

The Impact of Economic Policy Uncertainty and Investor Sentiment on Financial Stability

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Abstract

Based on the data from the fourth quarter of 2009 to the fourth quarter of 2020, this paper uses TVP-VAR-SV model to study the time variability of the interaction of the three at different periods and time points, and finally tests the intermediary effect. The research finds that: first, at different time points, a linkage mechanism of "economic policy uncertainty - investor sentiment - financial stability" will be formed; Second, in the short term, the rise of economic policy uncertainty can increase financial stability by suppressing investor sentiment, but in the long term, the rise of economic policy uncertainty will weaken financial stability; Third, investor sentiment plays an intermediary role in the transmission process of economic policy uncertainty to financial stability. In a period of time, rising investor sentiment will have a positive effect on financial stability. Therefore, at this stage, we should ensure the long-term effectiveness and stability of economic policies and strengthen the guidance of investors' rational expectations.

Keywords

Double Circulation; Economic Policy Uncertainty; Investor Sentiment; Financial Stability; TVP-VAR-SV Model.

1. Introduction

After the international financial crisis in 2008, the international environment entered a stage of deep adjustment and transformation. The economic downturn made investors depressed, and the stability of the financial market was prone to fluctuations. The world has entered a period of transformation and turbulence, and many scholars have begun to question the traditional theory of rational expectation. The theory holds that each participant in the economic system has sufficient knowledge and ability to form accurate expectations of future economic development. However, unlike institutional investors, many individual investors lack investment analysis knowledge and independent thinking ability, and tend to follow the trend blindly when making investment decisions. The uncertainty of economic policies brought about by macroeconomic fluctuations often misleads investors to form irrational forecasts of the market, thus affecting investor sentiment, inducing investors to blindly carry out investment activities in the market, promoting risk aggregation and endangering financial stability.

Compared with major international economies, after more than 40 years of reform and opening up, China's economic aggregate has been in the growth stage, forming a relatively complete financial market system and industrial chain, creating a good financial environment for social development. However, the high leverage of the society, the gradually accumulated real estate foam, and the imbalance of economic structure are all appendages of the pursuit of rapid economic development. Under the severe global economic situation, China should not only pay attention to the impact of economic policy uncertainty on investor enthusiasm and financial stability, but also adjust economic policies in time to cope with the complex external environment. As an emerging market with high-quality development and transformation, the

Chinese government has put forward a series of development plans in the face of a new era of economic development and a series of development problems. It is urgent to find new development momentum to stabilize the financial market.

It provides ideas for solving the problems of China's social and economic development, adds vitality to the sustainable development of the national economy, and provides policy guarantees for stabilizing the financial market. Since China entered the new normal of economy, the Chinese government has issued a number of new policies to cope with slow economic growth. Frequent adjustment of economic policies and the volatility of the financial system will have different expectations on the market, which will further affect investor sentiment.

Therefore, this paper selects the China economic policy uncertainty index constructed by Baker et al. (2016), the investor sentiment index constructed by Baker et al. (2012), and the financial stability index constructed by using the principal component analysis method based on 14 basic indicators in nine risk areas to establish the TVP-VAR-SV model to study the time variability of the dynamic relationship among the three at different times and points in time. In order to better monitor investor sentiment, effectively and purposefully implement relevant economic policies, and form a new development pattern of "double cycle".

The remaining arrangements of the article are as follows: the second part lists the theoretical research on the influence between the above two variables at home and abroad, which provides theoretical support and valuable experience for the research of this paper; The third part of the paper constructs financial stability index and investor sentiment index, and selects various indicators in the financial field such as bond market and stock market; The fourth part is the empirical analysis of TVP-VAR-SV model; The last part is the conclusion and policy recommendations.

