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The Impact of Economic Policy Uncertainty on Stock Market Liquidity

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Introduction

With the deepening of economic globalization, the economic development of countries around the world is getting closer, the world economic situation is unpredictable, the degree of global uncertainty is rising, and the market's dependence on economic policies is also increasing. In an incomplete capital market, the uncertainty of economic policies has increased the business risks of enterprises, aggravated the degree of information asymmetry, and affected the investment behavior of investors. In reality, investors' cognitive biases and emotional preferences will prompt investors to make a series of irrational behaviors in investment decisions. This behavior is often not in line with the expectations of classic financial theories, so it has produced some anomalies in the financial market.

Research Questions

How will the level of liquidity change when economic policy uncertainty increases?

Whether investor sentiment affects the relationship between economic policy uncertainty and stock liquidity?

Methodologies

Fixed effects model

Mathematical Formulas

$$ILLIQ = \alpha_0 + \alpha_1 EPU + \alpha_2 SMB + \alpha_3 BM + \alpha_4 LEV + \alpha_5 SIZE + \alpha_6 HML + \alpha_7 ROA + v + \varepsilon \quad (1)$$

$$ILLIQ = \beta_0 + \beta_1 CICSI + \beta_2 SMB + \beta_3 BM + \beta_4 LEV + \beta_5 SIZE + \beta_6 HML + \beta_7 ROA + v + \varepsilon \quad (2)$$

$$ILLIQ = \delta_0 + \delta_1 CICSI + \delta_2 EPU + \delta_3 CICSI \times EPU + \delta_4 SMB + \delta_5 BM + \delta_4 LEV + \delta_5 SIZE + \delta_6 HML + \delta_7 ROA + v + \varepsilon \quad (3)$$

Table

Table 3

VARIABLES	(1) ILLIQ	(2) ILLIQ	(3) ILLIQ
EPU	0.001		0.025***
	(0.24)		(5.46)
CICSI		-0.007***	-0.010***
		(-9.06)	(-11.17)
CICSI×EPU			0.005***
			(3.75)
LEV	0.075**	0.062**	0.075**
	(2.51)	(2.09)	(2.53)
SIZE	-0.008***	-0.004*	-0.005**
	(-3.12)	(-1.68)	(-2.16)
EPS	-0.028***	-0.023**	-0.246***
	(-2.69)	(-2.20)	(-4.08)
HML	-1.881***	-1.169***	-2.406***
	(-5.14)	(-4.00)	(-6.64)
ROA	-0.146***	-0.143***	-0.088*
	(-2.94)	(-2.93)	(-1.79)
Constant	0.217***	0.398***	0.512***
	(3.90)	(6.80)	(8.42)
Observations	3,531	3,531	3,531
Number of CODE	321	321	321
R-squared	0.032	0.056	0.068
Ftest	0	0	0
r2_a	-0.0670	-0.0403	-0.0272
F	17.41	31.53	29.32

t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Tables

Table 1 Decriptive statistics

VARIABLES	N	mean	sd	min	max
EPU	3,531	1.864	0.945	0.0379	3.648
ROA	3,531	0.0379	0.0858	-2.747	0.442
LEV	3,531	0.505	0.192	0.00708	2.024
EPS	3,531	0.246	0.444	-2.650	7.680
HML	3,531	0.00233	0.0104	-0.0117	0.0248
CICSI	3,531	38.37	4.221	32.12	47.45
ILLIQ	3,531	0.0737	0.185	0.000557	7.318
SIZE	3,531	22.18	1.310	18.29	26.27

Table 2

VARIABLES	ILLIQ	EPU	CICSI	LEV	SIZE	EPS	HML	ROA
ILLIQ	1							
EPU	-0.079***	1						
CICSI	-0.182***	0.549***	1					
LEV	0.042**	-0.048***	-0.040**	1				
SIZE	-0.059***	0.229***	0.187***	-0.0270	1			
EPS	-0.115***	0.0250	0.054***	-0.136***	-0.0140	1		
HML	-0.116***	0.635***	0.275***	-0.0230	0.153***	0.0240	1	
ROA	-0.120***	-0.0120	0.037**	-0.310***	-0.038**	0.534***	0.0220	1

Conclusion

This article explores the relationship between economic policy uncertainty and stock liquidity from a new perspective of economic policy uncertainty. The study found that economic policy uncertainty has a negative inhibitory effect on stock liquidity. The higher the economic policy uncertainty, the lower the level of stock liquidity. Investor sentiment has a significant role in promoting the liquidity of the stock market. The higher the investor sentiment, the higher the level of stock liquidity. At the same time, it can magnify the impact of economic policy uncertainty. In addition, this article only focuses on the impact of investor sentiment on stock liquidity, and does not further discuss the impact of two different investor sentiments and stock market liquidity based on the different characteristics of investors' rational and irrational sentiments. Rely on the further deepening and discussion of follow-up research.