

# Firm expectations and economic activity

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## Abstract

We assess how survey expectations impact production and pricing decisions on the basis of a large panel of German firms. We identify the causal effect of expectations by matching firms with the same fundamentals but different views about the future. The probability to raise (lower) production is 15 percentage points higher for optimistic (pessimistic) firms than for neutral firms. Optimistic firms are also more likely to raise prices. In a second step, we find optimism and pessimism to matter even if they turn out to be incorrect ex-post. Lastly, we quantify the contribution of incorrect optimism and pessimism to aggregate fluctuations.

JEL-Codes: C300, H720, H770.

Keywords: expectations, firms, survey data, propensity score matching, business cycle, news, noise, incorrect optimism.

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# 1 Introduction

To what extent do firms' expectations impact current decision making? According to theory, expectations should have a first-order effect. Expectations about the business cycle take center stage in modern macroeconomic theory according to which firms decide on production, investment and hiring as well as on prices in a forward-looking manner (e.g., Kydland and Prescott 1982; Lucas 1973; Mortensen and Pissarides 2009; Woodford 2003). This, in turn, is essential for why and how cyclical impulses propagate and how policy announcements shape economic outcomes (e.g., Del Negro et al. 2012; Eggertsson and Woodford 2003). Yet at an empirical level the systematic exploration of how expectations impact economic decisions and hence economic outcomes is still in its infancy. Arguably, two major difficulties are to blame. First, expectations are not directly observable. Second, expectations are responsive to changes in the economic environment; identifying a causal effect of expectations on economic decisions is therefore challenging.

In this paper, we take up the issue by exploiting a particular data set and a novel identification strategy. Specifically, our analysis is based on the EBDC Business Expectations Panel (BEP), maintained by the LMU-ifo Economics & Business Data Center (EBDC) in Munich. Our sample comprises monthly observations for the period 1991–2016. In each month, more than a thousand German firms report their expectations regarding future production in a qualitative manner: it may increase, not change, or decrease. Similarly, firms report expectations about business cycle conditions. The survey is the basis for the ifo business climate index, a widely-observed leading indicator for economic activity in Germany (Becker and Wohlrabe 2008). In addition, the BEP contains a rich set of observations for each firm. These include a large range of measures that capture the economic and financial conditions under which firms operate.

We exploit these data in order to identify the causal effect of firm expectations on their behavior, notably in terms of production and price setting. For this purpose, we match firms on the basis of fundamentals and compare price-setting and production decisions of firms that have the same fundamentals but differ in their views about the future. Formally, we estimate a probit model and match optimistic and pessimistic firms, in turn, with neutral firms on the basis of their propensity scores (Rosenbaum and Rubin 1983). Intuitively, we consider “optimism” and “pessimism” as a treatment that is randomly assigned across firms with the same fundamentals: we estimate the average treatment effect on the treated by comparing the behavior of treated and non-treated firms with the same probability of being treated.

We find that expectations have a significant effect on production and prices. In the impact period the probability of optimistic firms to raise production is 15 percentage points higher than those of neutral firms. Similarly, we also find that optimistic firms are considerably more likely to raise prices. For pessimistic firms we find an opposite effect of about the same magnitude—they are more likely to reduce production and prices.

These results are consistent with two distinct hypotheses regarding how expectations impact economic decision making. Under the first hypothesis, expectations that are orthogonal to current fundamentals are not necessarily orthogonal to future fundamentals. Put differently, expectations represent genuine information (“news”) about the future that is not yet reflected in current fundamentals. Under this interpretation, expectations matter as a transmission channel, but not as an exogenous source of variation. A number of influential contributions suggest that news is indeed an important source of business cycle fluctuations (Barsky and Sims 2012; Beaudry and Portier 2006; Schmitt-Grohé and Uribe 2012). Yet these studies provide only indirect evidence on the role of expectations as news. In contrast to our analysis, they do not exploit expectations data directly.

Under the second hypothesis, changes in expectations are fully exogenous and different labels are used to capture this notion, such as “noise,” “sentiment,” or “animal spirits”.<sup>1</sup> In this spirit, a number of recent contributions have put forward modern models of the business cycle in which “noise shocks” play a key role (Angeletos and La’O 2013; Lorenzoni 2009). But, again, these contributions also do not exploit expectations data directly. Instead, they only show that noise helps quantitative business cycle models to account for key features of aggregate time-series data.

The unique nature of our data set allows us to test the two hypotheses directly. For not only do we observe firm expectations regarding future production and business conditions, we also observe actual production and business conditions. We are thus able to construct a measure of firms’ forecast errors and identify firms whose optimism or pessimism turns out to be incorrect or “undue” from an ex-post point of view (Pigou 1927). In the second step of our analysis we therefore match, in turn, incorrectly optimistic and pessimistic firms with ex-ante neutral firms. We find that incorrectly optimistic firms are also relatively more likely to raise output and prices.

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<sup>1</sup>According to Keynes, animal spirits are “a spontaneous urge to action rather than inaction”, which drive economic decisions beyond considerations based “on nothing but a mathematical expectation” (Keynes 1936, pp. 161–162).

In a third step, we quantify the contribution of incorrect optimism and pessimism to aggregate fluctuations. For this purpose we compute an aggregate measure of incorrect optimism and pessimism in our population of firms. Specifically, we use an ordered probit model to measure the extent of optimism and pessimism at the firm level and classify such sentiment as incorrect whenever we observe a forecast error ex post. Finally, we aggregate across firms and project macro variables of interest on the resulting time series of incorrect optimism and pessimism. We find that optimism in particular causes industrial production and prices to rise.

Our paper relates to studies that focus on the expectation formation process. Coibion and Gorodnichenko (2012, 2015) document the presence of information rigidities on the basis of data from professional forecasters. More recently, Coibion et al. (2018a) exploit a survey of New Zealand firms. There is also work on expectation formation based on the ifo survey. An early study by Nerlove (1983) finds evidence in support of an adaptive expectations model. More recently, Bachmann and Elstner (2015) show that at most one-third of the firms in the ifo survey systematically over- or underpredict their production growth one-quarter ahead. Massenot and Pettinicchi (2018), in turn, identify various factors which account for forecasting errors of firms in the ifo sample.

Very few studies investigate empirically how expectations measured by survey data impact economic decision making. An exception is Boneva et al. (2018). They study expectations of firms in the UK and focus on price-setting decisions. Specifically, they find that survey expectations about inflation feature significantly in an estimated version of the New Keynesian Phillips curve. Coibion et al. (2018b) use a survey of Italian firms to estimate the effect of decision makers' inflation expectations on firm decisions. Bachmann and Zorn (2018) use ifo data to study the drivers of investment and find, among other things, a role for firm expectations. Gennaioli et al. (2015) analyze the Duke University quarterly survey of Chief Financial Officers and show that firm investment is explained by CFOs' expectations of earnings growth.

The remainder of the paper is structured as follows. The next section details our data and provides some descriptive statistics. Section 3 describes the estimation approach and the results of the first step of our analysis. In Section 4 we zoom in on the transmission channels of firm expectations and distinguish between firms with and without forecast errors. Afterwards we quantify the aggregate effects of firm expectations on the basis of local projections. Section 6 concludes.

## 2 Data

The EBDC Business Expectations Panel (BEP) combines monthly survey data from the ifo institute and annual balance sheet data from the Amadeus and Hoppenstedt databases (EBDC-BEP 2017). The survey data is collected through different surveys that cover German firms in four sectors: manufacturing, retail, construction, and services. The surveys include the same basic stock of questions for each sector, but the wording of these questions and answers may differ at times. In our analysis we focus on the manufacturing survey which includes the largest number of firms. Also, the wording of the survey questions is particularly suitable for the purpose of our investigation in this case.

One caveat is that the responses to the survey and the balance sheet data come at different frequencies: while the survey is conducted monthly, balance sheet data is only available annually. We will use balance sheet data to predict firm expectations. To ensure that we do not use information that is not yet available when firms report expectations, we only use the most recent balance sheet data at a given point in time. For example, if a firm publishes balance sheet data every September, we will use this data for all the following months until the next balance sheet is published.<sup>2</sup>

The BEP sample period starts in 1986 with the manufacturing survey. In our analysis we use data from 1991 to 2016 because some of the variables we rely on are available only since 1991. The unit of observation in the manufacturing survey may either be a product or a plant, depending on the firm. As a result, some firms provide several responses per month.<sup>3</sup> We conduct our analysis at the product/plant level and do not explicitly account for whether a product/plant is part of a multi-product firm. Still, in our analysis below we refer to the individual observation as a “firm” in order to ease the exposition. Table A.1 in the appendix provides some basic information on our sample. Firms stay in the survey for 66 months (5.5 years) on average and provide answers in 56 months, implying that they respond in 86% of the months they are in the sample. The total number of firm-month observations amounts to more than 320,000 and there are 5922 different respondents over the time span. Table A.2 shows the number of firms remaining in the sample

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<sup>2</sup>Our baseline specification is conservative as we neglect potential information known to firms in the months close to but preceding the publication of the balance sheet. In Appendix D.1 we pursue an alternative strategy but find the results obtained for the baseline specification robust.

<sup>3</sup>In our sample this is the case for less than 10% of firms.

**Table 1:** Selected ifo survey questions

| Label | Question <sup>1</sup>  | Possible answers  |
|-------|--|---|
| Q1    | Expectations for the next 3 months: Our domestic production activity regarding good XY will probably ...                                       | increase [1]<br>not change [0]<br>decrease [-1]                             |
| Q2    | Expectations for the next 6 months: Taking economic fluctuations into account our state of business will be ...                                | rather more favorable [1]<br>not changing [0]<br>rather less favorable [-1] |
| Q3    | Tendencies in the previous month: Our domestic production activities with respect to product XY have ...                                       | increased [1]<br>not changed [0]<br>decreased [-1]                          |
| Q4    | Tendencies in the previous month: Taking changes of terms and conditions into account, our domestic sales prices (net) for product XY have ... | increased [1]<br>not changed [0]<br>decreased [-1]                          |

<sup>1</sup> Most recent wording of question in German according to the EBDC (our translation).  
Questionnaire manual.

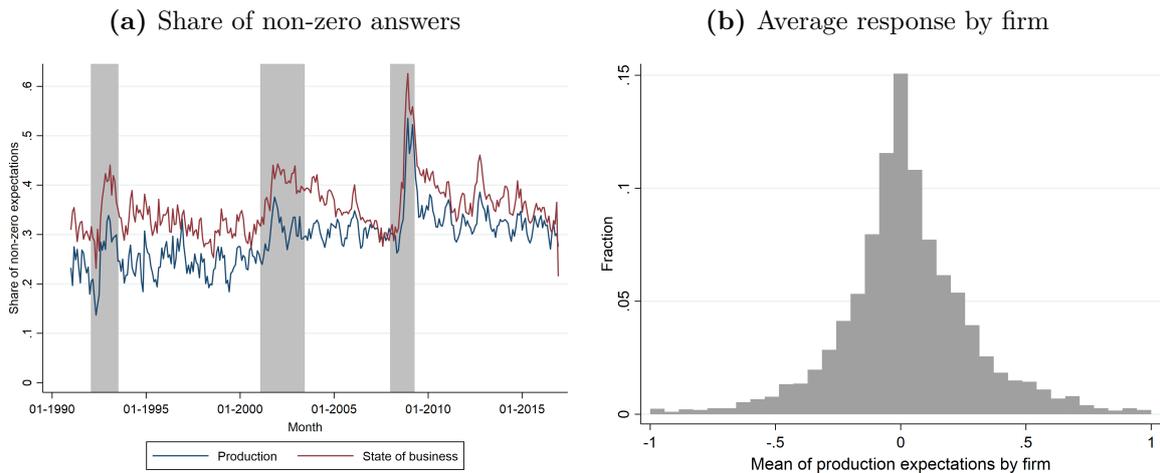
over different time periods and for different starting points. It confirms that considerable number of firms stays in the sample for long time spans.

The BEP covers a large set of questions, but only a subset of those are asked regularly. In our analysis we focus on four main questions. They are listed in Table 1. Some questions vary over time. Especially in 2002 many changes were implemented due to a harmonization of business and consumer surveys in the European Union. The changes relevant to our analysis are listed below.

Our measure of firm optimism will be based on question Q1 which refers to expectations about production activity in the next three months. The wording of this question has changed over time. Since July 1994 firms can additionally report that they have no significant domestic production. These firms are not included in our analysis. Furthermore, the question contained a note to ignore seasonal fluctuations until the end of 2001. Since these are minor changes affecting all firms in the same way, they are unlikely to matter for our results. Further details on the wording of the questions can be found in Table B.2 in the appendix.

Q2 is a broader question regarding expectations for the state of business over the next six months. Combined with a question on the current state of business it provides the basis for the ifo business climate index. In a sensitivity analysis, we consider optimism as reflected in the answer to this question and find similar results as in our baseline. Also, the answers to both questions tend to be highly correlated, see Figure A.1 in the appendix. In our baseline we use Q1, though, because its wording is more specific and the time horizon in question is shorter. Q2 also used to include an additional note to ignore seasonal fluctuations; it was dropped in 1997, see Table B.2.

**Figure 1:** Distribution of expectations, 1991-2016



*Notes:* Shaded areas mark recession periods as defined by the German Council of Economic Experts. Panel (b) only includes firms which respond at least 10 times.

Questions Q3 and Q4 refer to our outcome variables: changes in production and prices. These questions changed in 2002. Previously both questions asked about the change in production and prices in the current month compared to the previous month. Since 2002 both questions ask about the change in the respective variable in the previous month. We adjust the data to account for this change in timing. Also, to make sure that this adjustment does not affect results, we consider in our sensitivity analysis a reduced sample which starts in 2002 only. The results are very similar to those for the full sample (see Section 3).