2. Literature Review and Research Hypothesis

2.1. Economic Policy Uncertainty and Investor Sentiment

Although some scholars have discussed the uncertainty of economic policy and investor sentiment, the relevant literature is still insufficient. Chi Lixu and Zhuang Xintian (2011) [1] pointed out that different policies have different effects on investor sentiment. 1. Perspective of enterprise investors; Jin Guanghui (2008) [2] found that the uncertainty of economic policies made investors more inclined to avoid risks based on the perspective of enterprise investment; It is found that the increase of economic policy uncertainty will significantly inhibit investor sentiment; Zhu Guanping et al. (2019) [3] found that investor sentiment has an intermediary effect on policy transmission. 2. Perspective of individual investors; From the perspective of individual investors, Jin Guanghui et al. (2016) [4] found that uncertain expectations of economic policies would lead to negative emotions such as anxiety and fear among investors, which led them to be more cautious when investing.

2.2. Investor Sentiment and Financial Stability

Many scholars have conducted in-depth research on the relationship between investor sentiment and financial stability. Matsusake and Sbordone (1995) [5] believed that when investors were added to the macroeconomic model, the financial system would fluctuate synchronously; Ivanova and Lahiri (2001) [6] emphasized that financial fluctuations can be explained by investor sentiment during economic and political turbulence; Haugh (2005) [7] pointed out that during the economic recession, investor sentiment has a strong predictive ability for financial markets; Illing and Liu (2006) [8] proved that investor sentiment is more effective for financial stability in developed countries. Baker and Wurgler (2006) [9] found that when investors are in high mood on the market, they will invest their funds in high-risk and high return stocks, thus affecting the stability of the financial system. Ba Shusong and Zhu Hong

(2016) [10] obtained the positive correlation between investor sentiment and financial system volatility through mathematical modeling; Ling Zhiming and Wang jingle (2018) [11] found that during the financial crisis, changes in US investor sentiment will affect changes in the Chinese market; Zhu Baojiang et al. (2019) [12] further pointed out that during the financial crisis, the mutual infection between Chinese and American investor sentiment was significantly enhanced.

2.3. Uncertainty of Economic Policy and Financial Stability

Many scholars have studied the relationship between economic policy uncertainty and financial stability from the perspective of financial instability. Pastor and Veronesi (2012) [13] found that changes in policies will significantly increase the volatility of the financial system Mobility; In the context of asset pricing, Lin Jianhao et al. (2014) [14] proved that economic policy uncertainty has a positive impact on stock prices through sectors and time series. Li Fengyu and Yang Mozhu (2015) [15] believe that the increase of economic policy uncertainty will lead to a decrease in the holding rate of financial market investment funds and an increase in the holding rate of liquidity assets. Gilchrist et al. (2014) [16] found that economic policy uncertainty has a negative impact on investment in emerging industries and will lead to changes in financial stability in the framework of macroeconomic and enterprise levels. Liu Yang and Hou Mengqi (2020) [17] and others believe that economic policy uncertainty will lead to deviation in bank risk estimation, and will significantly promote the amount of bank loans, which may lead to financial systemic risks. Xiong Haifang, Liu Tianming (2020), Dong Rui (2020) [18] and others found that uncertainty will cause fluctuations in the short and medium term and have countercyclical characteristics by studying the impact of economic policy uncertainty on financial stability.

2.4. Theoretical Transmission and Research Hypothesis

It can be seen from the literature that the increase of economic policy uncertainty will affect financial stability through investors and enterprises' investment. On the one hand, rising economic policy uncertainty will undermine investor confidence, reduce market investment activities, suppress investor sentiment, and strengthen financial stability; On the other hand, the rise of economic policy uncertainty will increase the investment expenditure of enterprises, enterprises will reduce credit activities and investment, investors will be depressed, and the degree of financial stability will increase.

Based on the above literature review, three research hypotheses are proposed:

H1: there is a linkage mechanism in the financial market that "economic policy uncertainty investor sentiment financial stability" is transmitted in turn;

H2: The uncertainty of economic policy has a restraining effect on investor sentiment, and thus has a positive effect on financial stability;

H3: Investor sentiment is an intermediate variable between economic policy uncertainty and financial stability, playing a role of intermediary effect.

