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Title:

Economic policy uncertainty and sustainable financial growth: Does business strategy matter?

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Economic policy uncertainty and sustainable financial growth: Does business strategy matter?

Abstract

Using a data of 975 Chinese non-financial listed firms, this study investigates the impact of firm business strategy on sustainable financial growth during economic policy uncertainty. We use index-based measures of economic policy uncertainty, sustainable financial growth and business strategy and observe that economic policy uncertainty hurts the sustainable financial growth of Chinese firms. However, we find that a defensive business strategy positively moderates the negative impact of policy uncertainty, whereas an analytical business strategy mitigates the negative impact of policy uncertainty on sustainable financial growth. The results of the study provide guidance to corporations regarding strategy formulation to effectively deal with policy uncertainties. Our results are robust to different proxies of policy uncertainty and endogeneity issues.

Keywords: Policy uncertainty, Business strategy, Sustainable financial growth, Panel data

JEL classification: C23; G30; G32

1. Introduction

Companies operate in an environment with frequently changing economic policies. These policy uncertainties spur companies to react quickly and strategically (Kang et al., 2015). Economic policy uncertainty (EPU) has a direct impact on the sustainable growth of firms as firm growth and future investments may be disturbed by new economic policies. Shi et al. (2020) argue that EPU can lead companies to a multi-level distribution of their business operations. Corporations usually adopt different business strategies to mitigate any uncertainty that may affect their business operations (Laker et al., 2019; Ongsakul et al., 2021). However, Chinese companies operate locally as well as globally, making them particularly vulnerable to the EPUs prevalent in different markets. This vulnerability became even more apparent during the Trump era in the United States, as Chinese companies incurred tariffs and sanctions and were generally viewed with suspicion.

Economic policy uncertainty not only affects the sustainable growth of a company but also threatens its existence. Therefore, a business strategy against such uncertainties can play a crucial role in the sustainable financial growth (SFG) of firms. The decision to invest (or otherwise) depends upon the investment strategy adopted by firms. Firms formulate their strategies after analyzing their resources and operating environment (Gerry et al., 2001). The strategies that are adopted during uncertain operating conditions may vary depending on the personality traits of managers. Accordingly, owing to the irreversible nature of investments, risk-averse (defensive) managers may decrease company investments in response to higher EPU; however, risk-taking (aggressive) managers may capitalize on such uncertainties to seize new investment opportunities (Lane et al., 1996).

In this study, we investigate the impact of different business strategies during EPU on the SFG of firms, measured through a comprehensive index. Laker et al. (2019) explain that new policies can

severely affect the cost of sale/production, which, in turn, influences the growth rate of companies or threatens their continuity. They also illustrate that different business strategies can change the fate of companies or an entire industry. Empirical evidence on the Chinese market suggests that firms decrease (increase) their investment during periods of high (low) EPU (Wang et al., 2014). Gucerı et al. (2021) argue that periods of instability provide an important policy lapse that reduce investment while Mirza et al. (2020) explain that market and business risks are higher during uncertainties. Similarly, Taleb (2012) argues that companies should have robust “antifragile” strategies if they intend to weather uncertainty. Zhang et al. (2015) explain that Chinese firms decrease financial leverage when facing higher EPU. On the opposite, Schwarz et al. (2020) observe that Brazilian firms increase financial leverage when facing higher EPU. International evidence regarding EPU explains that economic policy uncertainty decreases firm performance (Iqbal et al., 2019) and CSR investments offset the negative impact of EPU on firm performance (Rjiba et al., 2020). However, none of the previous empirical studies investigate the role of corporate business strategy to deal with economic policy uncertainty to attain sustainable financial growth.

This study has three main contributions to the literature. First, this is the first study to establish a link between EPU and firm sustainable growth after Ahsan et al. (2021). This relationship is important as it provides significant insights to legislators and industry about the implications of unstable policies on firm sustainability. Second, this study offers possible strategic solutions by examining how different types of business strategies (defensive, analytical, and aggressive) can help firms sustain their growth during EPU. To the best of our knowledge, this is the first study to do so. Third, to examine the above relationship, this is the first study to use an index-based measure of sustainable financial growth while applying a dynamic regression technique (GMM-System) to control for endogeneity. We show that the impact of EPU on SFG is significant and negative; however, this negative association is positively moderated by a defensive business strategy and weakened by an analytical business strategy. We also observe significant impact of board attributes on sustainable financial growth of the Chinese firms. The results of the study have policy implications for corporates to develop an effective business strategy to deal with economic policy uncertainty.