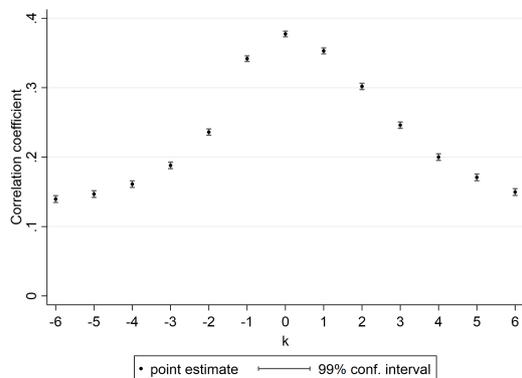
In what follows, we compute a number of descriptive statistics for the variables of interest. For the purpose of our quantitative analysis, we assign a value of 1 to positive responses (*increase/improve*) and a value of -1 to negative responses (*decrease/worsen*) and a value of 0 otherwise. Figure 1 shows the distribution of responses over time and across firms. Distributional statistics are not straightforward to compute with qualitative data. We present two different approaches here. In Panel (a) of Figure 1 we plot the sum of the non-zero responses, that is, the number of firms which respond that they expect a change in either direction. The figure reveals that the number of non-zero responses peaks during crises and tends to decrease before them. Furthermore, more firms report no change for production expectations than for state of business expectations. This might partially be due to the longer horizon to which Q2 pertains.

Panel (b) of Figure 1 focuses on differences across firms. It plots the average response of each firm to Q1 during the period the firm is in the sample.<sup>4</sup> We find that the share of notorious

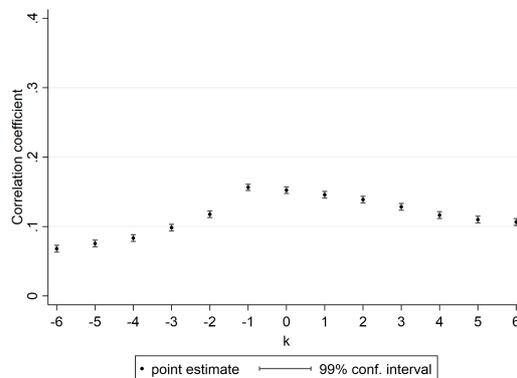
<sup>4</sup>Here we consider only firms which respond at least 10 times in total.

**Figure 2:** Correlation of expected changes in production with changes in realized production and prices in the manufacturing sector

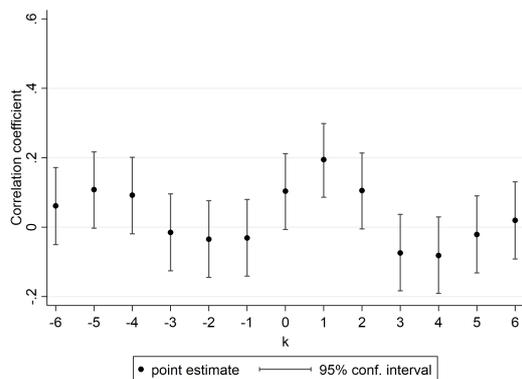
(a) Expected production in  $t$  and reported production  $t + k$ , firm level



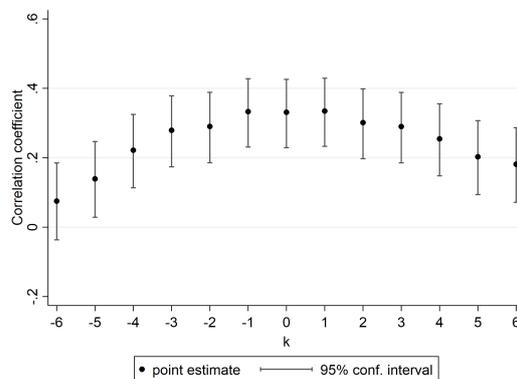
(b) Expected prices in  $t$  and reported prices  $t + k$ , firm level



(c) Mean expected production in  $t$  and industrial production in  $t + k$ , monthly



(d) Mean expected prices in  $t$  and producer prices in  $t + k$ , monthly



*Notes:* Survey data from the BEP; indices of production and prices in manufacturing from the German Statistical Office and the Bundesbank, respectively.

optimists and pessimists is limited. Most firms' average response is zero. The distribution is close to normal.

Figure 2 plots the correlation of expected production with six leads and lags of realized production and prices. The correlation between the expectations and reported outcomes is positive in both cases, across all leads and lags (panels (a) and (b)). The contemporaneous correlation of current production and prices, on the one hand, and production expectations, on the other hand, is particularly strong. In our analysis below we seek to establish the causal effect of production expectations on production and price setting decisions.

We also consider how average firm expectations within a month co-move with aggregate production and prices.<sup>5</sup> Panel (c) of Figure 2 shows the cross correlation between the monthly

<sup>5</sup>Recall that the ifo survey is the basis for the ifo business climate index, a widely watched leading indicator of the German business cycle (Abberger and Wohlrabe 2006; Henzel and Rast 2013).

average of production expectations across firms and leads and lags of the monthly growth in industrial production. The two time series are strongly correlated for small leads of industrial production. This is in line with the ifo business climate index being a leading indicator of economic activity. Analogously to the survey measures, we also consider the cross correlation between month-on-month changes in the producer price index and average production expectations. Panel (d) shows that also these measures are strongly correlated.

### 3 Do firm expectations matter?

The main purpose of our analysis is to identify the effect of firm expectations on firm decisions. Specifically, in our baseline specification we assess to what extent firms' production and price-setting decisions depend on production expectations. For this purpose we compare the behavior of firms that expect an increase (decrease) of production to firms that expect production to remain unchanged. A key challenge in this regard is to identify variation in expectations that is orthogonal to current fundamentals. For only to the extent that firms are comparable in terms of fundamentals, we may think of expectations as a "treatment" into which some firms are randomly selected and others are not.

Put differently, as we compare the behavior of firms with different views about the future we face a selection problem because firms with better fundamentals are also more likely to enjoy a more favorable outlook. In order to address this selection problem we rely on propensity score matching (see e.g. Caliendo and Kopeinig 2008; Imbens and Rubin 2015). The idea is to mimic randomized control trials where treatment is actually assigned in a random fashion and hence orthogonal to observable characteristics. The matching approach is particularly suited for the purpose of our analysis because we are dealing with qualitative data on expectations: firms may be either optimistic, neutral, or pessimistic. Hence, in our analysis, to the extent that firms receive a treatment, they are either treated with "optimism" or with "pessimism." Of course, our analysis does not require optimism or pessimism to be literally assigned in a random way. We merely assume that the assignment is orthogonal to current fundamentals. Note also that we do not require optimism/pessimism to be unrelated to future fundamentals. We take up that issue in more detail in the Section 4 below.

In general, the matching approach offers several advantages over conventional regression analysis. First, it ensures that the distribution of control variables is similar across treated units

and the control group (Dehejia and Wahba 2002; Imbens and Rubin 2015). This is important because differences in the distribution of controls can lead to significant bias when estimating treatment effects (Heckman et al. 1998). Second, the matching approach disciplines the analysis since the control group is specified prior to and independently of the estimation of the treatment effect (Imbens and Rubin 2015). Lastly, after matching, the treatment effect is estimated by a simple mean difference, thus allowing for a non-parametric estimation (Dehejia and Wahba 1999; Heckman et al. 1998).

### 3.1 Propensity score matching

We now briefly outline our approach following Caliendo and Kopeinig (2008). Inference is based on estimating the potential outcome of a treated firm under non-treatment, that is, the (unobserved) counterfactual outcome, had the treated firm not been treated. Formally, the object of interest is the average treatment effect on treated (ATT) firms:

$$\theta = E[Y(1) - Y(0)|D = 1] = E[Y(1)|D = 1] - E[Y(0)|D = 1],$$

where  $D = 1$  indicates treatment,  $Y(1)$  the outcome of a treated firm, that is, a firm which is optimistic (pessimistic), and  $Y(0)$  the counterfactual outcome of a treated firm in the absence of treatment. Since we do not observe the latter, we can only estimate the following relationship:

$$E[Y(1)|D = 1] - E[Y(0)|D = 0] = \theta + E[Y(0)|D = 1] - E[Y(0)|D = 0]. \quad (3.1)$$

This is equivalent to the ATT only if

$$E[Y(0)|D = 1] - E[Y(0)|D = 0] = 0,$$

that is, the potential outcomes are independent of treatment assignment. In randomized control trials this holds true due to the random assignment of treatment. In observational studies, additional assumptions are required. One approach is to assume that treatment is assigned randomly given a set of relevant covariates  $X$ :

$$Y(1), Y(0) \perp D | X.$$

Covariates are relevant if they affect both the (potential) outcome and the probability of being treated. In our case, this means that we need to include all information that matter for firms'

expectation formation as well as for their production and price-setting decisions. We describe these variables below. Since we are only interested in the effect on the treated, we merely need  $Y(0)$  to be independent of treatment status, see equation (3.1). In this case the required conditional independence assumption simplifies to

$$Y(0) \perp D|X.$$

In the expressions above we condition on the whole set of control variables. This can be challenging when the number of observable controls is large. In our analysis we include 4 continuous variables and 18 categorical variables with three outcomes each. If we were to split the sample by the categorical variables only, we would already have  $3^{18}$  potential bins. This makes accounting for controls by creating sub-samples of identical observations infeasible even with a large data set. We therefore rely on a result established by Rosenbaum and Rubin (1983): asymptotically, it is equivalent to condition either on the propensity to be treated,  $p(X) \equiv Pr(D = 1|X)$  or directly on  $X$ . The conditional independence assumption can thus be stated as follows:

$$Y(0) \perp D|p(X).$$

Conditioning on the propensity score requires the additional assumption of common support, that is, treatment is not fully determined:

$$0 < p(X) = Pr(D = 1|X) < 1. \quad (3.2)$$

In what follows, we estimate the ATT by comparing the outcome of each treated observation to one or several untreated units with the same (or very similar) propensity score. In our analysis there are two possible treatments: optimism and pessimism. To establish the effect of a treatment we compare firms in each case to firms which do not expect production to change at all (“neutral firms”). In order to estimate the propensity score we pursue two alternative approaches. Since we are dealing with two treatments, we first estimate an ordered probit model where optimism and pessimism are outcomes of a common model. Alternatively, we consider distinct probit models for optimists and pessimists. In the first case we estimate the probability of the latent variable,  $y_{it}^*$ , falling between two thresholds  $\alpha_{j-1}$  and  $\alpha_j$  for treatment  $j$  as

$$Pr(y_{it} = j) = Pr(\alpha_{j-1} < y_{it}^* \leq \alpha_j) = \Phi(\alpha_j - X'_{it}\beta) - \Phi(\alpha_{j-1} - X'_{it}\beta), \quad (3.3)$$

**Table 2:** Control variables in the propensity score model, measured in month  $t$ 

| Variable                           | Description  | Frequency              | Reference period |
|------------------------------------|--|------------------------|------------------|
| debt share <sup>1</sup>            | total debt over assets   | annual                 | $t-11$ to $t$    |
| financing coefficient <sup>1</sup> | liabilities minus provisions<br>divided by equity plus provisions    | annual                 | $t-11$ to $t$    |
| employees                          | no. of employees   | annual <sup>2</sup>    | October/November |
| state of business                  | answer to question on state<br>of business (values: 1, 0, -1)        | monthly                | $t$              |
| orders                             | answer to question on state<br>of orders (values: 1, 0, -1)          | monthly                | $t$              |
| foreign orders                     | answer to question on state<br>of foreign orders (values: 1, 0, -1)  | monthly                | $t$              |
| production                         | answer to question on change<br>in production (values: 1, 0, -1)     | monthly                | $t-1$            |
| prices                             | answer to question on change<br>in prices (values: 1, 0, -1)         | monthly                | $t-1$            |
| capacity utilization               | utilization of existing capacity in %                                | quarterly <sup>2</sup> | $t-1$            |
| demand                             | answer to question on demand<br>in previous month (values: 1, 0, -1) | monthly                | $t-1$            |

*Notes:* For all variables with monthly frequency three lags are also included. In addition various interaction terms are included (based on a log-likelihood ratio test).

<sup>1</sup> To ensure outliers and measurement error do not affect our results, we exclude the 99.99 percentile of observations for the debt share and the 0.02 and 99.98 percentiles for the financing coefficient.

<sup>2</sup> In months with no reporting we use data from the most recent balance sheet/most recent quarter the question was asked (if available).

where  $j = \{1, 0, -1\}$  corresponds to the three possible answers to Q1. We collect the control variables in the vector  $X_{it}$ . It includes time and sector fixed effects, the sector average of the reported state of business in each month, three lags of the dependent variables, and all firm specific variables listed in Table 2 (including three lags for each of the survey variables). More detailed information on the survey variables is provided in Table B.1 in the appendix.

The ordered probit does not directly yield the propensity score. In this case the propensity score,  $p^m(X_{it})$  for treatment  $m = \{optimism, pessimism\}$ , equals the conditional choice probability of the treatment given the alternative of no treatment, that is, if firms expect production to remain unchanged:

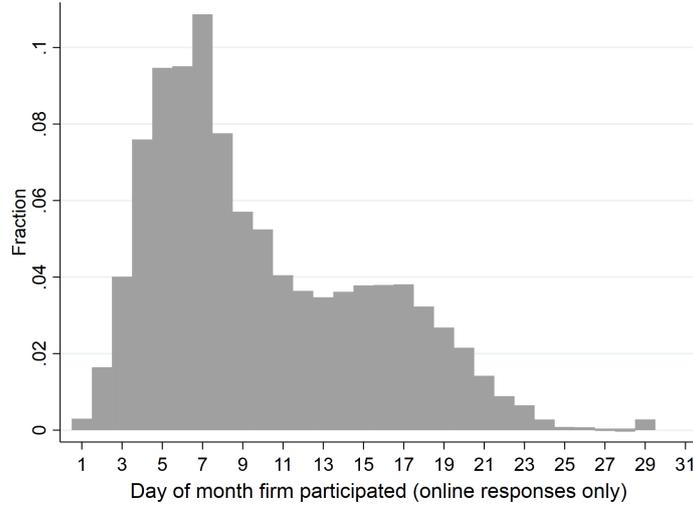
$$p^m(X_{it}) = \frac{Pr(y_{it} = m|X_{it})}{Pr(y_{it} = m|X_{it}) + Pr(y_{it} = 0|X_{it})},$$

see again Caliendo and Kopeinig (2008).

