

Role of consumer expectations in economic policy



- Zainab
Mukhtar
Maidabin
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Introduction

A theme that dominates modern discussions of macro policy is the importance of expectations, and economists have devoted a great deal of thought to expectations and the economy. Change in expectations can shift the aggregate demand (AD) curve; expectations of inflation can cause inflation. For this reason expectations are central to all policy discussions, and what people believe policy will be significantly influences the effectiveness of the policy.

Expectations complicate models and policymaking enormously; they change the focus of discussions from a response that can be captured by simple models to much more complicated discussions.

The adaptive expectations theory assumes people form their expectations on future inflation on the basis of previous and present inflation rates and only gradually change their expectations as experience unfolds. In this theory, there is a short-run tradeoff between inflation and unemployment which does not exist in the long-run. Any attempt to reduce the unemployment rate below the natural rate sets in motion forces which destabilize the Phillips Curve and shift it rightward.

Under adaptive expectations, forecasts of the future rate of inflation may be right on the money, but they may also exhibit systematic error. When inflation is accelerating, forecasts will tend to be too low. And when inflation is decelerating (that is, disinflation is taking place), then forecasts will tend to be too high.

The Rational expectations model was developed by Robert Lucas, rational economic agents are assumed to make the best of all possible use of all publicly available information. Before reaching a conclusion, people are assumed to consider all available information before them, then make informed, rational judgments on what the future holds. This does not mean that every individual's expectations or predictions about the future will be correct. Those errors that do occur will be randomly distributed, such that the expectations of large numbers of people will average out to be correct.

To illustrate, assume the economy has been in an equilibrium state for several years with low inflation and low unemployment. In such a stable environment, the average person would expect the inflation rate to stay where it is indefinitely. But now assume the Central Bank announces it is going to significantly increase the rate of growth of the money supply. Basic economic theory tells us an increase in the money supply will translate into higher prices, such that increasing the annual rate of growth of the money supply should bring about higher inflation rates. Knowing this, consumers will revise their inflationary expectations upward.

As this simple example shows, people do not rely only on past experiences to formulate their expectations of the future, as adaptive expectations

theory suggests. Rather people use all information available to them in judging what the future will hold. This information can include past data, but it will also include current policy announcements and all other information that give them reason to believe that the future might hold certain changes. If the adaptive expectations are backward looking the rational expectations are forward looking, in that they assume people will use all of the information available to them.

Expectations of inflation

Some workers may feel cheated by inflation. They might believe that without it, they would experience real-wage increases because their nominal wages are rising 5% a year. Unfortunately, they are wrong. They suffer what some economists call money illusion, a confusion of real and nominal weight. The source of the illusion is as thus; considering real wages are constant, the rise of their nominal wages by 5% is only as a result of the general 5% inflation. Assuming no inflation took place, there will be no increase in their nominal wages.

After a time, everyone in the economy will begin to expect that the 5% annual inflation that ensued in the past would continue in the future. Economists refer to this as expectations of inflation. People's expectations of inflation influences all facets of economic life. For example, in the steady-state economy described previously, textile producers will look forward to increasing the price of their products by 5% for the coming years. They will also expect their costs of steel and labor, for example, to increase the same

way. Workers will begin to believe that the increase in their wages will be matched by the same increase in the prices of goods they buy.

Also, wages are influenced by expectations. Suppose, for example, that both employers and employees expect 4% inflation in the year coming. Workers will start negotiations from a base of a 4% increase in money wages, which would hold their real wages constant. Firms also may be inclined to begin bargaining by yielding to increase at least 4% in money wages relative to productivity, because they expect that the prices at which they sell their products will rise by 4%. Starting from that base, workers will attempt to obtain some desired increase in their real wages. At this point, such factors as profits and bargaining power become important. The general expectation of some specific inflation rate creates pressure for wages to rise by that rate relative to productivity and, thus, the rise of unit cost at that rate.

Inflation expectations and Interest rates

When the public expects inflation, real and nominal rates of interest will differ because inflation needs to be accounted for in calculating the real return from lending and borrowing. Have in mind that the nominal interest rate is equal to the real interest rate plus expected inflation rate. If real rate of interest is 2% and inflation is 5% a year, the nominal rate is 7%. Although lenders receive 7% a year on their loans, their real return after inflation rate is just 2%.

