Uncertainty, Risk Aversion and the Effects on Business Cycles

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Abstract

While the VIX index reflects uncertainty in stock market, it is also viewed as a measure of risk aversion and fear of investors in the financial market. It is important to know whether the risk preference shock of market participants work any different from uncertainty shock on real economy. After decompose the VIX index into two components: expected stock market volatility ("uncertainty") and a proxy for risk aversion by using the data from January 2000 to March 2016, the effects of these two components on business cycles (industrial productions and CPIs)are analyzed for 8 advanced market economies, the impulse responses are generated by local projection method.

After decomposing the covariance of uncertainty and risk aversion, we also investigated the dynamic effects of uncertainty uncorrelated with risk aversion of market participants. From the comparison between effects of uncertainty correlated with risk aversion and uncorrelated with risk aversion, it suggests that despite the effects of uncertainty shock on business cycles are showed to be significantly larger than that of risk aversion shock, uncertainty shock in US market affects other economies through risk aversion.