The second approach involves two separate probit regressions: one for each treatment. The specification is the same as for the ordered probit model:

$$Pr(D_{it}^m = 1) = Pr(X_{it}'\beta) = \Phi(X_{it}'\beta), \quad (3.4)$$

**Figure 3:** Distribution of days firms respond to survey within month, 2004 to 2016



where  $D_{it}^m = 1$  is a dummy variable which is 1 for an observation responding *increase* in the case of the optimism treatment, -1 for an observation responding *decrease* in the case of the pessimism treatment, and 0 for an observation responding *stay the same* in both cases. We again collect the same control variables in vector  $X_{it}$ . Since the sample only includes the specific treatment group and the untreated, the estimated probability is a direct estimate of the propensity score:

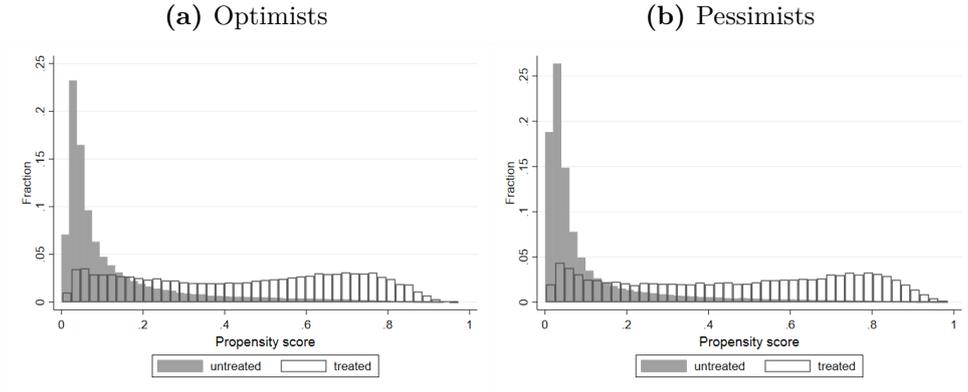
$$p^m(X_{it}) = Pr(D_{it}^m = 1).$$

Caliendo and Kopeinig (2008) discuss the use of serial probit estimation compared to multinomial models in the case of multiple treatments. They argue that generally authors found no difference or a slight advantage of using separate probit models. It turns out that also in our case the serial probit estimation has a slight advantage as it yields improved balancing statistics. We therefore use it in our baseline. However, results based on the ordered probit do not differ much from results using the two probit regressions, see results in Section 3.4.

As mentioned above, we include all potentially relevant variables as controls in order to capture the fundamentals of the firm, both current values as well as lags. However, we only consider realizations which are available at the time the survey is conducted. In this regard it is important to note that most firms respond to the survey in the first two weeks of the months. Figure 3 shows the distribution of participation days within the month. 50% answer within the first eight days of the month and another 25% answer in the following week.<sup>6</sup>

<sup>6</sup>These statistics pertain to firms that answer the survey online. They represent more than 60% of the firms since 2004.

**Figure 4:** Histogram of the density of the propensity scores



After computing the propensity scores, we match treated and untreated observations using a variant of caliper or radius matching (Caliendo and Kopeinig 2008).<sup>7</sup> We match each treated observation  $i$  (optimistic or pessimistic) to all untreated observations  $k$  (neutral) within the same month which satisfy

$$p(X_{it}) - 0.02 \leq p(X_{kt}) \leq p(X_{it}) + 0.02. \quad (3.5)$$

Here we allow for a radius of 0.02. This corresponds to about a tenth of the standard deviation of the estimated propensity score.<sup>8</sup> All untreated observations to which a treated observation is matched are given equal weights: the inverse of the number of untreated observations in each match. Note that the untreated observations can be matched more than once to different treated observations.

Figure 4 displays the distribution of the propensity scores. The left panel contrasts the distribution for firms which receive an optimism treatment (white bars) with those for untreated (gray bars) firms. The right panel reports results for pessimism. In each instance, we find that there is considerable overlap of the distribution (common support), although the mass of untreated firms is more concentrated at lower propensity scores.<sup>9</sup> Panel A of Table 3 reports basic statistics regarding our matches. We are able to find matches for about 93% of all treated optimists and for 90% of treated pessimists. This is due to the large overlap in propensity scores between treated and untreated firms.

<sup>7</sup>We also test an alternative matching procedure proposed by Lechner et al. (2011). The results are very close to our results. Details can be found in Appendix D.2.

<sup>8</sup>Alternative values for the radius give rise to similar results or, if not, fail to deliver satisfying balancing statistics (see next sections).

<sup>9</sup>There are also some treated observations with a larger propensity score than the largest propensity score of all untreated observations. We drop these observations in what follows. This trimming ensures that only suitable observations are matched. Specifically, we remove 15 optimists and 0 pessimists.

**Table 3:** Number of matched observations

|                                 | Optimism treatment |         | Pessimism treatment |         |
|---------------------------------|--------------------|---------|---------------------|---------|
|                                 | Total              | Matched | Total               | Matched |
| <i>Panel A: All firms</i>       |                    |         |                     |         |
| Treated observations            | 26 974             | 25 050  | 23 327              | 20 947  |
| Untreated observations          | 114 843            | 111 027 | 114 809             | 110 625 |
| <i>Panel B: Correct firms</i>   |                    |         |                     |         |
| Treated observations            | 12 366             | 9 995   | 12 123              | 9 493   |
| Untreated observations          | 82 317             | 73 321  | 82 519              | 72 762  |
| <i>Panel C: Incorrect firms</i> |                    |         |                     |         |
| Treated observations            | 10 634             | 9 671   | 7 641               | 6 614   |
| Untreated observations          | 82 505             | 76 349  | 82 497              | 74 357  |

### 3.2 Diagnostics

Before turning to the results, we report some diagnostics of the matching exercise. We compute balancing statistics in order to assess how similar the samples of treated observations and untreated observations are. The main statistic of interest is the standardized bias between the treated and untreated sample for each control variable. Following Rosenbaum and Rubin (1983), this is computed as follows:

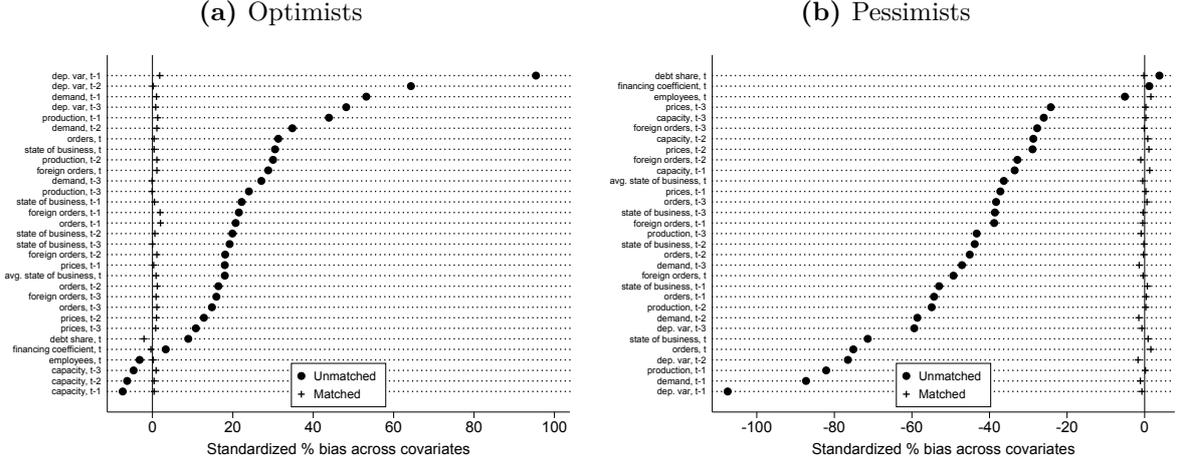
$$SB = 100 \frac{\bar{x}_1 - \bar{x}_0}{\sqrt{0.5(s_1^2 + s_0^2)}}, \quad (3.6)$$

where  $\bar{x}_1$  is the mean of the control variable among the matched treated observations,  $\bar{x}_0$  is the mean of the control variable for all matched untreated observations,  $s_1$  is the standard deviation of the treated observations and  $s_0$  the standard deviation of all untreated observations. Figure 5 shows that as a result of matching observations, we achieve a sizeable reduction of the standardized bias. According to a widely used rule of thumb, the matched sample is regarded as well balanced when all standardized biases are below 5% (Caliendo and Kopeinig 2008).<sup>10</sup> We meet this standard in all instances, see also Table C.1 in the appendix.

Rubin (2001) suggests a second measure of balancing. He argues that the variance of the part of each covariate that is orthogonal to the propensity score (the residual of a regression of the covariate on the propensity score) should be similar for treated and untreated firms. Specifically, the ratio of the variances should not be below 0.5 or above 2. Ratios between a range of 0.8 and 1.25 are considered acceptable. Figure 6 plots the variance ratios before and after matching.

<sup>10</sup>Imbens and Rubin (2015) suggest that 10% can also be considered a satisfactory value, especially when the initial bias is large.

**Figure 5:** Standardized bias, before and after matching



Again, we find that matching firm-month observations ensures that treated and non-treated firms appear well balanced in terms of covariates. Only the ratio for the number of employees and the financing coefficient (for pessimists) falls in the “of concern” area (outside dashed lines).

### 3.3 Computation of the treatment effect

In what follows, we focus on the average treatment effect on the treated (ATT) in terms of production and price-setting decisions. For each outcome variable, we compute the ATT as the mean difference, across all matches, of treated and untreated firms.

The computation of standard errors for estimates of the ATT computed after matching is not straightforward. One can use analytical variances or bootstrapping. Since bootstrapping has sometimes been shown to be invalid (Caliendo and Kopeinig 2008), we use the methodology of Lechner (2001). He shows that in case of variants of nearest neighbor matching, as in our case, the variance of the ATT,  $\hat{\tau}_{ATT}$ , is:

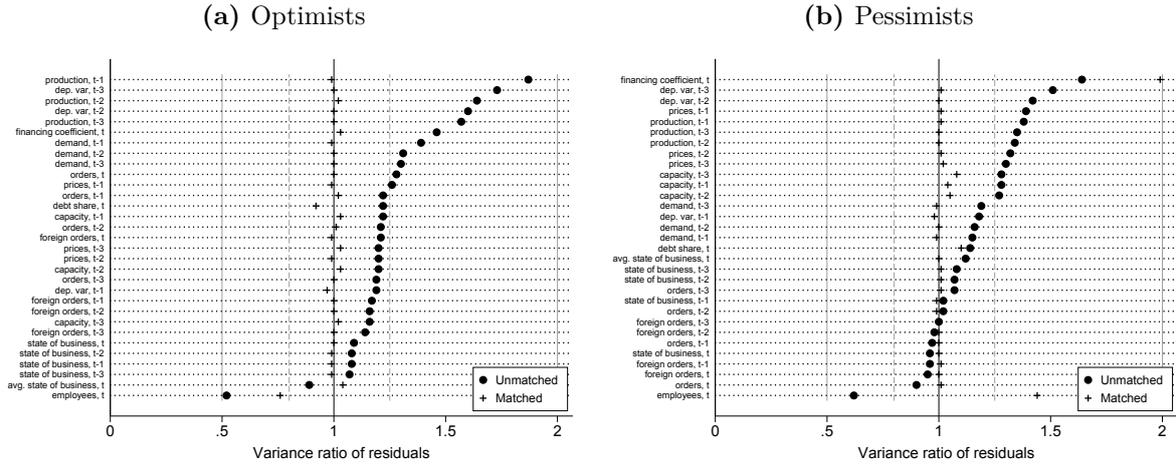
$$Var(\hat{\tau}_{ATT}) = \frac{1}{N_1} Var(Y(1)|D = 1) + \frac{\sum_{j \in \{D=0\}} (w_j)^2}{(N_1)^2} Var(Y(0)|D = 0),$$

where  $Y(1)$  and  $Y(0)$  refer to a variable of interest given the treatment indicator  $D$  equals 1 or 0.  $N_1$  is the number of matched treated firm and  $w_j$  is the weight of untreated firm  $j$  (see above).

### 3.4 Results

We now turn to the question which motivates our analysis: to what extent do firms’ expectations impact current decision making? Table 4 provides a first answer. In the upper part of the table

**Figure 6:** Variance ratio of residuals, before and after matching



*Notes:* Ratios below 0.8 and above 1.25 (dashed lines) are considered “of concern”; ratios below 0.5 and above 2 (gray solid lines) are considered “bad” according to Rubin (2001).

we report the ATT of optimism regarding future production, in the lower part we report the ATT of pessimism. In each instance, we focus on production and price-setting decisions. In the columns we consider alternative specifications.

The left-most column (1) reports results for our baseline. We find a significant positive treatment effect for production (Panel A). This positive effect may reflect a stronger tendency among treated firms to raise production or a reduced tendency to lower production, or both. Below, we disentangle the effect accordingly. For prices we also find a significant positive effect, although in this case the effect is much smaller (see panel B). Taken at face value, such an apparently small effect is consistent with the notion that prices are adjusted only infrequently in the short run. But, again, at this point the effect reflects the outcome of either more frequent upward adjustments or less frequent downward adjustments of prices among treated firms. Last, we note that the effect on prices is quite symmetric across optimism and pessimism, even though we estimate separate models for optimists and pessimists (see panels C and D of Table 4).