To sum up, many scholars carry out pairwise analysis of the three variables, while few scholars put the three variables together for research. Therefore, the innovations of this paper are as follows: First, the time-varying relationship between the three variables is studied; Second, it further verified the intermediary effect of investor sentiment.

3. Data Description and Model Construction

3.1. Variable Selection and Data Source

Based on the availability of data, this paper selects the time span from the third quarter of 2009 to the fourth quarter of 2020. The following is a description of variable selection and data sources.

3.1.1. Economic Policy Uncertainty Index (EPU)

This paper refers to previous studies and uses the method of text mining to construct the uncertainty index of economic policy. This paper selects the authoritative newspapers, People's Daily and Guangming Daily, which can best represent our government, to count the reading frequency of the reports on key words of economic situation that appear in these two newspapers, and divide them by the trend of removing news reviews published by the two newspapers, so as to obtain the time series about the uncertainty of our economic policy. The specific data comes from the official websites of the two major newspapers and the author's own collation.

3.1.2. Investor Sentiment (ISI)

The choice of investor sentiment is mainly based on the research results of Baker et al. (2012). The two scholars selected six investor sentiment variables, namely, the number of IPO, the first day return of IPO, dividend premium, market turnover rate, closed-end fund discount rate and stock financing ratio, and then used principal component analysis to extract common factors as investor sentiment indicators. In addition, they take the median value of the monthly composite index of investor sentiment as the benchmark, and those above the median value are regarded as high sentiment, while those below the median value are regarded as low sentiment. Since this paper selects quarterly data, the monthly average of investor sentiment is taken as the investor sentiment index. The monthly data is from the CSMAR database.

3.1.3. Financial Stability (FSI).

The measurement methods of financial stability are mainly divided into market information method and comprehensive index evaluation method. At present, the academic community has not reached an agreement on the quantitative measurement standard of financial stability. Compared with the market information method, which can only measure the unilateral risk of a single country's financial market, this paper believes that the comprehensive evaluation method can more comprehensively measure the degree of financial market stability. Most scholars use the comprehensive indicator evaluation method to construct the financial stability index based on the Financial Stability Report issued by the People's Bank of China in 2005 for demonstration. For example, Wang Jinming and Wang Xinpei (2021) selected 18 indicators from four dimensions of financial development, financial vulnerability, financial stability and world economic development prosperity to construct the financial stability index. Wang Xi et al. (2020) constructed the financial stability index from four dimensions of financial development, defense Stability and recovery ability select 18 indicators to construct a financial stability index with Chinese characteristics. This paper believes that the relevant research is not comprehensive and accurate in selecting indicators, so it uses the practice of Wang Jinsong and Ren Yuhang (2021) for reference, selects 14 indicators from 9 risk dimensions to build a financial stability index, and the 14 indicators are local government debt ratio, commodity housing sales price, financial industry restriction FDI restriction index, short-term capital flow volatility, third-party payment scale, non-performing loan ratio and capital adequacy ratio of major commercial banks China's existing shadow bank scale and commercial bank flow Dynamic ratio, volatility of Shanghai interbank offered rate, volatility of corporate bond index, volatility of price earnings ratio of listed companies on Shanghai Stock Exchange, leverage ratio of resident sector, and leverage ratio of non-financial enterprise sector. At the same time, since the National Bureau of statistics no longer publishes the sales price index of commercial housing, it is changed to use the cumulative sales price of commercial housing published by the Statistics Bureau of China economic network as the agent of real estate foam risk. In order to match the data frequency, the end of each quarter value is taken; The Financial Industry FDI restriction index is from the OECD database, using Eviews supplement and converting annual data into quarterly data; The short-term capital flow volume adopts the method generally

