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Research Article

Behavioral Macroeconomics in Emerging Economies: Sentiment Shocks, Policy Transmission and Market Volatility Dynamics

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Abstract
This article has examined how behavioural macroeconomics can help to explain economic effects in emerging economies and extends the study to the interactions between sentiment shocks, policy transmission and market volatility. But in addition to traditional macroeconomic fundamentals, consumer confidence and investor expectations and uncertainties will play an important role in how effective monetary/fiscal policy will be in the future. The potential multiplicative nature of behavioural reactions, the implications for financial stability and the implications for the policy outcomes are emphasised. The authors conclude that integration of behavioural indicators into the economy's macroeconomic policy-making process can enhance policy credibility, help make economies more resilient and facilitate the sustainable growth of more interconnected emerging market economies.

Keywords: Behavioural Macroeconomics, Emerging Economies, Sentiment Shocks.

INTRODUCTION

The role of expectations, confidence and perceived uncertainty on aggregate economic outcomes is a concern of behavioural macroeconomics. In the emerging countries, these behavioural factors are of interest since the calibration of credibility of the inflation process, the financial depth and the exchange rate sensitivity are not as strong as in advanced countries. People's inflation expectations, fiscal confidence and the credibility of monetary and fiscal policies can have a significant effect on the economy's response to shocks (IMF, 2023).

Sentiment Shocks in Emerging Economies

Economic sentiment is the overall feeling of households, companies and investors towards the current economic situation and overall prospects. A lack of certainty is likely to have an impact on investment, consumption, credit availability and on the downside and on markets of uncertainty (IMF, 2023). Growth can be impaired before any changes take place in the fundamentals.

Uncertainty over politics or geopolitics, information speed, a monetary policy tightening by major central banks, inflation shocks, uncertainty over politics or geopolitics and geopolitical tensions are all potential sources of sentiment shocks in emerging markets. Regarding global uncertainty, it is tied to inflation shocks and geopolitical tension, as pointed out by Mampouya (2025) in the Financial Stability Report, as economic sentiment is liable to change quickly in the presence of crucial shifts in the members' perception of the path of policy rates and central bank decisions (Figure 1).

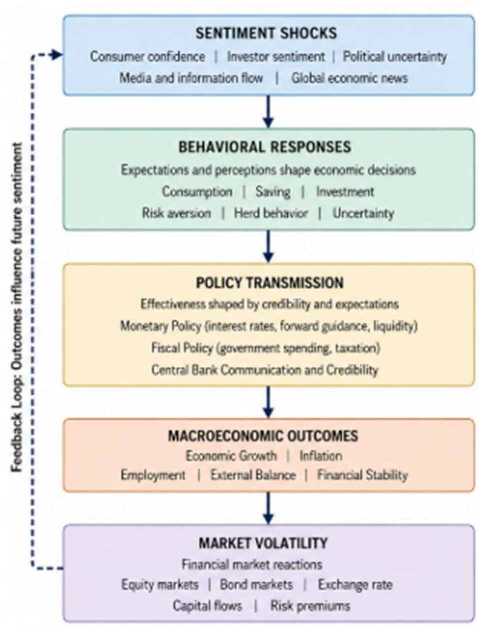

Figure 1: Conceptual Framework of Behavioural Macroeconomics in Emerging Economies
Source: Self-Developed

Spending at the home level could further drop, hiring and investment could be delayed at businesses and banks might be hesitant to lend to businesses. The downside growth scenario gets worse as the level of uncertainty grows and it can be transmitted to other countries through trade and finance (IMF, 2023). This means that sentiment shocks can have an impact on the macro-economy, not just a psychological one.