Table 4 also reports results for alternative specifications. In Column (2) we show results for a smaller radius in the matching procedure (0.01 instead of 0.02). In Column (3) we consider a short sample period (start date 2002 rather than 1991). In Column (4) we report results for a sample which excludes observations from the financial crisis, that is the years 2008 and 2009. Column (5) shows results for when we estimate an ordered probit model, jointly for pessimism and optimism. Column (6) refers to the case when we use expectations for the future state of business rather than future production. Recall that in this case the “forecasting horizon” is 6 months rather

**Table 4:** Average treatment effect on the treated; optimistic and pessimistic firms; production and prices

|   | (1)<br>Baseline       | (2)<br>Radius 0.01    | (3)<br>Sample<br>2002-2016 | (4)<br>Sample excl.<br>fin. crisis <sup>1</sup> | (5)<br>Ordered<br>probit | (6)<br>Exp. state of<br>business |
|---|-----------------------|-----------------------|----------------------------|---|--------------------------|----------------------------------|
| <i>Panel A: Optimists – Production (change in current month)</i>  |                       |                       |                            |   |                          |                                  |
| ATT   | 0.172***<br>(30.43)   | 0.170***<br>(29.34)   | 0.181***<br>(30.03)        | 0.170***<br>(28.52)                             | 0.152***<br>(27.14)      | 0.182***<br>(35.02)              |
| Observations  | 129812                | 120335                | 108683                     | 113690  | 128932                   | 129706                           |
| <i>Panel B: Optimists – Prices (change in current month)</i>      |                       |                       |                            |   |                          |                                  |
| ATT   | 0.025***<br>(5.97)    | 0.025***<br>(5.80)    | 0.027***<br>(5.74)         | 0.025***<br>(5.52)                              | 0.016***<br>(3.87)       | 0.020***<br>(5.18)               |
| Observations  | 129858                | 120367                | 108715                     | 113734  | 128977                   | 129759                           |
| <i>Panel C: Pessimists – Production (change in current month)</i> |                       |                       |                            |   |                          |                                  |
| ATT   | -0.173***<br>(-27.77) | -0.170***<br>(-26.47) | -0.169***<br>(-24.85)      | -0.172***<br>(-25.37)                           | -0.198***<br>(-32.53)    | -0.204***<br>(-35.03)            |
| Observations  | 125458                | 113992                | 104490                     | 106764  | 123941                   | 125091                           |
| <i>Panel D: Pessimists – Prices (change in current month)</i>     |                       |                       |                            |   |                          |                                  |
| ATT   | -0.031***<br>(-6.13)  | -0.033***<br>(-6.41)  | -0.029***<br>(-5.18)       | -0.035***<br>(-6.53)                            | -0.038***<br>(-7.80)     | -0.029***<br>(-6.33)             |
| Observations  | 125530                | 114050                | 104551                     | 106821  | 124014                   | 125169                           |

T-statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

<sup>1</sup> Excluding the years 2008 and 2009.

than only 3 months. We observe that in all instances the estimate of the ATT is close to that for the baseline and always significant. Balancing statistics for the three sensitivity specifications that require changes in the matching procedure are summarized in Tables C.2 and C.3 in the appendix.

As noted above, our results regarding the response of production and prices may reflect more upward adjustments or less downward adjustments, or both. In order to disentangle the overall effect, we transform the dependent variable into two binary variables for, in turn, production and prices, a frequently used approach when dealing with survey data. We then compute the probability of treated firms to raise (lower) prices or production as the mean difference in the newly defined variable across treated and non-treated firms.

Table 5 shows the results for the baseline specification. Columns (1) and (2) show that treated firms stand out by their increased probability of raising production. Specifically, the probability of a production increase is 14.9 percentage points higher for optimistic firms than for untreated firms. This accounts for the bulk of the overall effect discussed above. The probability of a production

**Table 5:** Average treatment effect on the treated; optimistic and pessimistic firms; increases/decreases in production and prices

|                            | (1)            | (2)            | (3)            | (4)            |
|----------------------------|----------------|----------------|----------------|----------------|
|                            | Prod. increase | Prod. decrease | Price increase | Price decrease |
| <i>Panel A: Optimists</i>  |                |                |                |                |
| ATT                        | 0.149***       | -0.022***      | 0.018***       | -0.008***      |
|                            | (36.93)        | (-6.86)        | (5.35)         | (-3.20)        |
| Observations               | 129812         | 129812         | 129858         | 129858         |
| <i>Panel B: Pessimists</i> |                |                |                |                |
| ATT                        | -0.024***      | 0.149***       | -0.005         | 0.025***       |
|                            | (-7.11)        | (31.35)        | (-1.63)        | (7.23)         |
| Observations               | 125458         | 125458         | 125530         | 125530         |

T-statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

decrease, in turn, is reduced by 2.2 percentage points. Optimism also raises the probability of a price increase by 1.8 percentage points and lowers the probability of a price decrease by 0.8 percentage points, see columns (3) and (4) of Table 5.

Likewise, pessimism increases the probability of a cut of current production by 14.9 percentage points, while the probability of a production increase is reduced by 2.4 percentage points. The response of prices to pessimism is somewhat larger than the one to optimism. The probability of a price decline increases by 2.5 percentage points. The probability of a price increase is not affected significantly.

## 4 News or noise?

In the previous section we have established that firm expectations impact firm decisions on current production and pricing. This raises the question of why this is the case. Two alternative hypotheses appear plausible. According to the first hypothesis, firms may have information about the future that has not yet materialized in current fundamentals. While our set of fundamentals includes forward looking variables such as orders, one cannot rule out the possibility that firms have additional information beyond what is already reflected in current fundamentals. According to this “news” hypothesis, firms have therefore a good reason to be either optimistic or pessimistic. It is only that these reasons are not yet observable to the econometrician. Instead, according to the second hypothesis, optimism and pessimism are just “noise”, that is, misperceptions about the future that are fundamentally unwarranted or “undue” (Pigou 1927). Of course, our estimate of the ATT may also reflect a mixture of news and noise.

In what follows, we seek to determine to what extent the expectations which govern firms' decisions about production and prices reflect news and noise. We do so on the basis of firms' forecast errors. Intuitively, if a given firm appears particularly optimistic relative to its current fundamentals, but later reports that actual production is unchanged or declined, its view about the future appears—with the benefit of hindsight—to have been misperceived. We are thus able to classify optimism and pessimism as incorrect from an ex post perspective. Note that we do not take a stand on whether expectations were rational or not from an ex-ante point of view. We simply compare them to actual outcomes. For instance, a firm may have been optimistic about some aspect of the future and correctly so. Actual production may still fall short of the expected level because of some other unforeseen development. Since in our case optimism pertains to *future production as such*, we nevertheless classify such firms as incorrect optimists.

In order to measure the forecast errors of firms we follow Bachmann et al. (2013). We interpret the qualitative responses to questions about expected and realized production (Q1 and Q3, respectively) as pertaining to the same latent variable and seek to measure whether or not there was an error, while remaining agnostic about its size. Table 6 provides an overview of all possible cases for which we define an error. According to our classification scheme, firms that expected a change of their production were correct if they report at least once a change in the expected direction and no change in the opposite direction in the following three months. Firms which expected no change are considered to have made no error if they report only one change in either direction or two changes in opposite directions.

Based on this classification scheme, we define a treatment with “correct optimism.” It refers to optimistic firms (answer 1 to Q1) without forecast error. The control group are all neutral firms (answer 0 to Q1) without forecast error. The second treatment we consider is “incorrect optimism.” Here we consider firms that are optimistic but make a forecast error from an ex-post point of view. The control group is the same as in the first case. The third and fourth treatment are defined analogously for pessimists. Using these four new treatment indicators, we perform the same matching procedure as described in Section 3.1.

Before turning to the results, we again consider some diagnostic statistics to ensure the matching methodology works also in this case. The statistics are the same as described in Section 3.2. Panels B and C of Table 3 above provide an overview of the number of observations for which a propensity score can be computed as well as the number of observations which can be

**Table 6:** Computation of the forecast error

| expected production, $t$ | average production, $t + 1$ to $t + 3$     | error |
|--------------------------|--|-------|
| 1                        | $> 0$                                      | 0     |
|                          | $\leq 0$                                   | -1    |
| 0                        | $> \frac{1}{3}$                            | 1     |
|                          | $\leq \frac{1}{3}$ and $\geq -\frac{1}{3}$ | 0     |
|                          | $< -\frac{1}{3}$                           | -1    |
| -1                       | $\geq 0$                                   | 1     |
|                          | $< 0$                                      | 0     |

matched. Since we now restrict our sample, the number of matches is smaller than in Section 3.2. Despite the sample reduction, however, common support is not an issue (see Figure C.1 in the appendix) and we still have a sufficiently large amount of observations to compute ATTs. We display balancing statistics in figures C.2 and C.3 in the appendix. For all four treatments balancing is achieved and no bias is above 5% (Table C.1 shows the bias in detail). Also the variance ratios are generally within the defined bounds with similar exceptions as before.

We report results in Table 7. We focus again on how firms' current production and price-setting decisions depend on optimism (upper part of the table) and on pessimism (lower part of the table). Now, however, we distinguish between correct and incorrect optimists/pessimists. Panels A and B show the results for production and prices for correct optimists, respectively, while panels C and D display the results for incorrect optimists.

We present estimates for the baseline in Column (1). As before, results are robust across alternative specifications, see columns (2) to (4). We find that the effect of optimism on firms' current decisions is stronger for correct optimists than for incorrect optimists; likewise for pessimists. Still, also for optimism and pessimism that turns out to be incorrect in light of actual developments, we find a significant effect. As before in case of optimism, this effect may reflect a mixture of more upward or less downward adjustments compared to untreated firms. For pessimism it may reflect more downward adjustments and fewer upward adjustments.

In order to shed some light on the underlying factors, we rely once more on the transformation of the dependent variables into two binary variables for, in turn, production and prices. Table 8 shows the results. We find that the probability of a production increase is 27.6 percentage points higher for correct optimists than for untreated firms, but only 7.2 percent for incorrect optimists. In addition, the probability of a production decrease also rises for incorrect optimists (albeit only

**Table 7:** Average treatment effect on the treated; correct and incorrect optimism and correct and incorrect pessimism; production and prices

|  | (1)<br>Baseline       | (2)<br>Radius 0.01    | (3)<br>2002-2016      | (4)<br>Sample ex. crisis <sup>1</sup> |
|--|-----------------------|-----------------------|-----------------------|---------------------------------------|
| <i>Panel A: Correct optimists – Production (change in current month)</i>   |                       |                       |                       |                                       |
| ATT  | 0.302***<br>(36.89)   | 0.298***<br>(34.85)   | 0.314***<br>(36.14)   | 0.297***<br>(34.26)                   |
| Observations   | 81254                 | 68946                 | 68785                 | 71391                                 |
| <i>Panel B: Correct optimists – Prices (change in current month)</i>       |                       |                       |                       |                                       |
| ATT  | 0.035***<br>(5.40)    | 0.034***<br>(5.18)    | 0.040***<br>(5.72)    | 0.033***<br>(4.90)                    |
| Observations   | 81254                 | 68945                 | 68778                 | 71392                                 |
| <i>Panel C: Incorrect optimists – Production (change in current month)</i> |                       |                       |                       |                                       |
| ATT  | 0.063***<br>(8.58)    | 0.060***<br>(7.94)    | 0.072***<br>(9.20)    | 0.063***<br>(8.13)                    |
| Observations   | 84029                 | 74232                 | 69715                 | 73973                                 |
| <i>Panel D: Incorrect optimists – Prices (change in current month)</i>     |                       |                       |                       |                                       |
| ATT  | 0.016***<br>(2.92)    | 0.015***<br>(2.58)    | 0.017***<br>(2.80)    | 0.011*<br>(1.89)                      |
| Observations   | 84032                 | 74232                 | 69714                 | 73978                                 |
| <i>Panel E: Correct pessimist – Production (change in current month)</i>   |                       |                       |                       |                                       |
| ATT  | -0.307***<br>(-33.71) | -0.300***<br>(-30.52) | -0.307***<br>(-30.78) | -0.303***<br>(-32.00)                 |
| Observations   | 80282                 | 66948                 | 67112                 | 68156                                 |
| <i>Panel F: Correct pessimist – Prices (change in current month)</i>       |                       |                       |                       |                                       |
| ATT  | -0.030***<br>(-3.83)  | -0.021**<br>(-2.52)   | -0.028***<br>(-3.24)  | -0.044***<br>(-5.66)                  |
| Observations   | 80285                 | 66941                 | 67109                 | 68158                                 |
| <i>Panel G: Incorrect pessimist – Production (change in current month)</i> |                       |                       |                       |                                       |
| ATT  | -0.086***<br>(-9.99)  | -0.093***<br>(-10.29) | -0.074***<br>(-7.92)  | -0.086***<br>(-9.15)                  |
| Observations   | 79026                 | 68414                 | 65323                 | 68835                                 |
| <i>Panel H: Incorrect pessimist – Prices (change in current month)</i>     |                       |                       |                       |                                       |
| ATT  | -0.003<br>(-0.36)     | -0.008<br>(-1.07)     | 0.000<br>(0.00)       | -0.008<br>(-1.08)                     |
| Observations   | 79033                 | 68420                 | 65326                 | 68842                                 |

T-statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

<sup>1</sup> Excluding the years 2008 and 2009.

by 0.9 percentage points). This increases the differences between the overall ATTs for correct and incorrect optimists. For prices, the differences are smaller. The probability of a price increase for correct optimists is about 2.8 percentage points, while it is 1.2 percentage points for incorrect optimists.

**Table 8:** Average treatment effect on the treated; correct and incorrect optimism and correct and incorrect pessimism; increases/decreases in production and prices

|                                      | (1)            | (2)            | (3)            | (4)            |
|--------------------------------------|----------------|----------------|----------------|----------------|
|                                      | Prod. increase | Prod. decrease | Price increase | Price decrease |
| <i>Panel A: Correct optimists</i>    |                |                |                |                |
| ATT                                  | 0.276***       | -0.026***      | 0.028***       | -0.007*        |
|                                      | (44.90)        | (-5.87)        | (5.45)         | (-1.93)        |
| Observations                         | 81254          | 81254          | 81254          | 81254          |
| <i>Panel B: Incorrect optimists</i>  |                |                |                |                |
| ATT                                  | 0.072***       | 0.009**        | 0.012***       | -0.004         |
|                                      | (13.82)        | (2.11)         | (2.84)         | (-1.24)        |
| Observations                         | 84029          | 84029          | 84032          | 84032          |
| <i>Panel D: Correct pessimists</i>   |                |                |                |                |
| ATT                                  | -0.033***      | 0.274***       | 0.000          | 0.030***       |
|                                      | (-6.62)        | (39.14)        | (0.01)         | (5.57)         |
| Observations                         | 80282          | 80282          | 80285          | 80285          |
| <i>Panel E: Incorrect pessimists</i> |                |                |                |                |
| ATT                                  | -0.002         | 0.084***       | 0.004          | 0.007          |
|                                      | (-0.46)        | (12.66)        | (0.96)         | (1.42)         |
| Observations                         | 79026          | 79026          | 79033          | 79033          |

T-statistics in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

Results for pessimists are quantitatively comparable. They are shown in the bottom panel of Table 8. Correct pessimists are 27.4 percentage points more likely to lower production, while the probability is 8.4 percentage points for incorrect pessimists. We thus note that there is some asymmetry in the response to incorrect optimism/pessimism: incorrect pessimists respond somewhat more strongly than incorrect optimists. Similarly, correct pessimists tend to lower the price to the same extent as correct optimists tend to raise them. Incorrect optimists, instead, do not respond by adjusting prices in a significant way. The average effect is roughly zero and the effects on the binary outcome variables are close to zero and insignificant.

