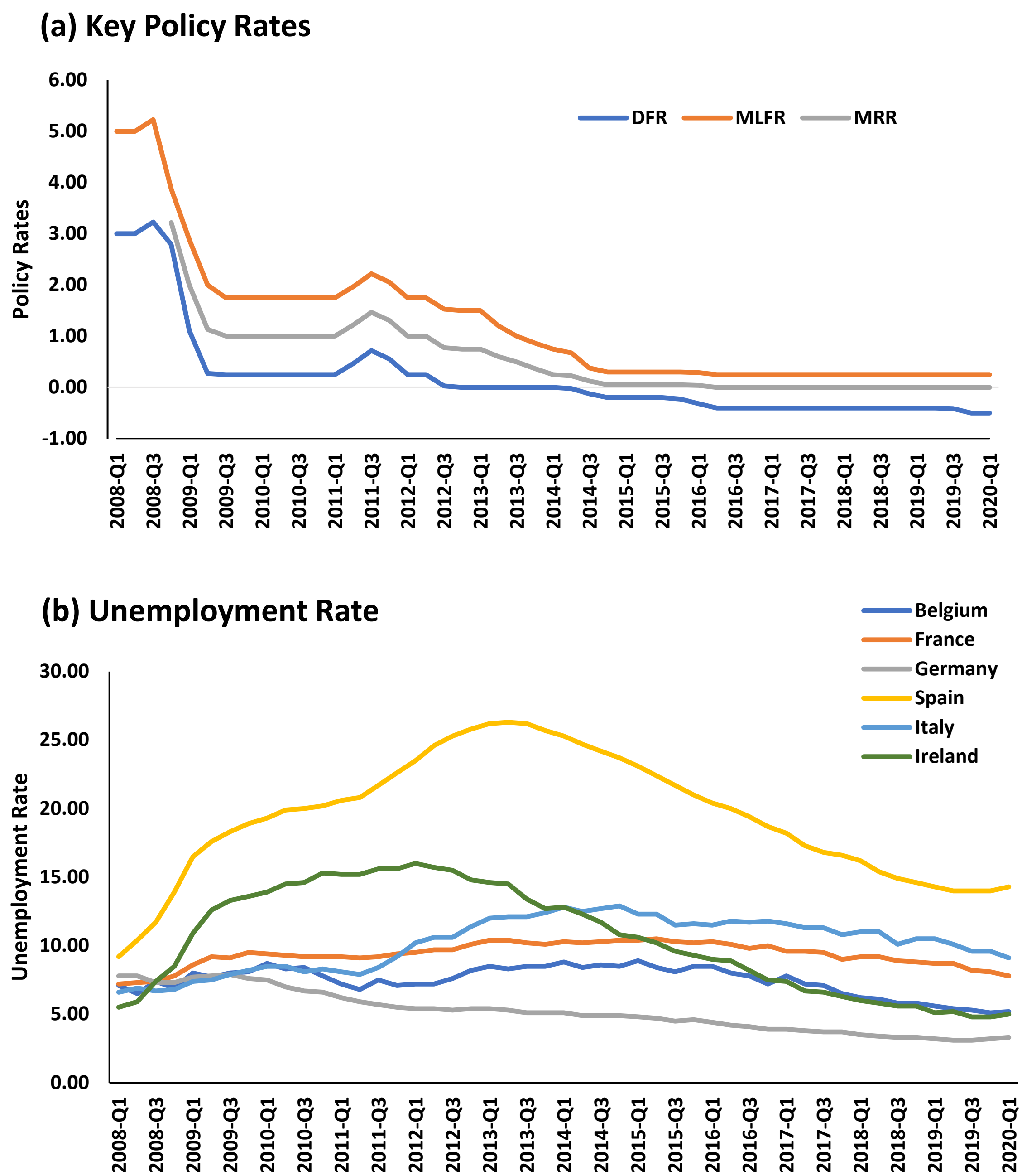
Fiscal Policy and Sentiments in a Monetary Union
By Abhiprerna Smit

Movements in economic sentiments of households and firms are an important indicator of aggregate economic activity. Along with a noisy signal about future consumption and productivity, sentiments can indicate the beliefs of economic agents about fundamental variables of the economy. As a result, they can significantly impact the transmission of monetary and fiscal policy to economic activity.[1]

Figure 1



In a monetary and fiscal union like the U.S., the two policies can be perfectly coordinated to achieve the desired economic outcomes. In the absence of a fiscal union adjoining the monetary union, as is the case of the European Economic and Monetary Union (EMU), the centralized monetary policy can be potentially suboptimal at the country level. Panel (a) of Figure 1 shows the three key policy rates set by the European Central Bank (ECB). Panel (b) shows the unemployment rate in six Euro area economies. The figures together show how monetary policy responding to the economic conditions of the union, can be suboptimal for individual countries. In the summer of 2011, the ECB raised its key rates by 50 basis points over a period of three months, citing strong economic recovery in the Euro bloc. However, the economic conditions varied significantly within the bloc where some countries like Belgium, France, and Germany showed stabilizing or strengthening economic conditions. On the other hand, countries like Ireland, Italy, and Spain continued experiencing high unemployment rates and weak growth. Such heterogeneity in a monetary union makes fiscal policy the main policy tool against domestic economic shocks.[2]

In my working paper, I explore the information contained in economic sentiments in transmission of fiscal policy in a monetary union and, moreover, how the sentiments channel of transmission of fiscal policy differs across core and peripheral European economies. Agents in peripheral European countries might view monetary policy as less countercyclical for domestic shocks and, thus, respond with higher confidence to countercyclical fiscal policy measures. This in turn can result in a higher response of fundamental variables, such as output, to fiscal policy, driven by higher consumer confidence.

Results for the EMU suggest that a higher response of confidence to fiscal policy results in a higher response of output. Moreover, in the case of the Euro area, this response is heterogenous between countries. The interaction between confidence and a fiscal policy shock raises output significantly for Italy and Spain, but it is not as important for Belgium, Germany, or France. The results suggest that economic sentiments are important determinants of macroeconomic policy and need to be incorporated in models studying coordination of fiscal and monetary policy.

References

Bachmann, R., & Sims, E. (2012). Confidence and the Transmission of Government Spending Shocks. *Journal of Monetary Economics 59*, 235-249.

Barksy, R. B., & Sims, E. (2012). Information, Animal Spirits, and the Meaning of Innovations in Consumer Confidence. *American Economic Review, 102(4)*, 1343-1377.

Gali, J., & Monacelli, T. (2008). Optimal Monetary and Fiscal Policy in a Currency Union. *Journal of Economic Perspectives 76*, 116-132.

Milani, F. (2017). Sentiment and the U.S. Business Cycle. *Journal of Economic Dynamics & Control*, 289-311.

[1] See Barsky & Sims (2012), Milani (2017), and Bachmann & Sims (2012).
[2] See Gali & Monacelli (2008).