Policy Transmission under Behavioural Influences

Traditional transmission policy guidelines revolve around interest rates, exchange rates, credit prices and asset prices. Behavioural Transmission adds to Predictability, faith and credibility. The study done by Aradian Checo *et al*. (2024) shows that a tightening of monetary policy leads to a rapid contraction in activity and a lag in both inflation and inflation expectations is more resilient when exchange rates are granted flexibility and financial markets are deep and policy frameworks are credible, across 33 advanced and emerging economies. In emerging markets, often both the bond market and expectations play a role in the transmission of monetary policy. The results from a recent study by Pragyan Deb *et al*. (2023) suggest that tightening of monetary policy leads to an increase in bond rates that results in less spending on the real economy, thus lowering inflation only after a lag. Emerging-market transmission paper that still says the credit and exchange-rate pathways are both still important, especially if central banks have implemented other policies to intervene in the foreign exchange market (Figure 2).

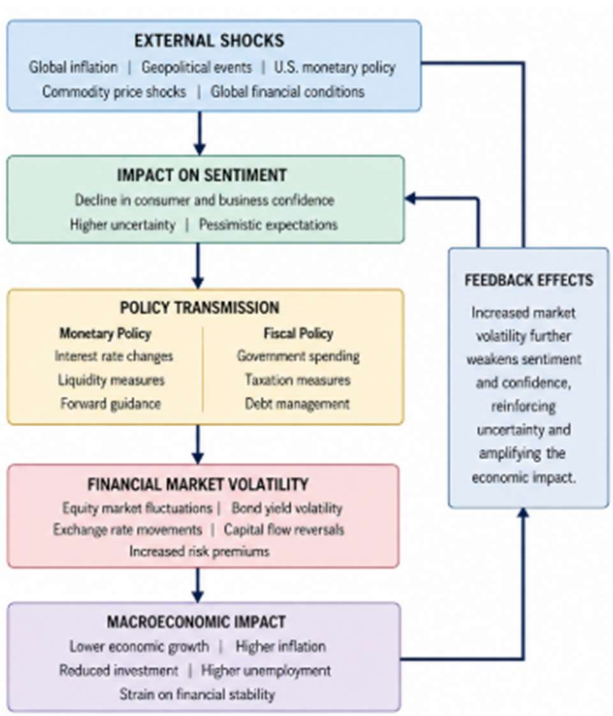

Figure 2: Interaction Between Sentiment Shocks, Policy Transmission and Financial Market Volatility
Source: Self-Developed

Another facet of fiscal policy is also confidence. Whereas the IMF (2025) reports that inflationary expectations of emerging markets are more responsive to fiscal policy and debt, in part due to some level of uncertainty about fiscal dominance and political interference. This is a blow to the public finances, implying unwelcome inflation without any price adjustments. Policy transmission performance is less good in shallow markets, in less credible inflation management and if exchange-rate policy fails to work because of exchange-rate management. Kodjovi Eklou (2023) points to positive fundamentals and policy developments improving resilience, while the vulnerabilities of economies negatively affect the influence of foreign monetary shocks.

Market Volatility Dynamics in Emerging Economies

Volatility of EM stocks is not only a reflection of fundamentals, but it is also a reflection of uncertainty, sentiment and overall trading appetite of EM stocks globally. But the rise in the strength of resilient expectations was evident as flows to emerging-economy bonds and the strengthening of stock valuations increased, BIS (2024) reports. Pulls and pushes of behaviour can add to price volatility. Ghani *et al*. (2025) stability chapter illustrates the link between investor sentiments and downside tail risk and the BIS market commentaries illustrate how quickly financial space has changed due to communications and inflation news. The patterns are indicative of the joint action response to uncertain, convenient news by collective investors.

Sentiment, policy and markets reinforce each other. Well, as long as central banks can communicate clearly, people ought to keep their expectations in check; in the world people live in, the resulting central bank communication's weakness, or their over-strength in the event of growing fiscal worries, can lead to currency, bond and equity volatility. With the results of Owusu, (2023), higher policy frameworks and expectations were correlated with lower external shocks. The high volatility drives up the cost of borrowing, reduces the investment drive and compromises financial stability. Inappropriate levels of uncertainty can constrain credit supply and worsen macroeconomic vulnerabilities, especially when there are significant amounts of public and private debt in place. It may also create a danger for emerging economies of not being able to forecast the available resources and thus the potential for long-term development.