This observation lends support to the view that downward price rigidities prevent an adjustment of prices unless the need for adjustment is particularly strong. Arguably this is the case if pessimism is correct but not if it is incorrect, which might be related to a lower degree of pessimism. In the latter case, it turns out, firms appear more responsive in terms of quantities instead of prices.

## 5 Incorrect optimism and aggregate fluctuations

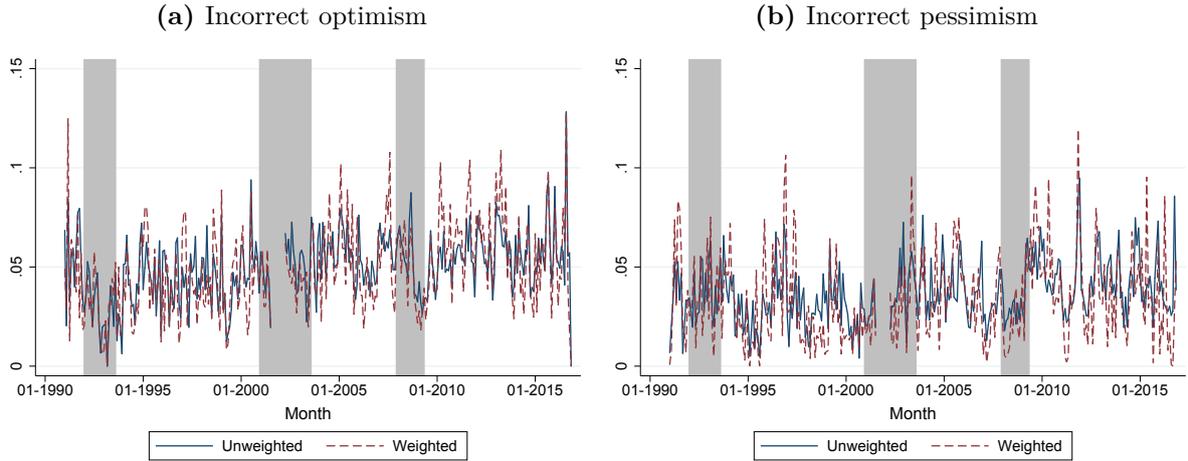
Up to now we have focused on individual firms and, more specifically, we have documented that incorrect optimism causes firms to raise prices and production. Likewise, incorrect pessimism causes firms to lower prices and production. In what follows, we ask whether incorrect optimism and pessimism at the firm level matters for aggregate outcomes. Intuitively, if a sufficiently large number of firms or a number of sufficiently large firms are incorrectly optimistic (pessimistic) this may cause economic activity to rise (fall) at the aggregate level. Our analysis proceeds as follows. In a first step, we construct a time series for incorrect optimism and incorrect pessimism at the aggregate level. For this purpose we measure for each month in our sample the fraction of incorrectly optimistic and pessimistic firms. In a second step, we rely on local projections to estimate the impact of incorrect optimism and pessimism on industrial production and prices.

### 5.1 Incorrect optimism and pessimism at the macro level

In order to quantify incorrect optimism and pessimism at the aggregate level we aggregate the firm-level measures established in the previous sections. We proceed as follows. First, we use the ordered probit model estimated in Section 3. Now, however, rather than matching firms based on their propensity score, we measure the extent of optimism and pessimism by computing the difference between a firm's response and the prediction of the ordered probit model as in equation (3.3). We use the ordered probit, rather than distinct models for optimists and pessimists, because we need to be able to account for all outcomes simultaneously. Recall that the ordered probit model includes as control variables time and sector fixed effects, the sector average of the reported state of business in each month, three lags of the dependent variables, and all firm-specific variables listed in Table 2 (including three lags for each of the survey variables). On the basis of the ordered probit model we classify firms as optimists (pessimists) whenever they respond with “+1” (“−1”) even though the model predicts otherwise.

Second, we further refine our aggregate measure by focusing on incorrect optimism and pessimism. For this purpose we only consider firms for which we additionally observe a non-zero forecast error, as defined in Section 4 above. Finally, we compute the shares of firms that turn out either incorrectly optimistic or incorrectly pessimistic relative to all firms in the corresponding month.

**Figure 7:** Incorrect optimism and pessimism, 1991 to 2016



*Notes:* Aggregate time series for incorrect optimism and pessimism, unweighted and weighted by employees. Shaded areas mark recession periods as defined by the German Council of Economic Experts.

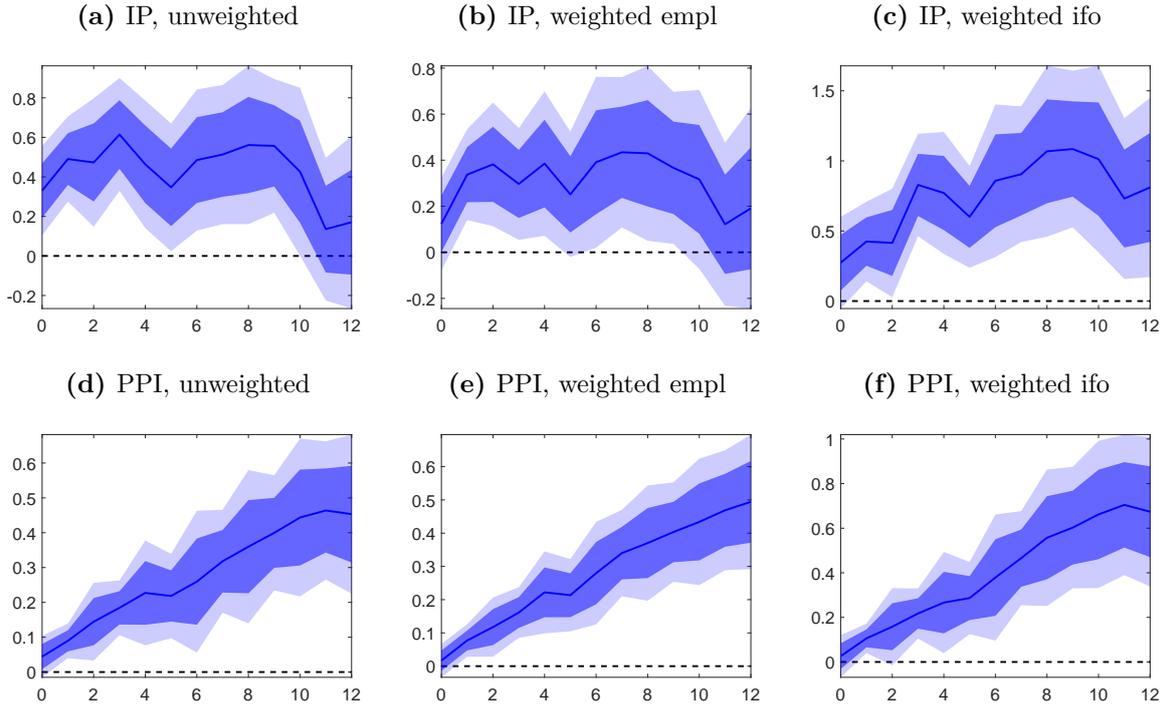
We compute three measures. One is the unweighted share. For the second measure, we compute weighted shares using firm employees. We drop the largest 5 percent of our observations to ensure that results are not driven by individual firms. Finally, we weigh firms in line with the approach by the ifo institute for aggregating answers to the business climate index (Sauer and Wohlrabe 2018). Here, all firms within a 2-digit WZ08 sector (the German system of industry classification) are weighted using the number of employees in production as reported in the survey. Instead of using the number of employees directly, the weight is a logarithmic transformation of employment.<sup>11</sup> The sector averages are then aggregated using data on gross value added by sector from the German Statistical Office.

Figure 7 displays the unweighted and the employee-weighted time series for incorrect optimism and pessimism (using ifo weights results in a very similar time series). The computation of these shares requires firms to be in the survey for at least eight consecutive months because we need three lags for the estimation of the ordered probit model and four leads for the computation of the forecast error.<sup>12</sup> This leads to a gap in our time series from August 2001 to March 2002 because the ifo survey was not conducted in December 2001. In addition, it reduces the number of observations in the last five months of 2016 since currently not all data for 2017 is available to us. The main takeaway of Figure 7 is that there is considerable variation of incorrect optimism and pessimism over time. In addition, we note that the time series exhibit little persistence.

<sup>11</sup>Specifically, the weight is  $w = (\log_{10}(N))^e$ , with  $N$  being the number of employees, see the EBDC Questionnaire Manual. This transformation ensures that very large firms do not distort the averages.

<sup>12</sup>That is, we need production for the next three months, but since production is reported only for the previous month we need four leads of the survey.

**Figure 8:** Impulse responses to incorrect optimism



*Notes:* Responses of IP and PPI (both manufacturing) to incorrect optimism. Local projections with constant, linear trend, one lag of dependent variable and 12 of the shocks. Shaded areas indicate 68 and 90 percent confidence intervals.

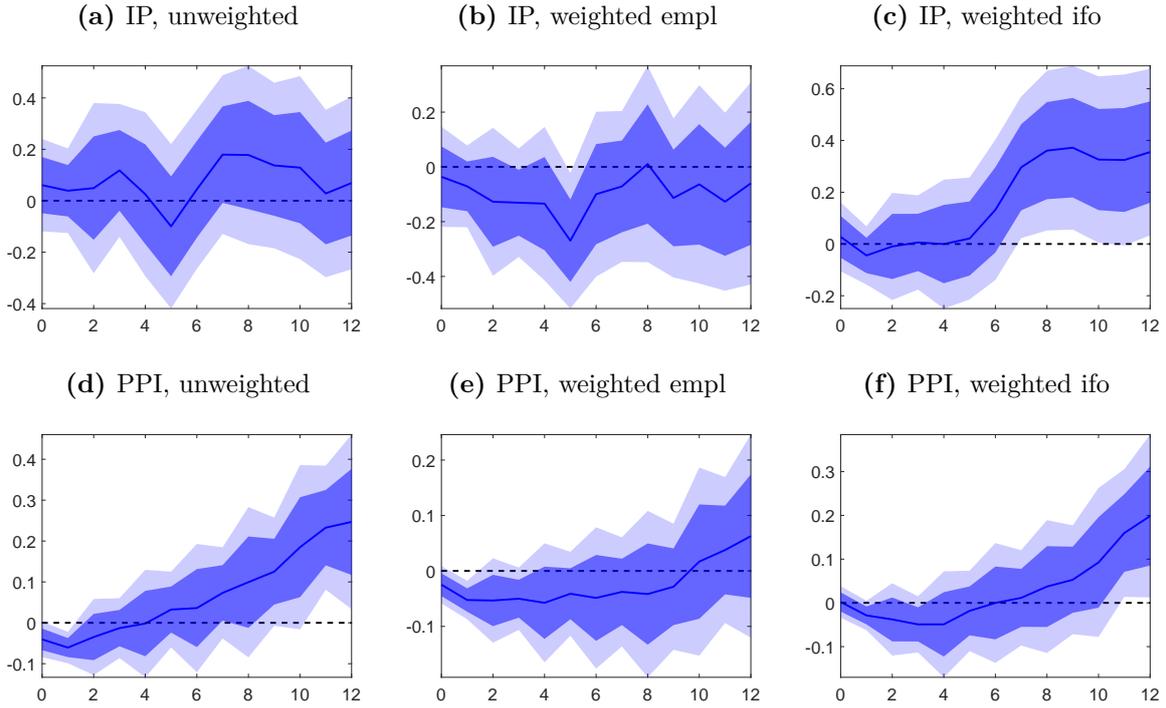
## 5.2 Aggregate effects of incorrect optimism

Our measure of incorrect optimism and pessimism is an aggregate of firm-level responses. In computing our measure we have allowed for time-fixed effects. As such, aggregate optimism and pessimism is unlikely to be caused by macroeconomic shocks. Similarly, to the extent macroeconomic shocks impact different firms differently, it is important that we focus on incorrectly optimistic/pessimistic firms, that is, firms whose expectations turn out to be unwarranted from an ex-post perspective. For these reasons we treat our aggregate measure as an explanatory variable of macroeconomic outcomes that is not itself caused by macroeconomic developments.

Against this background we may resort to local projections to estimate the effect of incorrect optimism on aggregate outcomes (Jordà 2005). Formally, using  $e_t^o$  and  $e_t^p$  to denote the time-series observations for incorrect optimism and pessimism, respectively, and  $x_t$  for the realization of a macroeconomic variable of interest, we estimate following model:

$$x_{t+h} = c^{(h)} + \sum_{j=1}^J \alpha_j^{(h)} x_{t-j} + \sum_{k=0}^{K-1} \beta_k^{(h)} e_{t-k}^o + \sum_{k=0}^{K-1} \gamma_k^{(h)} e_{t-k}^p + \varepsilon_{t+h}, \quad (5.1)$$

**Figure 9:** Impulse responses to incorrect pessimism



*Notes:* Responses of IP and PPI (both manufacturing) to incorrect pessimism. Local projections with constant, linear trend, one lag of dependent variable and 12 of the shocks. Shaded areas indicate 68 and 90 percent confidence intervals.

where  $c$  is a (horizon-specific) constant. Additionally, we include a linear time trend. To enhance efficiency, we also include the residuals of the previous horizon when increasing the horizon by steps of one (see Jordà 2005). For the estimation, we include 1 lag of the dependent variable and 12 lags of incorrect optimism and pessimism. In all estimations, we include both incorrect optimism and pessimism to account for a potential correlation between the two variables.

