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# Economic Policy Uncertainty and a Cross-Correlation Analysis

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## Introduction

When economic policy uncertainty (EPU) or any other uncertainty, such as geopolitical uncertainty, is present, there is ample evidence that Islamic stock markets perform differently from conventional stock markets. From the perspective of multifractality, this paper investigates the cross-correlation of the US EPU with Islamic and conventional stock markets in this setting. Five major nations' daily stock market prices are taken into consideration: India, Thailand, Indonesia, Pakistan and the United States We demonstrate that all pairs of US EPU have strong power law and multifractal characteristics by utilizing the multiracial detrended cross-correlation analysis (MF-DCCA) to confirm the existence of long-range cross-correlation between US EPU and all of the stock markets that were taken into consideration. In addition, the strength of the multifractal patterns in each pair varies, with the US EPU and US conventional stock market displaying the highest levels.

## Description

Additionally, a persistent cross-correlation between the various stock markets and the US EPU is discovered. This study's findings are relevant to investors, who may be able to use them to diversify their portfolios, among other things and to the various market participants in both Islamic and conventional markets. In the early research on EPU, major economic activities like economic growth, inflation, output, unemployment and monetary policy were examined. Academic interest in examining the connection between EPU and financial markets, emphasizing the significance of uncertain economic policy, was rekindled by the recent extreme financial market volatility brought on by COVID-19 and the Russia-Ukraine war [1,2].

Policy uncertainty can have a variety of negative effects on investors, businesses and consumers. It can discourage businesses from making new investments and encourage consumers to make fewer purchases. Due to increased uncertainty regarding government economic policy, lenders may take a more cautious approach to their lending practices. As a consequence of this, the direct effects of policy uncertainty may eventually have an impact not only on the global economy but also on global financial markets. Our study adds significantly to the body of knowledge on the connection between EPU and conventional and Islamic equity markets. According to their findings, neither crypto currencies nor gold can be used as a secure hedge against US EPU prior to or during COVID-19 [3].

The majority of currency pairs traded on the global forex market, as well as the oil market, are heavily influenced by EPU, according to the United States. Study of bond spreads and their volatility in developing markets investigate the predictive capabilities of global and regional EPU measures. The outcomes demonstrate that bond spreads can be predicted using EPU measures in both the upper and lower market quantiles. The aforementioned findings have a number of repercussions for investors, policymakers and decision-makers working in the conventional and Islamic stock markets. First, conventional linear models like vector-regression, OLS, or correlation coefficient cannot be used to model the internal dynamics of cross-correlations between stock markets and US EPU. According to the non-linear structure in the cross-correlations between pairs of markets that cannot be explained by the data's assumptions of linearity and stationary may be linked to the existence of multiracial patterns. Second, when developing a portfolio and diversification strategy, it is recommended to take these distinctions into consideration because the US EPU has a significant impact on both the conventional and Islamic stock markets [4,5].

## Conclusion

It is recommended that investors be aware of the fact that Islamic stocks' conservative characteristics do not offer better options for investing or hedging during times of economic policy instability and financial crisis. Our findings may assist Islamic regulatory bodies in developing policies and regulations that will protect investors and portfolios that adhere to Islamic sharia from high risk and volatility in the mainstream equity market. Lastly, the lower US EPU multifractality of the Pakistani markets compared to other markets suggests that they are both more efficient than other markets. To put it another way, EPU shocks affect other stock markets more than they do Pakistani ones. Consequently, investors may maximize portfolio returns through diversification by investing in Pakistani markets, particularly during periods of significant economic policy uncertainty and financial turmoil. In order to better comprehend its relationship with EPU and other uncertainty measures, we suggest that future research employ additional uncertainty measures or use additional Islamic instruments on intraday data sets. This study has the potential to be expanded to investigate the cross-correlation between various Islamic market variations by modifying the MF-DCCA model.

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