adopted by scholars at present. First, the current increment of foreign exchange funds is used to subtract the current account trade surplus, and then the actual foreign direct investment is subtracted to calculate the monthly total amount of capital flow. Then, the corresponding quarterly standard deviation is obtained through rolling standard deviation processing of the data to measure its fluctuation level; The proportion of third-party payment market size is measured by dividing the third-party Internet payment size by the sum of deposits and loans of financial institutions. The former comes from the report issued by Analysys International, and the latter comes from the CEIC database; The non-performing loan ratio, capital adequacy ratio and liquidity ratio of commercial banks are from CEIC database; The scale of existing shadow banks is measured by the ratio of total assets of shadow banks strictly defined by the Central Bank to total assets of banking financial institutions. The latter comes from the CEIC database. The former uses Fang Xianming's (2017) practice to represent the scale of shadow banks by the sum of the stock size of entrusted loans, trust loans and non discounted bank acceptances of financial institutions, and the data comes from the wind database; The short-term inter-bank offered rate of the Shanghai interbank offered market, the Shanghai corporate bond index and the price earnings ratio of stocks are all from the wind database, and the quarterly standard deviation is taken to represent the volatility. The first step is to positively treat the negative indicators. Except for the Financial Industry FDI restriction index, commercial bank capital adequacy ratio and liquidity ratio, all other indicators are negative indicators; The second step is to unify the dimensions and standardize all indexes by subtracting the mean and dividing it by the standard deviation. Third, use principal component analysis to extract common factors to obtain the financial stability index.

3.2. Empirical Model Selection

In order to deeply analyze the time-varying characteristics and capture the sudden change of potential economic structure, TVP-SV-VAR model is selected to study the dynamic correlation among the three variables of economic policy uncertainty, investor sentiment and financial stability.

4. Empirical Results and Analysis

4.1. Unit Root Test

In this paper, ADF test is used to test the stationarity of variables, and AIC standard is selected to test the unit root of data. The test results are shown in Table 1, and each variable is a stationary series. Including economic policy uncertainty index and gold.

The financial stability index is stable at a significance level of 1%, and investor sentiment is stable at a significance level of 5%. This provides assurance for the following analysis.

Table 1. Unit Root Test

variable	ADF test value	P value	critical value (1% 5% 10%)	Stability
EPU	-9.268272	0.0000	-2.618579 -1.948495 -1.612135	stable
ISI	-2.413861	0.0170	-2.622585 -1.949097 -1.611824	stable
FSI	-2.919238	0.0047	-2.628961 -1.950117 -1.611339	stable

4.2. Empirical Analysis based on TVP-VAR-SV Model

4.2.1. Empirical Model Test

This paper uses OxMetrics6.0 software to build TVP-VAR-SV model with time variation. The widely used Markov chain Monte Carlo method (MCMC) is used to calculate the posterior distribution of parameters. Considering the convergence of the model and the efficiency of computer operation, the sampling method is set to 10000 times, and the distribution of the last

9000 samples is taken as the real distribution of parameters. Table 2 reports the relevant statistics of TVP-VAR-SV model. Through observation, it is found that the posterior mean of parameters are all within the confidence interval, and Geweek test cannot reject the original hypothesis. Further observation shows that the maximum ineffective factor is about 40, which indicates that the sampling method can obtain about $10000 / 40 = 250$ unrelated samples, which indicates that the estimation of TVP-VAR-SV model based on MCMC method is practical and effective.

Table 2. Parameter estimation results

parameter	mean value	standard deviation	95% confidence interval	Geweek value	Invalid factor
sb1	0.0228	0.0026	[0.0183,0.0286]	0.815	4.81
sb2	0.0227	0.0026	[0.0183,0.0285]	0.147	1.64
sa1	0.0872	0.0402	[0.0438,0.1883]	0.986	35.53
sa2	0.0824	0.0312	[0.0436,0.1669]	0.683	17.58
sh1	0.3401	0.1391	[0.1496,0.6839]	0.970	40.73
sh2	0.3778	0.2234	[0.0784,0.9405]	0.270	43.05

4.2.2. Time Variant Analysis based on TVP-VAR-SV Model

In the model period setting, this paper sets one quarter as the short term, three quarters as the medium term, and four quarters as the long term; In the time setting, this paper selects the third quarter of 2013, the second quarter of 2015 and the fourth quarter of 2019 based on the major external economic shocks, which correspond to the "money shortage" of the banking industry, the stock market disaster and the outbreak of the COVID-19 epidemic. In these three periods, the government has strengthened macro-control and intervened in the market for many times, and the economic policy uncertainty is high.