The estimated coefficients  $\beta^h$  and  $\gamma^h$  provide a direct measure of the impulse response at horizon  $h$ , given a shock in period  $t$ . Figure 8 displays the responses to a one percentage point increase in the share of incorrectly optimistic firms. The top panels show the response of industrial production in the manufacturing sector (IP), measured in percentage deviations from the trend, while the bottom panels show the response of the producer price index in the manufacturing sector (PPI), also measured in percentage deviations from the trend. The left column displays results using the unweighted measure, the middle column is based on employee-weighted shares, while the right column shows responses for ifo weights.

**Table 9:** Forecast error variance decomposition (one year horizon)

|           | Variable | Unweighted | Empl. weights | ifo weights |
|-----------|----------|------------|---------------|-------------|
| Optimism  | IP       | 14%        | 10%           | 18%         |
|           | PPI      | 19%        | 23%           | 20%         |
| Pessimism | IP       | 1.3%       | 1.7%          | 6.4%        |
|           | PPI      | 5.9%       | 0.9%          | 2.9%        |

In each instance, time is measured in months along the horizontal axis. The blue solid line represents the point estimate, dashed red lines are 90 percent confidence bounds. We find that industrial production responds strongly and significantly to an increase in incorrect optimism. The observed increase is temporary and turns insignificant after approximately one year, except in case we use ifo weights. Consistent with the results at the firm level, reported in Section 4 above, we also find a strong and significant increase in the price level after an increase in incorrect optimism. This reaction is in line with the interpretation of optimism shocks as a specific form of demand shocks, see Lorenzoni (2009) and Enders et al. (2017).

Figure 9 displays the results for incorrect pessimism. Here we find much weaker effects. Specifically, industrial production remains insignificant throughout and the producer price index falls (marginally significant) only in period 1 after the shock. This finding is surprising not least because the effects of optimism and pessimism are fairly symmetric, see Table 8 above.

Finally, Table 9 displays a forecast error variance decomposition (FEVD) for a horizon of 12 months, using the methodology of Gorodnichenko and Lee (forthcoming). We present results for incorrect optimism and pessimism and for all three measures of aggregate optimism/pessimism. We find that incorrect optimism is responsible for 10-18% of aggregate fluctuations of industrial production at a one-year horizon. At the same horizon, around 20% of the PPI is driven by incorrect optimism. This amounts to a sizeable contribution. Pessimism, on the other hand, has much a smaller impact on IP and the PPI. The specification for the PPI with unweighted observations delivers a value of around 6%, similar to that with ifo weights for IP. Regarding the small impact on prices, these results are in line with those of firm-level effects, reported in Section 4 above.

## 6 Conclusion

In this paper we ask to what extent firm expectations matter for firm decisions. From a theoretical point of view, the answer to the question seems obvious: expectations should matter a great deal. However, to date there is little direct evidence to support the theory. In this paper, we aim at filling this gap on the basis of a particularly suited data set and a new identification strategy.

We use a large survey of firms in the German manufacturing sector. Firms report on a monthly basis whether they expect production to increase, to remain constant, or to decline. For each firm-month observation we also observe a large number of firm characteristics, including balance-sheet information. This allows us to match firms on the basis of fundamentals, that is, we compare firms which have very similar fundamentals but differ in their views about the future. Firms which expect production to go up are thus more optimistic than firms which do not—despite approximately identical fundamentals. The converse applies to pessimistic firms.

We find that optimistic firms tend to raise prices and production today. This can be explained in two ways. According to the “news view,” firms have simply additional information about future developments that is not reflected in current fundamentals. Their optimism is thus fundamentally justified—by future fundamentals, so to speak. According to the “noise view,” firms are optimistic or pessimistic for no fundamental reason. They simply have wrong ideas about the future or, put differently, are driven by animal spirits.

We disentangle the effect of news and noise on firms’ decision makers as we define a forecast error. Because we observe the actual developments *ex post* we can assess whether firms were right about the future or not. We match incorrectly optimistic and pessimistic firms, in turn, to neutral firms, as well as correctly optimistic/pessimistic firms. For both groups we find a positive (negative) effect of optimism (pessimism) on current production and prices, although the effect is considerably smaller in case of incorrect expectations. These results suggest that firms are to some extent guided by noise/animal spirits.

Finally, we turn to the aggregate effects of optimism and pessimism. For this purpose we aggregate incorrect optimism and pessimism identified at the firm level and run local projection to estimate their effects on aggregate production and prices. We find, in particular, that aggregate optimism, even if incorrect, causes industrial production and producer prices to increase. Incorrect optimism also plays a significant role in causing business cycles. Our result supports the notion that animal spirits are a force which underly cyclical fluctuations.

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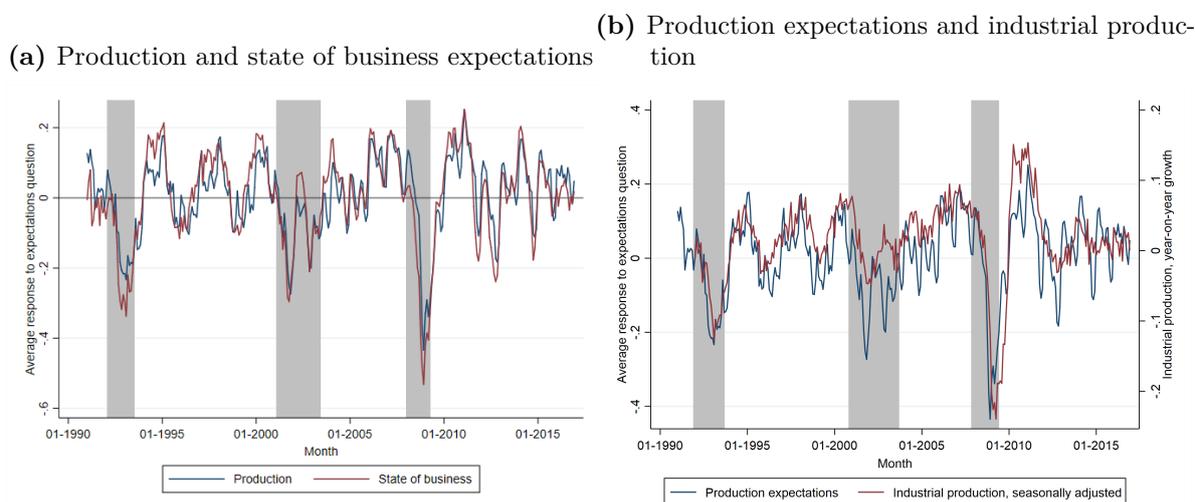
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## A Additional descriptive statistics

**Table A.1:** Observations and average duration in panel, 1991 to 2016

| Observations                |         | Months                   |        |
|-----------------------------|---------|--------------------------|--------|
| Respondents                 | 5 922   | Avg. number of responses | 56.39  |
| Respondents $\times$ months | 323 823 | Avg. duration in survey  | 66.52  |
|                             |         | Response rate            | 85.71% |

**Figure A.1:** Average expectations and industrial production, 1991-2016



*Notes:* Shaded areas mark recession periods as defined by the German Council of Economic Experts. Average response defined as share of positive responses (*increase/improve*) minus share of negative responses (*decrease/worsen*). Survey data from the BEP. Industrial Production from the German Statistical Office.

**Table A.2:** Sample attrition

| Start date | Total | Fraction of firms surviving after |      |      |      |      |      |      |      |      |      |      |
|------------|-------|-----------------------------------|------|------|------|------|------|------|------|------|------|------|
|            |       | 6m                                | 1y   | 2y   | 3y   | 4y   | 5y   | 6y   | 7y   | 8y   | 9y   | 10y  |
| 1991m1     | 190   | 1                                 | 0.99 | 0.99 | 0.96 | 0.93 | 0.87 | 0.84 | 0.79 | 0.76 | 0.72 | 0.70 |
| 1992m1     | 184   | 1                                 | 0.99 | 0.96 | 0.93 | 0.88 | 0.84 | 0.78 | 0.75 | 0.70 | 0.68 | 0.67 |
| 1993m1     | 195   | 0.98                              | 0.96 | 0.93 | 0.87 | 0.84 | 0.78 | 0.75 | 0.70 | 0.68 | 0.67 | 0.62 |
| 1994m1     | 262   | 0.97                              | 0.95 | 0.89 | 0.85 | 0.80 | 0.77 | 0.72 | 0.69 | 0.67 | 0.62 | 0.55 |
| 1995m1     | 285   | 0.98                              | 0.94 | 0.89 | 0.85 | 0.82 | 0.76 | 0.72 | 0.70 | 0.66 | 0.59 | 0.57 |
| 1996m1     | 283   | 0.97                              | 0.94 | 0.89 | 0.86 | 0.80 | 0.76 | 0.74 | 0.70 | 0.63 | 0.60 | 0.55 |
| 1997m1     | 299   | 0.97                              | 0.93 | 0.90 | 0.84 | 0.80 | 0.77 | 0.74 | 0.65 | 0.63 | 0.58 | 0.53 |
| 1998m1     | 311   | 0.99                              | 0.96 | 0.90 | 0.85 | 0.82 | 0.77 | 0.69 | 0.67 | 0.62 | 0.57 | 0.55 |
| 1999m1     | 358   | 0.96                              | 0.93 | 0.87 | 0.83 | 0.79 | 0.72 | 0.69 | 0.65 | 0.61 | 0.57 | 0.51 |
| 2000m1     | 415   | 0.97                              | 0.93 | 0.88 | 0.81 | 0.73 | 0.70 | 0.66 | 0.62 | 0.57 | 0.52 | 0.45 |
| 2001m1     | 550   | 0.99                              | 0.94 | 0.89 | 0.81 | 0.77 | 0.73 | 0.69 | 0.64 | 0.59 | 0.51 | 0.47 |
| 2002m1     | 1152  | 0.98                              | 0.95 | 0.88 | 0.84 | 0.80 | 0.75 | 0.71 | 0.65 | 0.59 | 0.54 | 0.49 |
| 2003m1     | 1277  | 0.97                              | 0.92 | 0.88 | 0.84 | 0.78 | 0.73 | 0.67 | 0.61 | 0.56 | 0.51 | 0.46 |
| 2004m1     | 1534  | 0.98                              | 0.95 | 0.89 | 0.83 | 0.78 | 0.72 | 0.66 | 0.60 | 0.55 | 0.50 | 0.45 |
| 2005m1     | 1689  | 0.97                              | 0.94 | 0.88 | 0.81 | 0.75 | 0.69 | 0.63 | 0.58 | 0.53 | 0.48 | 0.42 |
| 2006m1     | 1821  | 0.97                              | 0.93 | 0.86 | 0.80 | 0.74 | 0.67 | 0.62 | 0.57 | 0.51 | 0.45 | 0.34 |
| 2007m1     | 1792  | 0.97                              | 0.92 | 0.86 | 0.79 | 0.72 | 0.66 | 0.61 | 0.55 | 0.48 | 0.36 | 0.05 |
| 2008m1     | 1693  | 0.97                              | 0.92 | 0.86 | 0.78 | 0.71 | 0.65 | 0.59 | 0.51 | 0.39 | 0.05 | 0    |
| 2009m1     | 1673  | 0.97                              | 0.92 | 0.85 | 0.78 | 0.71 | 0.63 | 0.55 | 0.41 | 0.05 | 0    | 0    |
| 2010m1     | 1661  | 0.97                              | 0.91 | 0.83 | 0.75 | 0.68 | 0.59 | 0.45 | 0.05 | 0    | 0    | 0    |
| 2011m1     | 1677  | 0.96                              | 0.91 | 0.83 | 0.73 | 0.65 | 0.49 | 0.05 | 0    | 0    | 0    | 0    |
| 2012m1     | 1878  | 0.96                              | 0.90 | 0.80 | 0.69 | 0.52 | 0.05 | 0    | 0    | 0    | 0    | 0    |
| 2013m1     | 1751  | 0.94                              | 0.89 | 0.78 | 0.59 | 0.06 | 0    | 0    | 0    | 0    | 0    | 0    |
| 2014m1     | 1646  | 0.96                              | 0.87 | 0.65 | 0.06 | 0    | 0    | 0    | 0    | 0    | 0    | 0    |
| 2015m1     | 1501  | 0.95                              | 0.74 | 0.07 | 0    | 0    | 0    | 0    | 0    | 0    | 0    | 0    |

*Notes:* ‘Total’ refers to the number of different firms at the respective start date, independent of whether they have been in the sample previously.

## B Details on survey questions

**Table B.1:** Complete list of survey questions used in our analysis

| Label | Name                       | Question <sup>1</sup>   | Possible answers <sup>2</sup>  |
|-------|----------------------------|---|--|
| Q1    | expected production        | Expectations for the next 3 months: Our domestic production activity regarding good XY will probably ...  | increase [1]<br>not change [0]<br>decrease [-1]                                |
| Q2    | expected state of business | Expectations for the next 6 months: Taking economic fluctuations into account our state of business will be ...                                     | rather more favorable [1]<br>not changing [0]<br>rather less favorable [-1]    |
| Q3    | production                 | Tendencies in the previous month: Our domestic production activities with respect to product XY have ...  | increased [1]<br>not changed [0]<br>decreased [-1]                             |
| Q4    | prices                     | Tendencies in the previous month: Taking changes of terms and conditions into account, our domestic sales prices (net) for product XY have been ... | increased [1]<br>not changed [0]<br>decreased [-1]                             |
| Q5    | employees                  | Number of employees: In our company (domestic enterprises only) we employ [...] persons, of which $x$ persons are for producing product XY.         | $x$ is the number of persons employed for XY                                   |
| Q6    | orders                     | We consider our order backlog to be   | relatively high [1]<br>sufficient [0]<br>too small [-1]<br>no export of XY [4] |
| Q7    | foreign orders             | We consider our order backlog for exports to be   | relatively high [1]<br>sufficient [0]<br>too small [-1]<br>no export of XY [4] |
| Q8    | capacity utilization       | The current utilization of our capacities for producing XY (standard utilization = 100%) is currently $x\%$ .                                       | $x$ is a value between 30 and 100 divisible by 10                              |
| Q9    | demand                     | Tendencies in the previous month: The demand situation with respect to product XY is ...  | better [1]<br>not changed [0]<br>worse [-1]                                    |

<sup>1</sup> Authors' translation of the most recent formulation of the question in German according to the EBDC Questionnaire manual.