The rest of the paper is structured as follows: Section 2 develops theoretical framework regarding policy uncertainty, sustainable financial growth, and business strategy. Section 3 explains the data and the methodology. Section 4 presents the empirical results and section 5 concludes the findings of the study. References are provided at the end.

2. Theoretical framework

Economic policies play an important role in determining the corporate performance and growth as these policies affect economic conditions and shape the operating environment for the firms. Uncertainty regarding economic policies increases information asymmetry between the investors and the firms and consequently increases firm-risk, cost of capital, and reduces firm performance (Ahsan et al., 2021; Iqbal et al., 2019; Mirza et al., 2020). In addition, economic policy uncertainty decreases corporate investments due to the fact of investment irreversibility and, consequently, reduces firm growth (Bernanke, 1983; Wang et al., 2014). On the other hand, Kinght (1921) suggests that uncertainty opens new investment opportunities for entrepreneurs

and brings growth and profits for them. However, making investments during uncertain conditions can be riskier (Mirza et al., 2020). The decision to invest or not depends upon corporate investment strategy and the firms devise their strategies after analyzing their resources as well as the operating environment (Gerry et al., 2001). Strategy formulation during uncertain operating conditions may also vary depending upon the personality traits of the managers. Risk-averse (defensive) managers may decrease the investments due to the fact of investment irreversibility in response to higher economic policy uncertainty.; However, risk-taking (aggressive) managers may take the uncertainty to seize new investment opportunities (Lane et al., 1996). Empirical studies carried out in the Chinese context suggest that economic policy uncertainty increases business and market risk of the firms (Mirza et al., 2020), reduces corporate risk-taking (Wen et al., 2020), and increases corporate precautionary cash-holdings (Su et al., 2020).

Keeping in view the information asymmetry aspect of policy uncertainty, we use a news-based index developed by Baker et al. (2016) as this is a comprehensive index to measure overall level of policy uncertainty in an economy and is being used by many significant empirical studies (Gulen et al., 2015; Rjiba et al., 2020; Wen et al., 2020; Wu et al., 2021). Further, as policy uncertainty affect corporate performance, risk, and growth, therefore, we develop an index to measure sustainable financial growth of the Chinese firms comprising four different dimensions (Profitability, Operating Capacity, Solvency, and Development Ability) by applying factor analysis on nine financial indicators (Ahsan et al., 2021). Moreover, to measure business strategy, we follow Bentley et al. (2013) and develop an index based on six indicators to classify firms according to three different business strategies i.e. defensive, analytical, and aggressive. The variable definitions are explained in Appendix A. Following the empirical evidence and above discussion, we present our hypotheses as under:

Hypothesis-1: Economic policy uncertainty reduces the sustainable financial growth of Chinese firms.

Hypothesis-2: Defensive business strategy positively moderates the impact of economic policy uncertainty on the sustainable financial growth of Chinese firms.

3. Data and methodology

We collect the data of all non-financial Chinese firms using the China Stock Market and Accounting Research (CSMAR) database. After screening for missing values, we were left with 2,983 firm-year observations of 975 firms listed on the Shenzhen and Shanghai stock markets from 2006¹ to 2017. To investigate the direct impact of EPU on SFG, we construct the following model:

$$SFG_{it} = \beta_0 + \beta_1 SFG_{it-1} + \beta_2 EPU_t + \beta_3 Cont_{it} + \gamma_i + \mu_t + \varepsilon_{it} \dots (1)$$

where SFG_{it} is sustainable financial growth and SFG_{it-1} is one-year lagged sustainable financial growth. EPU_t is the natural logarithm of the EPU index. $Cont_{it}$ represents firm-level control

¹We used five-years' moving average of the variables to measure firm business strategy (FBS_{it}); therefore, our final dataset used for regression analysis is from 2010 to 2017.