4.3. Time-varying Analysis of the Impact of Economic Policy Uncertainty on Investor Sentiment

Figure 1 shows the time-varying impulse response function of investor sentiment to the uncertainty of economic policy. It is observed that the positive impact of economic policy uncertainty on a unit leads to changes in investor sentiment in the long, medium and short term. It is found that the short-term impact represented by the solid line and the medium-term impact represented by the long dotted line are significantly greater than the long-term impact represented by the dotted line. This shows that in the short and medium term, investor sentiment has a greater impact on the uncertainty of economic policy. At the same time, Figure 2 shows the time point impulse response function of economic policy uncertainty to investor sentiment. It can be found that, at different time points, the rising uncertainty of economic policies has a positive transmission effect on investor sentiment, and the negative effect of the impact in the fourth quarter of 2019 is significantly higher than other time points; This means that the interval is relatively long, and the increasing uncertainty of economic policies at the end of 2019 will have a greater inhibition on investor sentiment.

4.4. Time-varying Analysis of Investor Sentiment and Financial Stability

Figure 1 shows that the positive impact of investor sentiment will reduce the negative transmission effect of financial stability, but the negative effect caused by the interval between the fourth quarter is significantly weaker than the interval between the first quarter and the third quarter. As time goes on, the negative effect will weaken in the long term. Therefore, the rising investor sentiment does not always accumulate risks with time. It is also necessary to observe the investment behavior and preference of investors in the market and guide the formation of investors' rational expectations.

Figure 2 shows that the positive impact of investor sentiment will cause the transmission effect of financial stability from negative to positive to negative. At different time points, the transmission effect of financial stability caused by investor sentiment has the same direction but different transmission strength. In the second quarter of 2015 and the fourth quarter of 2019, the impact of investor sentiment on financial stability was relatively strong; In the third quarter of 2013, the impact was weak.

At the same time, it should be noted that although the impulse response diagrams at different times and time points are nonlinear, there are great differences between them. The impulse response diagram of the period has always been below the value of 0, which indicates that the rise of investor sentiment will damage financial stability, but the damage is different. The impulse response diagram of the time point indicates that the rise of investor sentiment at different times will first reduce financial stability in the short term but will be beneficial to financial stability in the long term. This shows that we should not hold back investor sentiment just because investor sentiment decreases and financial stability is stable, but should guide market participants to form rational expectations and avoid the "herd effect" of investment behavior.

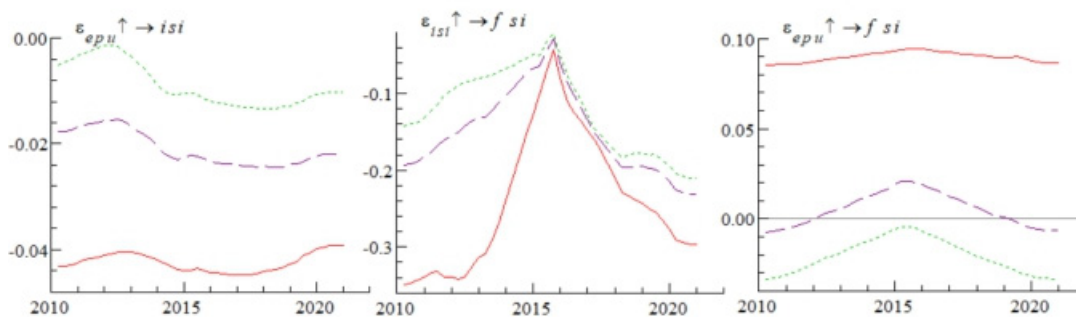


Figure 1. Equiinterval impulse response diagram of economic policy uncertainty, investor sentiment and financial stability