<sup>2</sup> Only those answers which we consider. Specifically we exclude answers like "no production" or similar answers which indicate the questions does not apply to the firm.

**Table B.2:** Main survey questions, changes over time

| Label | Time period     | Question <sup>1</sup>  |
|-------|-----------------|--|
| Q1    | 01/1980-06/1994 | Our domestic production activity regarding good XY in the next 3 months <b>taking economic fluctuations into account – i.e. after eliminating purely seasonal fluctuations</b> – will probably ... increase/not change/decrease.   |
|       | 07/1994-06/1997 | Our domestic production activity regarding good XY in the next 3 months <b>taking economic fluctuations into account – i.e. after eliminating purely seasonal fluctuations</b> – will probably ... increase/not change/decrease/ <i>no substantial domestic production</i> . |
|       | 07/1997-11/2001 | Our domestic production activity regarding good XY in the next 3 months <b>taking economic fluctuations into account</b> will probably ... increase/not change/decrease/ <i>no substantial domestic production</i> .   |
|       | Since 01/2002   | Expectations for the next 3 months: Our domestic production activity regarding good XY will probably ... increase/not change/decrease/ <i>no substantial domestic production</i> .   |
| Q2    | 01/1980-06/1997 | Our state of business regarding good XY in the next 6 months taking economic fluctuations into account – <b>i.e. after eliminating purely seasonal fluctuations</b> – will be ... rather more favorable/ not changing/rather less favorable.                                 |
|       | 07/1997-11/2001 | Our state of business regarding good XY in the next 6 months taking economic fluctuations into account will be ... rather more favorable/ not changing/rather less favorable.  |
|       | Since 01/2002   | Expectations for the next 6 months: Taking economic fluctuations into account our state of business will be ... rather more favorable/ not changing/rather less favorable.   |
| Q3    | 01/1980-06/1994 | <b>In comparison to the previous month</b> our domestic production activities regarding good XY have ... <b>been more lively/unchanged/weaker</b> .  |
|       | 07/1994-11/2001 | <b>In comparison to the previous month</b> our domestic production activities regarding good XY have ... <b>been more lively/unchanged/weaker</b> / <i>no substantial domestic production</i> .  |
|       | 01/2002-02/2002 | <b>In the last 2-3 months</b> our domestic production activities regarding good XY have ... <b>been more lively/unchanged/weaker</b> / <i>no substantial domestic production</i> .   |
|       | Since 03/2002   | Tendencies in the previous month: Our domestic production activities with respect to product XY have ... increased/not changed/decreased/ <i>no substantial domestic production</i> .  |
| Q4    | 01/1980-11/2001 | <b>Compared to the previous month</b> our domestic prices (net prices) of good XY – taking changes of terms and conditions into account – have been ... increased/not changed/decreased. <sup>2</sup>  |
|       | 01/2001-02/2002 | <b>In the last 2-3 months</b> our domestic prices (net) of good XY – taking changes of terms and conditions into account – have been ... increased/not changed/decreased.  |
|       | Since 03/2002   | Tendencies in the previous month: Taking changes of terms and conditions into account, our domestic sales prices (net) for product XY have been ... increased/not changed/decreased.   |

<sup>1</sup> Authors' translation of the question in German according to the EBDC Questionnaire manual.

<sup>2</sup> In several months in 1980 the question was split into two parts, one covering regular and additional orders.

*Notes:* **Bold font** highlights components which change from the initial formulation or drop out.

*Italic font* highlights components which are added later on.

## C Balancing statistics

**Table C.1:** Balancing statistics; standardized bias; baseline specification

| Variable                           | Optimists |         |           | Pessimists |         |           |
|------------------------------------|-----------|---------|-----------|------------|---------|-----------|
|                                    | All       | Correct | Incorrect | All        | Correct | Incorrect |
| dep. var, $t-1$                    | 1.8       | 1.6     | 1.8       | -0.7       | -0.7    | -0.9      |
| dep. var, $t-2$                    | 0.2       | -0.2    | -0.3      | -1.7       | -3.5    | -2.5      |
| dep. var, $t-3$                    | 0.8       | 0.7     | 0.1       | -0.7       | -2.8    | -0.5      |
| production, $t-1$                  | 1.3       | 0.1     | -0.6      | 0.2        | -0.3    | -0.6      |
| production, $t-2$                  | 1.1       | 0.3     | -0.9      | 0.3        | 1.1     | 0.8       |
| production, $t-3$                  | -0.1      | -0.2    | -0.8      | -0.9       | -1.3    | 1.6       |
| prices, $t-1$                      | 0.3       | 1.8     | -0.0      | 0.3        | 1.5     | 0.1       |
| prices, $t-2$                      | 1.0       | -0.8    | 0.8       | 1.1        | 3.1     | -0.1      |
| prices, $t-3$                      | 0.8       | 1.5     | 0.1       | 0.3        | 2.0     | -0.6      |
| demand, $t-1$                      | 1.0       | 1.1     | 0.6       | -1.1       | -0.6    | -1.5      |
| demand, $t-2$                      | 1.1       | 2.0     | -1.3      | -1.5       | -1.0    | 1.2       |
| demand, $t-3$                      | -0.1      | -0.4    | -0.8      | -1.4       | -1.7    | 1.6       |
| capacity, $t-1$                    | 0.4       | 0.4     | 0.3       | 1.3        | 3.3     | 1.0       |
| capacity, $t-2$                    | 0.4       | 0.6     | 0.5       | 0.8        | 3.1     | 1.3       |
| capacity, $t-3$                    | 0.9       | 1.2     | -0.1      | 0.3        | 3.1     | 0.6       |
| employees, $t$                     | 0.2       | -0.8    | 0.1       | 1.6        | 1.0     | 1.2       |
| Avg. State of business, sector $t$ | 0.9       | 1.8     | -0.5      | -0.5       | -0.9    | -0.3      |
| state of business, $t$             | 0.4       | -0.7    | -0.5      | 0.9        | 2.0     | 1.2       |
| state of business, $t-1$           | 0.5       | -0.0    | -0.7      | 0.7        | 1.0     | 1.0       |
| state of business, $t-2$           | 0.6       | 0.6     | -0.5      | -0.2       | 0.9     | 1.8       |
| state of business, $t-3$           | 0.0       | 0.1     | -0.3      | -0.4       | -0.2    | 0.7       |
| orders, $t$                        | 0.4       | -1.4    | -0.4      | 1.6        | 1.8     | -0.4      |
| orders, $t-1$                      | 2.0       | 2.1     | -0.8      | 0.4        | 0.7     | 0.1       |
| orders, $t-2$                      | 1.2       | 1.4     | 0.0       | -0.3       | -1.4    | -0.6      |
| orders, $t-3$                      | 1.1       | 0.9     | 0.0       | 0.6        | -0.9    | 0.1       |
| foreign orders, $t$                | 1.1       | -0.4    | -0.4      | -0.4       | -2.1    | -0.0      |
| foreign orders, $t-1$              | 1.9       | 1.0     | -0.8      | -0.5       | -1.5    | 0.9       |
| foreign orders, $t-2$              | 1.1       | 0.6     | -0.5      | -1.0       | -1.7    | -0.6      |
| foreign orders, $t-3$              | 0.9       | 0.8     | -0.1      | -0.1       | -2.1    | -0.1      |
| debt share, $t$                    | -2.1      | -2.8    | -1.2      | -0.2       | -4.5    | -2.6      |
| financing coefficient, $t$         | -0.4      | -0.7    | -1.5      | 0.7        | 0.9     | 0.1       |

**Table C.2:** Balancing statistics; standardized bias; specification with radius  $r=0.01$ 

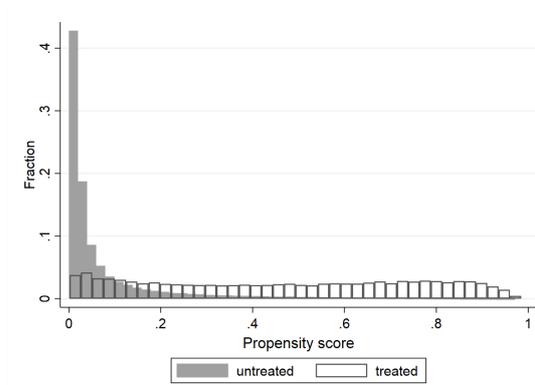
| Variable                           | Optimists |         |           | Pessimists |         |           |
|------------------------------------|-----------|---------|-----------|------------|---------|-----------|
|                                    | All       | Correct | Incorrect | All        | Correct | Incorrect |
| dep. var, $t-1$                    | 1.3       | 2.4     | 1.9       | -0.1       | -1.1    | -0.1      |
| dep. var, $t-2$                    | 0.1       | -0.9    | -0.3      | -1.8       | -2.8    | -2.2      |
| dep. var, $t-3$                    | 0.1       | 0.8     | 0.5       | -0.2       | -2.6    | 0.6       |
| production, $t-1$                  | 0.8       | 0.1     | -1.6      | 0.3        | 0.1     | -0.4      |
| production, $t-2$                  | 0.8       | -0.7    | -0.3      | 0.9        | 2.3     | 2.4       |
| production, $t-3$                  | -1.0      | -2.2    | -0.8      | -0.4       | 0.4     | 3.4       |
| prices, $t-1$                      | 0.6       | 1.4     | 0.0       | -0.2       | 3.6     | -0.5      |
| prices, $t-2$                      | 1.3       | -0.6    | 2.0       | 0.8        | 4.7     | 1.0       |
| prices, $t-3$                      | 0.7       | 1.2     | 0.1       | -0.1       | 3.5     | -0.5      |
| demand, $t-1$                      | 0.9       | 1.6     | -0.5      | -1.3       | -1.1    | -1.6      |
| demand, $t-2$                      | 0.9       | 0.8     | -1.2      | -0.3       | -1.5    | 3.0       |
| demand, $t-3$                      | -0.4      | -0.7    | -0.5      | -1.0       | -1.6    | 3.5       |
| capacity, $t-1$                    | 0.0       | -0.7    | 1.2       | 2.8        | 4.3     | 1.4       |
| capacity, $t-2$                    | 0.1       | -0.6    | 1.5       | 2.3        | 3.7     | 1.1       |
| capacity, $t-3$                    | 0.6       | -0.6    | 0.8       | 1.7        | 3.8     | 0.5       |
| employees, $t$                     | 0.7       | -0.0    | 0.6       | 2.0        | 2.0     | -0.3      |
| Avg. State of business, sector $t$ | 0.6       | 1.0     | 0.0       | -0.7       | -0.5    | -1.0      |
| state of business, $t$             | 0.8       | -1.6    | -0.8      | 1.9        | 3.6     | 1.5       |
| state of business, $t-1$           | 0.5       | -1.0    | 0.4       | 2.1        | 2.7     | 1.2       |
| state of business, $t-2$           | -0.0      | -0.4    | -0.2      | 1.4        | 1.7     | 1.9       |
| state of business, $t-3$           | -0.2      | -1.4    | 0.7       | 0.7        | 0.4     | 1.0       |
| orders, $t$                        | 0.7       | -2.1    | -0.8      | 2.0        | 3.6     | 0.5       |
| orders, $t-1$                      | 1.5       | 0.5     | -0.2      | 1.3        | 0.9     | 0.5       |
| orders, $t-2$                      | 0.5       | 0.6     | 0.6       | 0.6        | -0.1    | -0.7      |
| orders, $t-3$                      | 0.9       | -0.2    | 1.1       | 1.8        | 0.5     | -0.5      |
| foreign orders, $t$                | 1.3       | -1.2    | -0.9      | 0.5        | -1.1    | 0.3       |
| foreign orders, $t-1$              | 1.6       | -0.2    | -0.4      | 0.3        | -0.7    | 1.2       |
| foreign orders, $t-2$              | 0.9       | -0.6    | -0.9      | 0.0        | -0.7    | -1.4      |
| foreign orders, $t-3$              | 1.0       | -0.4    | 0.1       | 1.1        | -1.0    | -0.9      |
| debt share, $t$                    | -1.7      | -0.9    | -1.2      | 0.1        | -5.2    | -2.2      |
| financing coefficient, $t$         | -1.3      | -0.6    | -1.2      | 1.5        | 1.5     | 0.7       |

**Table C.3:** Balancing statistics; standardized bias; specifications with ordered probit and state of business expectations