We know that in the long run the real interest rate does not bank on monetary policy because money is neutral; i. e. the price level is affected by the money supply. However, the nominal rates of interest do bank on

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monetary policy because the policy influences the rate of inflation, which in the long run is bent on the growth of the money supply. It has been pointed out that countries with greater money growth naturally have higher nominal interest rates than countries with lower money growth rates because they have higher inflation. What this means is that country A and B have the same real rate of interest, but country A has a higher inflation rate, it will also have a higher nominal interest rate.

Inflation expectations and money demand

The amount of money people want to hold will also be affected by expectations about inflation. If the public expects a 5% inflation a year, then its demand for money will also increase by 5% a year. This is because people know everything will cost 5% more, so they'll need more money in their possession to pay for the same goods and services. This is an example of the real-nominal principle: As long as the government allows the increase in the supply of money by 5% , the same amount as inflation, the demand for money and supply are both growing at the same rate, real and nominal interest rates will not change.

Effects of expectations on changes in future income

Today's consumption decisions may depend not only on current income, but also on the income that one expects to earn in the future. For example, an individual who is currently not employed but who has a contract to begin a high-paying job in three months will probably consume more today than another unemployed individual with no job prospects.

To illustrate the effect of changes in expected future income, suppose that instead of receiving the \$6000 bonus during the current year, a consumer learns that she will receive a \$6000 bonus (after taxes) next year. The promise of the bonus is legally binding, and said consumer has no doubt that extra income will be received next year. How will this information affect the consumer's consumption and saving in the current year? Because current income is unaffected, the consumer could leave her current consumption and saving unchanged, waiting until the bonus is actually received to increase her consumption. If her decisions are guided by a consumption-smoothing motive, however, she will prefer to use the bonus to increase her current consumption as well as her future consumption. She can increase her current consumption, despite the fact that her current income remains unchanged, by reducing her current saving (she could even "dissave," or have negative current saving, with current consumption exceeding current income, by using her accumulated assets or by borrowing). Suppose, for example, that consumer decides to consume \$1000 more this year. Because current income is unchanged, the \$1000 increase in current consumption is equivalent to a \$1000 reduction in current saving. The \$1000 reduction in current saving will reduce the available resources in the next year, relative to the situation in which her saving is unchanged, by $\$1000 \times (1 + r)$. For example, if the real interest rate is 0.05, cutting current saving by \$1000 reduces the available resources next year by $\$1000 \times 1.05 = \1050 . Overall, her available resources next year will increase by \$6000 because of the bonus but will decrease by \$1050 because of reduced current saving, giving a net increase in resources of $\$6000 - \$1050 = \$4950$, which can be used to increase consumption next year or in the

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following years. Effectively, the consumer can use the increase in her expected future income to increase consumption both in the present and in the future.

To summarize, an increase in an individual's expected future income is likely to lead that person to increase current consumption and decrease current saving. The same result applies at the macroeconomic level: If people expect that aggregate output and income, Y , will be higher in the future, current desired consumption, c_d , should increase and current desired national saving, s_d , should decrease.

Economists can't measure expected future income directly, so how do they take this variable into account when predicting consumption and saving behavior?

One approach is to survey consumers and ask them about their expectations. Their answers can be useful for assessing developments in the macroeconomy.

In conclusion,

The central role of expectations means that there is a great deal of uncertainty in the economy. Put simply: What people believe plays a central role in how they react to policy. Expectations can change the effect of a policy. Most discussion of policy today assumes that people are forward looking, that they think strategically, and that they base their actions on expected policy actions. Thus in some way their expectations are rational. But modern policy discussion is also built on the belief that the economy is

complicated and that many possible expectations are rational. This includes adaptive expectations and combinations of expectations strategies.

What the above assumptions mean in terms of policy is that depending on the beliefs that individuals hold, monetary and fiscal policy will work in different ways. People aren't stupid and they aren't super intelligent; they are people. If the government uses an activist monetary and fiscal policy in a predictable way, people will eventually come to build that expectation into their behavior. If the government bases its prediction of the effect of policy on past experience, that prediction will likely be wrong. But government never knows when expectations will change.

Let's consider an example. Say that everyone expects government to run expansionary fiscal policy if the economy is in recession. In the absence of any expected policy response from the government, people will lower their prices when they see a recession coming. Expecting government expansionary policy, however they won't lower their price. Thus, the expectation of policy can create its own problems.

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