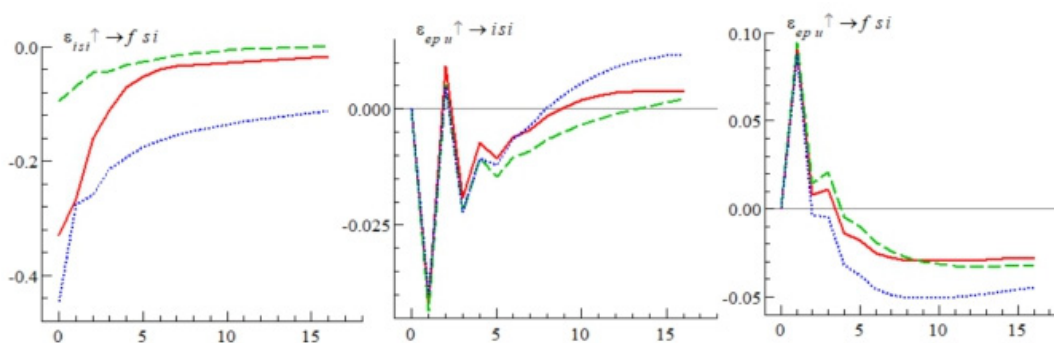


Figure 2. Equal time impulse response chart of economic policy uncertainty, investor sentiment and financial stability

4.5. Time-varying Analysis of Economic Policy Uncertainty on Financial Stability

Economic policy uncertainty has a consistent trend in the short and medium term, which has a positive transmission effect on financial stability; It produces negative conduction effect in the long term. In the short to medium term, uncertainty will reduce the amount of investment, the financial market risk has not yet accumulated, and the financial market is relatively stable. However, in the long run, as the uncertainty of economic policy continues to rise, the accumulated financial risks will erupt, and the increase in the uncertainty of economic policy will increase the level of financial pressure and reduce the stability of the market.

At different time points, the transmission effect of rising economic policy uncertainty on financial stability began to turn from positive to negative in the second and fifth periods respectively. Economic policy uncertainty will increase financial stability in the fourth quarter of 2019. Due to the outbreak of COVID-19, the economic policy uncertainty brought by the government's strengthening of macro-control at this time has greatly reduced market economic activities and strengthened the stability of the financial market to a certain extent. However, after the gradual recovery of the economy, the continued rise of economic policy uncertainty will still increase the vulnerability of the financial market.

The above analysis proves that all three assumptions are true. In general, from the perspective of investors, we find that: first, at different times, the uncertainty of economic policy inhibits investor sentiment, and investor sentiment has a nonlinear impact on financial stability. The uncertainty of economic policy also has different impacts on financial stability at different times, indicating that there is a transmission path from the uncertainty of economic policy to investor sentiment, and then to financial stability; Second, it has obvious heterogeneity and time variability in different periods. Economic policy uncertainty has a positive impact on financial stability in the short term, which indicates that economic policy uncertainty will stabilize the financial market by suppressing the market activities of micro investors, and the impact of economic policy uncertainty on financial stability is gradually accumulating; Investor sentiment has a nonlinear effect on financial stability, which indicates that at this stage, we should strengthen the guidance of market investors to form rational expectations, not blindly follow the trend and follow the crowd, and prevent the formation of systematic financial risks.