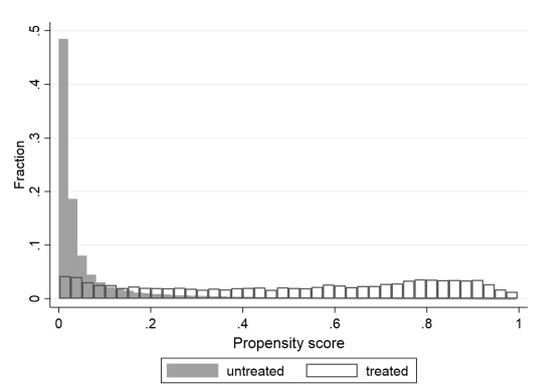
| Variable                           | Ordered probit |            | State of business exp. |            |
|------------------------------------|----------------|------------|------------------------|------------|
|                                    | Optimists      | Pessimists | Optimists              | Pessimists |
| dep. var, $t-1$                    | -0.7           | -0.2       | 2.0                    | -1.0       |
| dep. var, $t-2$                    | 0.6            | -3.6       | 1.4                    | -1.0       |
| dep. var, $t-3$                    | 2.0            | -0.3       | 0.4                    | -1.1       |
| production, $t-1$                  | -7.5           | -12.8      | -0.1                   | -1.1       |
| production, $t-2$                  | -1.4           | -2.7       | -0.9                   | 0.0        |
| production, $t-3$                  | -0.3           | -0.4       | -0.9                   | -0.2       |
| prices, $t-1$                      | -2.8           | -2.5       | 0.0                    | -0.2       |
| prices, $t-2$                      | -1.9           | -0.7       | -0.5                   | 0.1        |
| prices, $t-3$                      | -0.5           | -0.3       | -0.1                   | 0.5        |
| demand, $t-1$                      | -4.3           | -5.1       | 0.7                    | -1.5       |
| demand, $t-2$                      | -1.8           | -2.2       | -0.2                   | -0.4       |
| demand, $t-3$                      | -0.4           | -1.1       | -0.8                   | -0.9       |
| capacity, $t-1$                    | -6.5           | -6.2       | -0.8                   | -1.2       |
| capacity, $t-2$                    | -5.1           | -3.2       | -0.9                   | -0.8       |
| capacity, $t-3$                    | -4.6           | -3.0       | -0.8                   | -0.9       |
| employees, $t$                     | -0.2           | -0.3       | -0.1                   | 1.4        |
| Avg. State of business, sector $t$ | -0.6           | -2.8       | -0.4                   | -0.5       |
| state of business, $t$             | -6.7           | -5.0       | -0.7                   | 0.2        |
| state of business, $t-1$           | -3.5           | -1.2       | -1.0                   | 0.2        |
| state of business, $t-2$           | -2.6           | -0.2       | -0.7                   | -0.0       |
| state of business, $t-3$           | -2.8           | 0.8        | -0.3                   | -0.0       |
| orders, $t$                        | -8.6           | -6.3       | -1.2                   | 0.1        |
| orders, $t-1$                      | -4.3           | -5.0       | -0.4                   | -0.7       |
| orders, $t-2$                      | -4.3           | -3.8       | -0.4                   | -0.9       |
| orders, $t-3$                      | -3.9           | -1.6       | -0.2                   | -0.9       |
| foreign orders, $t$                | -5.2           | -2.3       | -0.7                   | -1.2       |
| foreign orders, $t-1$              | -2.6           | -1.9       | -0.5                   | -1.8       |
| foreign orders, $t-2$              | -2.5           | -1.6       | -0.6                   | -1.8       |
| foreign orders, $t-3$              | -2.5           | 0.2        | -0.2                   | -1.1       |
| debt share, $t$                    | -0.5           | 2.5        | -1.2                   | -0.4       |
| financing coefficient, $t$         | -0.4           | 1.7        | 0.6                    | 0.6        |

**Figure C.1:** Histogram of the density of the propensity scores

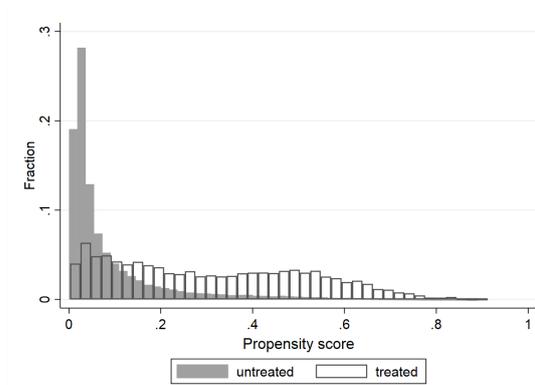
(a) Correct optimists



(b) Correct pessimists



(c) Incorrect optimists



(d) Incorrect pessimists

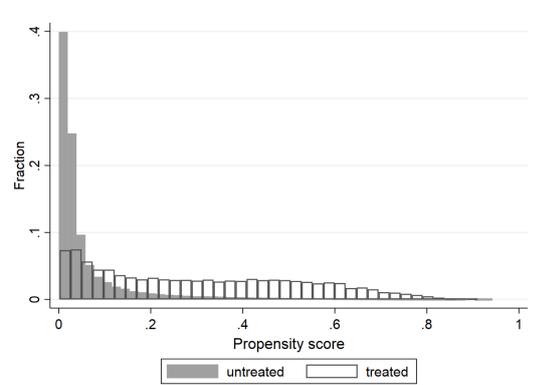
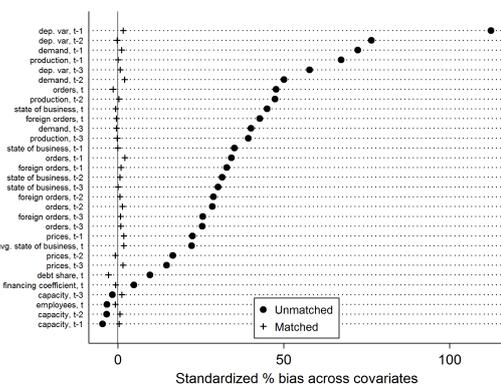
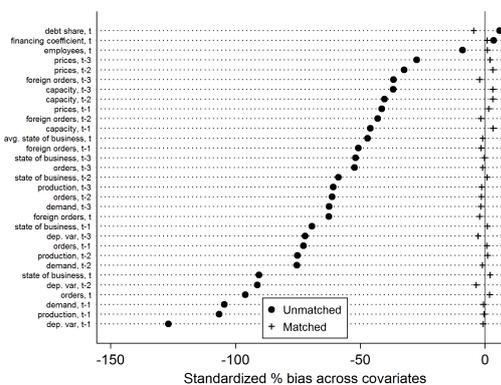


Figure C.2: Standardized bias; before and after matching; correct and incorrect treatments

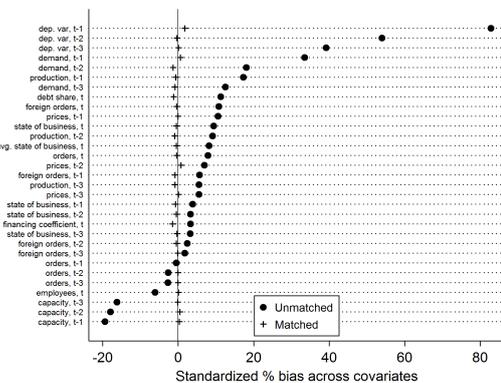
(a) Correct optimists



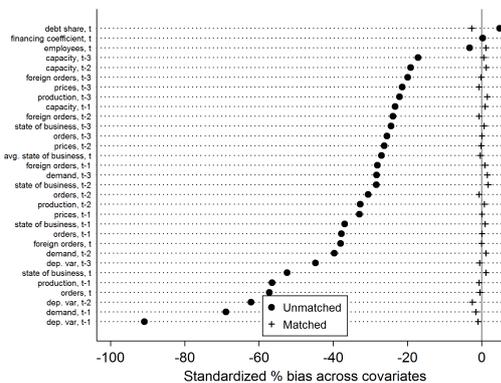
(b) Correct pessimists



(c) Incorrect optimists

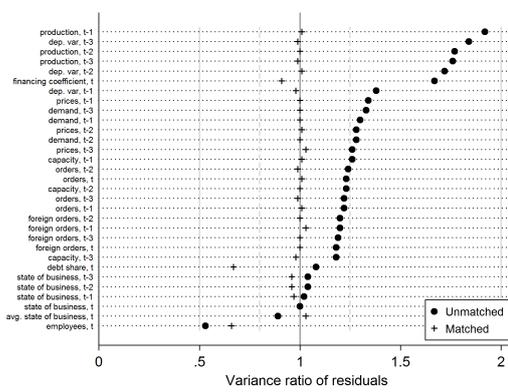


(d) Incorrect pessimists

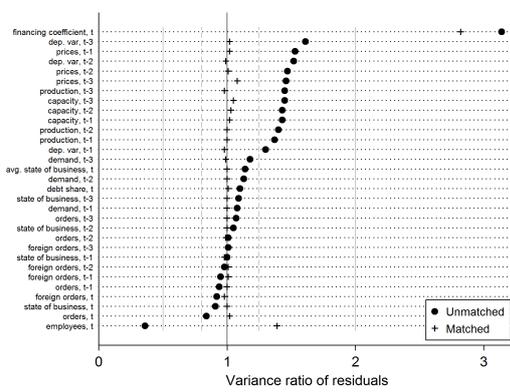


**Figure C.3:** Variance ratio of residuals, before and after matching

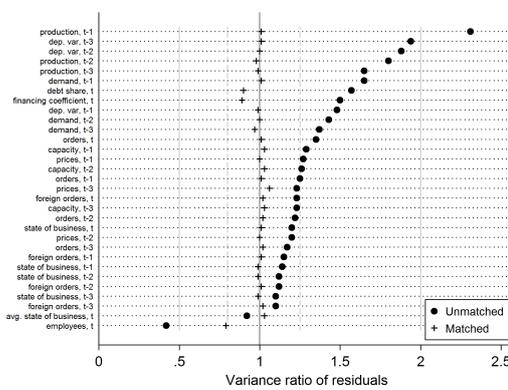
(a) Correct optimists



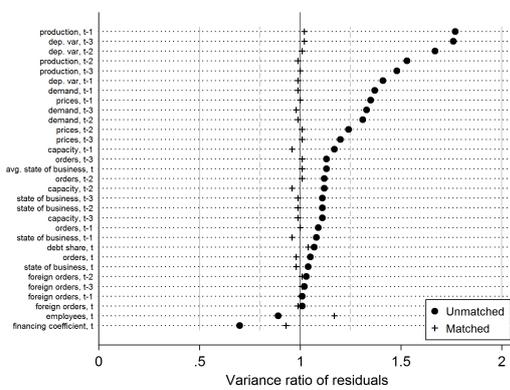
(b) Correct pessimists



(c) Incorrect optimists



(d) Incorrect pessimists



*Notes:* Ratios below 0.8 and above 1.25 (dashed lines) are considered “of concern”; ratios below 0.5 and above 2 (grey solid lines) are considered “bad” according to Rubin (2001).

## D Sensitivity analysis for Sections 3 and 4

**Table D.1:** Aggregate results with alternative use of balance sheet data

| Dep. variable: | Optimists           |                     | Pessimists           |                      |
|----------------|---------------------|---------------------|----------------------|----------------------|
|                | Production          | Prices              | Production           | Prices               |
| ATT            | 0.170***<br>(0.006) | 0.026***<br>(0.004) | -0.175***<br>(0.006) | -0.029***<br>(0.005) |
| Observations   | 120754              | 120802              | 116470               | 116548               |

Standard errors in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

### D.1 Alternative use of balance sheet data

As discussed in Section 2 the survey data has a different frequency than the balance sheet data. In our baseline setting we use the most recently published balance sheet data to estimate the debt share and financing coefficient in each month. This implies that in the months before a new balance sheet is published we use information which is almost one year old. We use this approach to avoid including any future information which is not yet available to firms at the time expectations are formed. However, one may argue that firms become aware of changing fundamentals already ahead of the publication of the new balance sheet. We therefore now propose an alternative method to link the annual balance sheet data to the monthly survey data. Specifically, for the six months following the publication of the balance sheet we use the most recent report as before. However, for the next six months until the new balance sheet is published we use the new data. This means that we always use the balance sheet data with the publication date closest to the respective month.

Table D.1 shows that changing the method for allocating the balance sheet data barely affects the results. Given that we only use two balance sheet variables in the probit regressions determining the propensity score this is not very surprising. Nevertheless, it is reassuring that our estimation is robust in this regard.

### D.2 Alternative matching method

In order to ensure our results are not affected by our choice of matching algorithm, we implement an alternative algorithm as described in Lechner et al. (2011). These authors propose a radius (or caliper) matching procedure which includes weighting proportional to the distance of the match and a bias adjustment.

Specifically, the algorithm first selects all nearest neighbors in terms of the propensity score and potentially other variables (in the latter case using the Mahalanobis distance) without replacement. In our case we use the propensity score from the simple probit

**Table D.2:** Aggregate results with alternative matching procedure

|  | Optimists           |                     | Pessimists           |                      |
|--|---------------------|---------------------|----------------------|----------------------|
|  | No bias corr.       | Bias corr.          | No bias corr.        | Bias corr.           |
| <i>Panel A: Production (change in current month)</i> |                     |                     |                      |                      |
| ATT  | 0.172***<br>(0.007) | 0.172***<br>(0.007) | -0.174***<br>(0.007) | -0.174***<br>(0.007) |
| Observations   | 135170              | 135170              | 131656               | 131656               |
| <i>Panel B: Prices (change in current month)</i>     |                     |                     |                      |                      |
| ATT  | 0.027***<br>(0.005) | 0.027***<br>(0.005) | -0.037***<br>(0.006) | -0.037***<br>(0.006) |
| Observations   | 135170              | 135170              | 131656               | 131656               |

Standard errors in parentheses. \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

regressions described in Section 3.1 and the month as an additional variable. The latter is done to ensure comparability to our matching procedure. In a next step the radius is computed as a function of the maximum distance within a matched pair in step one. Using this radius additional matches are selected if they are within the radius around the respective observation. This matching step is done without replacement, i.e. untreated observations can be matched to different treated observations. Weights are computed as the inverse of the distance between the untreated and treated observations in a match.

Finally, a regression bias adjustment is implemented by regressing the outcome variable on an intercept, the propensity score, the square of the propensity score, and any further variables used to define the distance. The regression is done only for the matched untreated observations using the weights obtained from matching. Using the regression coefficient one then predicts the potential outcome under no treatment for all observations. The difference between the weighted mean of the predicted outcome in the untreated group and the mean of the predicted potential outcome in the treated group is the estimated bias. This bias is then subtracted from the estimated ATT. The variance is computed analytically.

This approach differs from our matching algorithm because the radius is determined endogenously, the weights are proportional to distance, matches can be from different months (albeit only from close months because we include month as an additional distance measure), and finally there is regression adjustment. We implement this procedure using the STATA code provided by Huber et al. (2015). For simplicity we use their default settings. The results can be found in Table D.2. Using this alternative matching procedure does not affect our results substantially. Compared to our baseline specification in column 1 of Table 4 results only differ at the third digit. The largest difference is observed for prices of pessimists: -0.036 compared to -0.031 in the baseline. Reassuringly the bias adjustment also does not have any effects up to three digits. This implies that using a more simple matching procedure with no bias correction is valid in our data set.