

Description for the general public

Cyclical economic fluctuations can originate in shifts in sentiments about economic activity. This idea goes back at least to Pigou (1927) and Keynes (1936), who postulated that waves of optimism or pessimism might influence current economic conditions. For many years mainstream macroeconomic models have largely ignored the role of such factors as drivers of business cycles. More recent literature attempts to formalize and quantify the impact of fluctuations in moods. Our project's main objective is to investigate the role of sentiments in driving the international co-movement of economies. More specifically we want to address the following questions:

1. To what extent do sentiment fluctuations determine business cycles in Poland and the euro area?
2. To what extent can spillovers of business cycles from a large, closed (euro area) to a neighboring small, open economy (Poland) be explained by sentiment fluctuations in the large economy?
3. Which sentiments are more important - supply or demand type?
4. Do sentiments spill over directly (i.e. they affect sentiments in the small economy and so the business cycle there) or indirectly (i.e. they affect the business cycle in the large economy and spill over to the small economy via foreign trade)?

The importance and relevance of these questions stem from two observations. First, that economic fluctuations between countries are highly correlated, so that obviously business cycles spill over borders. Second, that the literature has a clear problem with explaining where such high correlation comes from.

The project will be divided into two sub-projects. The first one will be entirely empirical. Here we will follow a data-driven approach to calculate the role of sentiment fluctuations in driving the business cycle. We plan to extend the existing empirical models of sentiment shock propagation to assess the relative importance of foreign and domestic sentiment shock in driving the business cycles in a small open economy. The model will be estimated for the euro area and Poland.

The second subproject will be based on a theoretical model. In this part we will construct a two-country business cycle model incorporating confidence factors. Both approaches will be used to answer the questions listed above and to provide a better understanding of the role of sentiments in driving business cycles.