variables (see Appendix A). γ_i and μ_t are industry fixed effects and time fixed effects, respectively, and ε_{it} is the error term. Furthermore, to investigate the moderating effect of business strategy on the relationship between EPU and SFG, we extend our model as below:

$$SFG_{it} = \beta_0 + \beta_1 SFG_{it-1} + \beta_2 EPU_t + \beta_3 FBS_{it} + \beta_4 EPU_t * FBS_{it} + \beta_5 Cont_{it} + \gamma_i + \mu_t + \varepsilon_{it} \dots (2)$$

where FBS_{it} is a dummy for the business strategy type (defensive, analytical, aggressive). $EPU_t * FBS_{it}$ represents one of the three interaction terms of EPU_t with FBS_{it} , i.e., $EPU_t \times Defensive$ (interaction term of EPU_t with a dummy for defensive firms), $EPU_t \times Analytical$ (interaction term of EPU_t with a dummy for analytical firms), $EPU_t \times Aggressive$ (interaction term of EPU_t with a dummy for aggressive firms). Other variables are the same as in model 1. We apply the generalized method of moments (GMM) regression analysis to address the potential reverse causality and omitted variable bias.

4. Empirical analysis

4.1. Descriptive statistics

We present the descriptive statistics in Table 1. The mean value of -0.013 for SFG indicate that on average the financial growth of the Chinese firms is low. However, the minimum (-0.105) and the maximum (0.080) values indicate that some of the Chinese firms are having a very good financial growth while others not. The mean values of leverage (0.375), size (21.999), and capital intensity (8.376) with standard deviation of 0.174, 0.940, and 9.731, respectively, indicate variations in the selected sample firms. The mean values of ownership concentration (0.311), board size (8.228), board independence (2.703), and board gender diversity (0.320) with standard deviation of 0.127, 1.431, 0.350, and 0.149, respectively, indicate variations in governance characteristics of the selected sample firms. Further, the mean value of natural logarithm of EPU is 5.543, while the minimum value and maximum value are 5.897 and 5.899 respectively, indicating that the policy uncertainty varies in different periods.

Table 1: Descriptive Statistics

Variables	Mean	STD.	Median	Minimum	Maximum
SFG _{it}	-0.013	0.441	-0.227	-0.105	0.080
LEV _{it}	0.375	0.174	0.237	0.369	0.500
SIZE _{it}	21.999	0.940	21.339	21.918	22.564
CPI _{it}	8.376	9.731	2.385	5.763	10.506
OCN _{it}	0.311	0.127	0.212	0.298	0.393
BDS _{it}	8.228	1.431	7	9	9
BDI _{it}	2.703	0.350	2.333	3	3
BGD _{it}	0.320	0.149	0.211	0.316	0.421
EPU _t	5.543	0.439	5.200	5.897	5.899

Note: The table presents the descriptive statistics of all the variables included in the study.

4.2. Regression results

We first investigate the direct relationship between EPU and SFG (Table 2, model 1) and observe a significant negative association, indicating that policy-induced uncertainty hurts the sustainable financial growth of Chinese firms. These results favor hypothesis-1, the plausible reason for this negative association may be that the policy-induced uncertainty increases information

asymmetry, decreases corporate investment, and consequently reduces sustainable financial growth of the firms. In model 2, we introduce the interaction term of EPU with defensive business strategy (EPU x Defensive) and observe a significant positive association between the interaction term and SFG, indicating that a defensive business strategy positively moderates the negative impact of policy uncertainty and contributes to the SFG of Chinese firms. In model 3, we introduce the interaction term of EPU with analytical business strategy (EPU x Analytical) and observe a significant negative association between the interaction term and SFG. However, the coefficient value is smaller (-0.118***) than the coefficient value (-0.723***) of the direct negative impact of EPU on SFG, indicating that an analytical business strategy also helps to mitigate the negative impact of policy-induced uncertainty and contributes to the SFG of firms. In model 4, we introduce the interaction term of EPU with aggressive business strategy (EPU x Aggressive) and observe an insignificant association between the interaction term and SFG, indicating that an aggressive business strategy does not have any role in increasing/decreasing the impact of policy-induced uncertainty on SFG.

Further, we observe a significant positive association of one-year lagged SFG with current SFG, indicating that previous sustainability in firm growth contributes to the current sustainable financial growth of the firms. We also observe a significant negative association of leverage (LEV) and significant positive association of size (SIZE) with SFG, indicating that higher use of debt financing reduces while bigger firm size contributes to the sustainable financial growth of the Chinese firms. Furthermore, we observe a significant negative association of BDS and significant positive association of BDI as well as BGD with SFG, indicating that bigger board size reduces while board independence and diversity contribute to the sustainable financial growth. We also carry out the same analysis using an alternative policy uncertainty index developed by Davis et al. (2019), and the results remain consistent (Table 3).