DISCUSSION

The evidence indicates that, in addition to following conventional macroeconomic variables, behavioural variables should be treated as an additional component, but should also be viewed as an important factor that affects the effectiveness of policy measures in emerging countries. Modern macroeconomic theory assumes that economic agents' reactions to policy shocks are rational, but emerging evidence shows how this may not be true, because confidence and expectations, as well as perceptions of uncertainty, play an important role in the transmission of either monetary and/or fiscal policies. As a result, sentiment shocks have the potential to contaminate household spending and reduce the impetus of private investment, as well as impact credit growth and introduce additional volatility to financial markets despite a relatively stable economy (Shaghil Ahmed, *et al*. 2024).

The impact of behavioural factors, however, is not necessarily the same among emerging economies. The higher the credibility of a central bank, the more transparent the policy framework, the higher the institutional quality, the more effective the policy transmission: the more stable inflation expectations, the more trust investors have in such expectations, in this case. By contrast, poorly governed, politically unstable, or shallow financial markets economies are more vulnerable to bad news and will exhibit less responsive policy responses. In addition, other exogenous factors like the global inflationary environment, ongoing and potential geopolitical risks and concerns, tighter U.S. monetary policy and rising domestic uncertainties and exchange-rate depreciation can add to sensitivities to market fluctuations, capital outflows, and, if any, exchange-rate depreciation. The indicators suggest that traditional macroeconomic indicators are not sufficient. Instead, macroeconomic analysis ought to take the behavioural aspects into account, consumer confidence and investor expectations in greater detail, which would have a significant positive impact on policy design, policy's resilience to exogenous factors and also on financial and economic stability in the long run.

CONCLUSIONS

Today, behavioural macroeconomics shows that expectations, confidence and investor sentiment, as well as economic fundamentals, are important to the performance of the economy and the economy's performance in emerging economies. From the discussion, it is clear that the uncertainty surrounding the political climate, inflationary factors, worrisome global financial climate and the flow of information have a significant effect on household consumption, business investment and activity in the financial markets. Not to mention the importance of the trust that the public has in the policy and the “Peace” of the policy, in monetary and fiscal policy, respectively, are absolutely crucial for them to be effective. Instruments of monetary policy operate more effectively in the financial market as well as in the economy if inflation expectations are kept well under control and the country's central bank sets the policies in a clear manner. Similarly, a lack of institutional credibility and greater uncertainty can lead to more uncertain markets and less effective policy measures. The findings indicate not only the relevance of behaviour in macroeconomics in emerging economies, but also its incorporation within it.

The findings indicate that it is beneficial to include behavioural data as a factor in economic policymaking, so that economic resilience can be promoted. Establishing institutional trust by ensuring uniform and careful communication of policy and reducing market uncertainty by minimising confidence issues in the market would contribute to the success of the policy. It is recommended that emerging economy governments and central banks pay attention to markets as well, since a behavioural indicator adds to traditional macroeconomic indicators. Emerging economies' governments and central banks are advised to listen to the markets as well as their traditional macroeconomic instruments. This can help ensure financial wellbeing, reinforce policy delivery and help drive sustainable growth.

Recommendations

Good governance and transparency in the communication of monetary policy by emerging economies' central banks must be emphasised in order to build credibility of policy action and thus the foundations of inflation expectations. Moreover, governments should enhance financial education and investor awareness by implementing financial education programs that will grant households and investors the ability to make sound financial decisions in the event of uncertainty. Policy makers ought to adopt behavioural approaches to policy development when evaluating and crafting policy, such as investing in consumer confidence, the sentiment of businesses and investors. More effective regulation and monitoring of financial market risks can dampen speculation and enhance financial market resilience to changes in the external environment. Governments and central banks should encourage the development and use of sentiment indicators derived from information and data, based on high-frequency surveys, financial market indicators and digital information sources, to monitor signs of economic distress early. All these would entail policy responsiveness, increase market confidence and ensure the macroeconomic stability of emerging economies (Casiraghi and Perez, 2022).

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