (2017) propose a slightly different specification to study the effects of uncertainty in a VAR framework by ordering their policy uncertainty measure after production (GDP) and prices (PPI), consistent with the notion that the economy responds to shocks with a lag. After the uncertainty index, we also incorporate the federal funds rate and the slope of the yield curve, defined as the 10-year yield minus the 3-month yield, similar to their main specification. The results from this identification also suggest that a standard deviation increase in B&E Uncertainty is associated with a 1% decline in future GDP, while there is no statistically significant relationship between higher P&G Uncertainty and GDP.\footnote{We find that higher uncertainty is associated with higher PPI, although not statistically significant at the 90% confidence level. This result is consistent with Crael and Wu (2017), who also found higher uncertainty relates to higher (but not statistically significant) inflation. Others have found that uncertainty leads to lower CPI inflation around 0.15%-0.8% (Husted et al., 2017; Leduc and Liu, 2012; Castelnuovo and Tran, 2017; Caggiano et al., 2017).}

Importantly, we find that higher B&E Uncertainty is associated with future steepening of the yield curve—an increase in the slope of 10 basis points. In order to further explore the channels through which B&E Uncertainty operates, we run different VAR specifications and find that this increase in the slope is due to an increase in the 10-year yield and not necessarily a decline in the short end of the yield curve. Our findings indicate that B&E Uncertainty is more likely related to long-term expectations of economic activity; in particular, we find a statistically significant effect on the 10-year term premium. These results suggest that the B&E Uncertainty that is documented on Federal Reserve Beige Books captures future perceived weakness in the economy, for which investors’ demand a higher premium to invest in long-term bonds. This premium is above and beyond the expected future path of the short rate, captured by the risk-neutral yield, suggesting that B&E Uncertainty is not necessarily related to forward guidance and the clarity provided by the Fed about the future path of interest rates, but is instead related to the risk component embedded in the term premium.\footnote{Consistent with the notion that B&E Uncertainty captures uncertainty about future economic activity, we find that higher B&E Uncertainty is associated with higher credit spreads—the risk priced by the difference between Moody’s Seasoned Baa corporate bond rate and the federal funds rate.} Finally, we explore the effects of B&E Uncertainty on the U.S. dollar and find that a one standard deviation increase in B&E Uncertainty is associated with a 1% future depreciation of the currency, consistent with expected economic weakness.

5. Conclusion

Although uncertainty in the U.S. has remained elevated in these past few years, our methodology reveals that this is more likely related to politics and government and not the overall health of the economy, with
negligible effects on economic activity. This finding is consistent with the recent decoupling of certain measures of uncertainty and general financial conditions observed in the U.S. We propose that along with quantifying uncertainty, it is important to also distinguish the type of uncertainty that is being measured.

Acknowledgments

We thank the Blanchard Fund for Economics for financial support; *Amenity Analytics* for providing their NLP engine; and Alex Richter, Nate Tefft, and Paul Shea for helpful comments and suggestions.

References