5. Conclusions and Policy Recommendations

5.1. Conclusion

Based on the data from the fourth quarter of 2009 to the fourth quarter of 2020, this paper uses tvp-var-sv model to study the time variability of the interaction of the three at different periods and time points, and on this basis, explores the intermediary effect of investor sentiment. Research findings:

First, at different time points, a linkage mechanism of "economic policy uncertainty investor sentiment financial stability" will be formed;

Second, in the short term, the rise of economic policy uncertainty will increase financial stability by suppressing investor sentiment, but in the long term, the rise of economic policy uncertainty will reduce financial stability, which has obvious nonlinear characteristics between them;

Third, investor sentiment plays an intermediary role in the transmission mechanism of economic policy uncertainty to financial stability. Over a period of time, rising investor sentiment will have a positive effect on financial stability. Therefore, we should strengthen the guidance of investors' rational expectations at this stage.

5.2. Policy Recommendations

First of all, to ensure the consistency and continuity of economic policies, the government should not only consider the impact of the policy itself on the economy, but also pay attention to the impact of uncertainty caused by frequent policy changes when formulating policies. When formulating policies, the government should not only fully consider whether the policies conform to the actual operation rules of society, but also pay attention to the frequency of policy issuance and modification. Otherwise, it is easy to affect investor sentiment and thus have a greater impact on the financial system. Compared with major international economies, after more than 40 years of reform and opening up, China's economic aggregate has been in the growth stage, forming a relatively complete financial market system and industrial chain, creating a good financial environment for social development. However, the high leverage ratio

of the society, the gradually accumulated real estate bubble, and the imbalance of the economic structure are all accessories for the pursuit of rapid economic development. Under the severe global economic situation, China should not only pay attention to the impact of economic policy uncertainty on investor enthusiasm and financial stability, but also adjust economic policies in time to cope with the complex external environment. As an emerging market with high-quality development and transformation, the Chinese government has put forward a series of development plans in the face of a new era of economic development and a series of development problems. It is urgent to find new development momentum to stabilize the financial market.

Secondly, over the past decades, the financial system has experienced many abnormal fluctuations due to the imperfection of the system and the lack of supervision. Each participant in the economic system has sufficient knowledge and ability to form accurate expectations of future economic development. However, unlike institutional investors, many individual investors lack investment analysis knowledge and independent thinking ability, and tend to follow the trend blindly when making investment decisions. The uncertainty of economic policies brought about by macroeconomic fluctuations often misleads investors to form irrational forecasts of the market and thus affect investor sentiment. Therefore, the relevant national departments should improve the financial system by establishing and improving the financial market supervision system and relevant laws and regulations, We will focus on implementing supply side structural reform, maintain financial stability, and promote the healthy development of the financial market.

Finally, investor sentiment plays a key role in the release of national policies and the stability of the financial system. Individual investors lack rich investment knowledge and irrational investment, which makes the development of the financial system very different from rational expectations. The uncertainty of economic policy has a positive impact on financial stability in the short term. The uncertainty of economic policy will stabilize the financial market by restraining the market activities of micro investors. The impact of the uncertainty of economic policy on financial stability is gradually accumulated; Investor sentiment has a nonlinear effect on financial stability, which indicates that at this stage, we should strengthen the guidance of market investors to form rational expectations, not blindly follow the trend and follow the crowd, and prevent the formation of systematic financial risks. Therefore, the government should increase and relax the relevant regulations on institutional investors, popularize investment theories and risks for individual investors, and strengthen the guidance of individual investors to form rational expectations, so as to ensure the reasonable and orderly market investment and the stability of the financial system.

At present, China has market supply and demand and institutional support. Practice has proved that under the guidance of the new development concept, we should accelerate the construction of a new development pattern, improve the certainty of economic policies and financial stability, continue to strengthen the driving force of developing social potential, promote continuous progress in scientific research and innovation, ensure product quality, and enable people to lead a better and happy life. Therefore, building a new development pattern of "double circulation" is a long-term strategy for China's future economic development. We should adhere to "people-oriented" and "everything for the people", be good at grasping development opportunities, and promote high-level transformation and upgrading. Only in this way can we develop steadily in the process of building a modern country.

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