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THE ROLE OF FOREIGN SENTIMENT IN SMALL OPEN ECONOMY**Abstract:**

The role of foreign sentiment is researched for explaining macroeconomic fluctuations in small open economy. The main goal is to find out whether the domestic variables react significantly to the shocks in the foreign sentiment. For this purpose a structural vector autoregression model is constructed for the Czech Republic and the Slovak Republic including relations between foreign environment and domestic variables. Both small open economies considered are highly dependent on foreign demand from euro area. Therefore the foreign development is represented by real GDP in euro area and alternatively is explored the possibility to replace foreign real GDP by economic sentiment indicator of euro area as sentiment indicators are available in advance. The impact of foreign shocks is examined by impulse response functions on the following domestic variables – real gross domestic product, consumer prices and effective exchange rate against euro area trading partners. The study confirms that foreign economic sentiment can be used for explaining fluctuations of domestic variables of a small open economy.

Keywords:

economic sentiment indicator, structural vector autoregression, variance decomposition, impulse response functions

JEL Classification: C51, E32