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Essays on Economic Expectations and Monetary Union Heterogeneity

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Summary

The research contained in this dissertation is concerned with several questions that emerged in the context of the macroeconomic situation of Western economies in the last decade, in particular the apparent disconnect between monetary policy and unemployment on the one hand and inflation on the other. As traditional tools of monetary policy proved to be ineffective to stabilize the economies of the United States, the Euro Area and other Western countries, the management of economic expectations of the general public, in particular its inflation expectations, became a centerpiece of monetary policy making. Chapters 2 and 3 contribute to the literature on the potential effects of such efforts on consumption behavior of households as well as the capability of central banks to influence economic expectations in the first place. Chapters 4 and 5 discuss econometric issues that could lead to spuriously flattening Phillips Curve slopes when estimating reduced form regressions of the relationship.

Research interest in the reaction of consumption to expected inflation has increased in recent years due to efforts by central banks to kick-start demand by steering inflation expectations. Chapter 2 contributes to this literature by analyzing whether various components of households' balance sheets determine how consumption reacts to expected inflation. Two channels in particular are conceivable: an increase in inflation expectations can raise consumption through direct increases in expected real wealth, e.g. for households with nominal financial liabilities. By affecting the real interest rate, expected inflation can interact with wealth if only those households can adapt their consumption to current real interest rates that are not budget constrained or sufficiently liquid to shift funds between consumption and savings. The chapter investigates these channels empirically using household-level information on balance sheets, durable consumption, and inflation expectations from the Dutch Central Bank's Household Survey. The analysis shows that investments in risky assets as well as a household's net worth moderates the relation between expected inflation and durable spending decisions. The net worth effect is most pronounced for households with fixed interest rate mortgages.

Chapter 3 studies the impact of the Fed's monetary policy announcements on households' expectations by comparing responses to the Survey of Consumer Expectations before and after Federal Open Market Committee (FOMC) meetings, over the period 2013-2019. The results show that Fed decisions affect expectations of interest rates on savings accounts, particularly for respondents with high financial and numerical literacy. The impact of monetary policy announcements on inflation expectations is muted, even in response to some of the most relevant meetings of the FOMC that took place during that period. Expectations of personal financial conditions are barely affected. The results stand in contrast to experimental studies that find strong effects of monetary policy and other macroeconomic news on expectations of households receiving a specific treatment, suggesting that the news naturally reaching the general population may provide weaker signals.

Chapter 4 illustrates the impact of heterogeneous slopes on the estimation of the union-wide Phillips Curve slope in a monetary union. If regional slopes differ, any attempt to estimate a union wide slope either on aggregate or pooled regional data will suffer from substantial omitted variable bias. The reason is that the slope of the Phillips Curve changes the implicit weight a union member gets in the central bank's monetary policy rule. In regions with steep Phillips Curves, demand shocks will be stabilized to a larger degree than the mere size of the economy would justify as these demand shocks would impact aggregate union inflation to a larger degree than demand shocks in regions with flat Phillips Curves. The more pronounced the heterogeneity, the larger the bias to coefficients from aggregated or pooled estimations.

Chapter 5 tests whether the patterns in simulated data hold in Euro Area country-level data. First, it provides evidence on causally identified estimates of the inflation-unemployment trade-off for a group of 10 Euro Area member states. It goes on to show that applying controls for slope heterogeneity proposed by Breitung & Salish (2020) lead to an insignificant steepening of the estimated Phillips Curve slopes when analyzing the Euro period as a whole. A sub-period analysis reveals that the slope of the Euro Area Phillips Curve has steepened by more than what reduced form estimates omitting heterogeneity controls suggest in the period since 2009 and the augmenting regressor

controlling for slope heterogeneity turns significant.