Table 2: The impact of policy uncertainty and business strategy on sustainable financial growth

	(1)	(2)	(3)	(4)
	SFG _{it}	SFG _{it}	SFG _{it}	SFG _{it}
SFG _{it-1}	0.121*** (0.036)	0.120*** (0.036)	0.108*** (0.034)	0.127*** (0.037)
LEV _{it}	-0.903*** (0.102)	-0.786*** (0.101)	-0.855*** (0.110)	-0.924*** (0.102)
SIZE _{it}	0.177*** (0.024)	0.179*** (0.025)	0.184*** (0.026)	0.182*** (0.029)
CPI _{it}	0.001 (0.002)	0.001 (0.002)	0.001 (0.001)	0.001 (0.002)
OCN _{it}	0.165 (0.101)	0.166* (0.099)	0.109* (0.059)	0.163 (0.100)
BDS _{it}	-0.034*** (0.005)	-0.034*** (0.005)	-0.033*** (0.006)	-0.029*** (0.006)
BDI _{it}	0.082*** (0.018)	0.081*** (0.019)	0.073*** (0.021)	0.061** (0.024)
BGD _{it}	0.145** (0.072)	0.150** (0.071)	0.107** (0.046)	0.117 (0.075)
EPU _t	-0.656*** (0.092)	-0.667*** (0.094)	-0.723*** (0.098)	-0.668*** (0.107)
Defensive		-0.711*** (0.180)		
EPU _t x Defensive		0.122*** (0.032)		
Analytical			0.674*** (0.239)	
EPU _t x Analytical			-0.118*** (0.041)	
Aggressive				-0.341 (0.379)
EPU _t x Aggressive				0.054 (0.073)
Constant	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
Obs.	1938	1938	1938	1938
Firms	858	858	858	858
Hansen	55.413	51.776	49.200	50.277
Hansen_P	0.608	0.736	0.815	0.784
AR2	-0.866	-0.866	-0.410	-1.208
AR2_P	0.387	0.386	0.682	0.227
Year Effect	Yes	Yes	Yes	Yes
Industry Effect	Yes	Yes	Yes	Yes

Note: The table represents the results of regression analysis (GMM-System) to investigate the direct impact of economic policy uncertainty on sustainable financial growth and the moderating impact of business strategy on the relationship between economic policy uncertainty and sustainable financial growth of the Chinese firms. All the models use a one-year lag of the dependent variable; therefore, the number of firm-year observations is reduced to 1938, and the number of firms is reduced to 858. The variables are as defined in Appendix A. Standard errors are in parenthesis, *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

**Table 3: The impact of policy uncertainty and business strategy on sustainable financial growth
Robustness – Using alternate proxy of economic policy uncertainty**

	(1)	(2)	(3)	(4)
	SFG _{it}	SFG _{it}	SFG _{it}	SFG _{it}
SFG _{it-1}	0.121*** (0.036)	0.120*** (0.036)	0.117*** (0.037)	0.127*** (0.038)
LEV _{it}	-0.903*** (0.102)	-0.840*** (0.099)	-0.894*** (0.107)	-0.939*** (0.101)
SIZE _{it}	0.177*** (0.024)	0.179*** (0.025)	0.178*** (0.026)	0.178*** (0.027)
CPI _{it}	0.001 (0.002)	0.001 (0.002)	0.000 (0.001)	0.000 (0.002)
OCN _{it}	0.166* (0.101)	0.144 (0.101)	0.114 (0.070)	0.156 (0.097)
BDS _{it}	-0.033*** (0.005)	-0.036*** (0.005)	-0.032*** (0.006)	-0.027*** (0.006)
BDI _{it}	0.083*** (0.018)	0.091*** (0.018)	0.075*** (0.025)	0.053** (0.022)
BGD _{it}	0.145** (0.072)	0.136* (0.073)	0.100* (0.056)	0.118 (0.072)
EPU _t	-0.726*** (0.102)	-0.735*** (0.103)	-0.715*** (0.106)	-0.723*** (0.112)
Defensive		-0.686*** (0.222)		
EPU _t x Defensive		0.133*** (0.044)		
Analytical			0.844*** (0.275)	
EPU _t x Analytical			-0.169*** (0.053)	
Aggressive				-0.390 (0.524)
EPU _t x Aggressive				0.072 (0.111)
Constant	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
Obs.	1938	1938	1938	1938
Firms	858	858	858	858
Hansen	55.412	54.424	51.829	51.358
Hansen_P	0.609	0.645	0.735	0.750
AR2	-0.866	-0.847	-0.743	-1.108
AR2_P	0.387	0.397	0.457	0.268
Year Effect	Yes	Yes	Yes	Yes
Industry Effect	Yes	Yes	Yes	Yes

*Note: The table represents the results of regression analysis (GMM-System), using an alternate proxy of economic policy uncertainty developed by Davis et al. (2019), to investigate the direct impact of economic policy uncertainty on sustainable financial growth and the moderating impact of business strategy on the relationship between economic policy uncertainty and sustainable financial growth of the Chinese firms. All the models use a one-year lag of the dependent variable; therefore, the number of firm-year observations is reduced to 1938, and the number of firms is reduced to 858. The variables are as defined in Appendix A. Standard errors are in parenthesis, *** p<0.01, ** p<0.05, * p<0.10.*

4. Conclusion

Economic policies have a bearing on a firm's ability to grow financially in a sustainable way. These policies can impact a single industry or an entire market. Sustainable companies stand ready to face any uncertainties that may disturb their operations. This is by considering any potential threats when drafting their business strategies. This study investigates the role of business strategies in facing such policy uncertainties. We classified the business strategy types of Chinese non-financial firms into defensive, analytical, and aggressive using a discrete composite index following Bentley et al. (2013) and constructed a comprehensive index to measure the SFG of firms. The results show that a defensive or an analytical business strategy can moderate the negative impact of policy-related uncertainty on Chinese firms' sustainable growth. The results reflect the importance of implementing the right strategy during uncertain times and provide valuable insights to the managers regarding the role of different business strategies in the ever-changing business environment. The results also provide insights to policymakers regarding the impact of changing policies on the growth of businesses and the implications on businesses that lack the right strategy. Future studies can examine the impact of uncertainty on the sustainable growth of firms during the COVID-19 crisis. These studies may investigate the strategies that companies adopted in anticipation or as a response to the government policies including the lockdowns and border closure.

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Appendix A: Definition of variables

Variable Level	Variable Name	Symbol	Definition
Dependent	Sustainable Financial Growth	SFG	Nine financial indicators are synthesized through factor analysis incorporating four dimensions: Profitability (return on assets, return on equity), Operating Capacity (asset turnover, accounts receivable turnover), Solvency (current ratio, quick ratio, cash ratio), and Development Ability (total asset growth rate, net asset growth rate).
Strategy	Firm Business Strategy	FBS	To measure business strategy, following Bentley et al. (2013), six indicators are averaged over the previous 5 years. The indicators are the Tendency to Develop New Products (R&D Investment / Operating Income), Productivity (Operating Income / Number of Employees), Historical Growth Level (Operating Income Growth Rate), Marketing Efforts ((Sales Cost + Management Fee) / Operating Income), Organizational Stability (Rate of Employee Volatility), and Fixed Assets Intensity (Net Fixed Assets / Total Assets). The averaged indicators are grouped into five quantiles, assigning 1 for the smallest quantile and 5 for the largest. Then grouping scores for the six indicators are summed to give a strategy score (FSB), which ranges from 6 to 30. A score higher than 24 means an aggressive business strategy, and a score lower than 12 means a conservative strategy. A score between 12 to 24 is categorized as an analytical business strategy.
Policy Uncertainty	Economic Policy Uncertainty	EPU	Natural logarithm of Economic Policy Uncertainty Index developed by Baker et al. (2016).
Control	Leverage	LEV	Total liabilities / total assets
	Company Size	SIZE	Natural logarithm of total assets
	Capital Intensity	CPI	Total Assets / Operating Income
	Ownership Concentration	OCN	The shareholding ratio of the largest shareholder
	Board Size	BDS	Total number of directors
	Board Independence	BDI	Ratio of independent directors to the total number of directors
	Female on Board	BGD	Ratio of female directors to the total number of directors