Adaptive and rational reactions to the impact of macroeconomic stabilisation poli...

After defining Adaptive Expectations and Rational Expectations, explain how the conclusions on theimpact of macroeconomic stabilisation policies(and, in particular, disinflation policies) differ depending on whether the agents' expectations are adaptive or rational. Present arguments in favour or against these two theories.

Adaptive expectations is an economic theory which focuses on the events which have occurred in the past to predict future events. The theory is clearly displayed when predicting inflation. Under adaptive expectations if the rate of inflation had increased in the last years, people would predict and expect for the rate of the inflation in the upcoming year to be higher therefore in the adaptive expectation hypothesis people base their expectations of inflation relying on past inflation rates.

The adaptive expectations model is quite simplistic, assuming people base future predictions on what happened in the past. In the real world, data from the past is a factor which has an effect on behavior in the future. During the time whereby inflation is moving in an upward or downward trend adaptive expectations are limited. Therefore it creates the situation where in a period of rising inflation agents which use adaptive expectations make systematic errors. If for instance agents forecast a given variable in a given period to be below the expected then people were assumed to adapt their expectations of the future value in the following period to be higher. In the case of inflation whereby the inflation rate is turns out higher than expected, people would adjust, and revise their forecasts for the future inflation upwardly. These limitations led to the development of rational expectations which incorporated many factors into the decision making process. As opposed to

adaptive which follows backward-looking rules. Where people often assume to have static expectations which means that they expect the future to be like the present. This assumption is used when explaining investment decisions with a Phillips curve.

Rational expectation is a model which suggests that people are more forward-looking and do not base their expectations on past trends rather they follow current economic policy and look forward to a certain outcome. An example of this would be during the economic policy of an interest cut or a government inflationary tax cut whereby people expect inflation to take place and do not wait for its' occurrence.

Although rational expectations expect that an average person has a high level of economic knowledge and insight with abilities to formulate expectations on their knowledge of economic reactions to certain economic policy. Economic theory states that during the process of decision making individual agents will base their decisions on the best information available in order to avoid previous errors and learn from past trends. The theory differs from adaptive expectations as agents used all available information and thereby systematic errors are avoided the agents use models to form their expectations of outcomes. Thereby the rational expectations theory holds the assumption that people learn from their mistakes and errors made in the past. As people hold expectations for future outcomes due to their knowledge this will have implications on economic policy as people expect the policy to have a certain outcome the impact of economic policy such as expansionary fiscal policy will be different.

Most empirical studies of wage or price inflation have used past inflation rates, rather than the concept of wage norms, to help explain current inflation. The effect of lagged inflation in these models has generally been interpreted as representing the influence of inflationary expectations on current inflation, where these expectations are formed by an adaptive process. In such models, developments affecting inflation continue to have an influence long after they occur. And the effect of a sustained shock affecting inflation grows with the passage of time. Because the lagged inflation terms directly embody long-run and expectational effects, a sustained macroeconomic policy change is not expected to alter either the constant term or the coefficients of the equation relating output and inflation.

New classical models differ in important respects from either of the models just described. They reject adaptive expectations as a description of how future price expectations are formed. Generally they relate these expectations to the policies that are anticipated, but that idea has never been implemented in a widely accepted way in a predictive equation. The problem is in determining what economic agents expect policy to be and what amount of inflation they think will accompany it. These models also hypothesize that markets always clear and that in doing so they incorporate expected future prices in an important way. In the pure form of such models, levels of output and employment deviate from full employment levels only because economic agents are mistaken about policy now and in the future. They interpret the very flat short-run Phillips curve estimated from historical

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It should be noted that, if expectations are simply formed by actual experience, there is no useful distinction between the wage norm and credibility hypotheses in their predictions for the present period of disinflation. Both would then require an extended period of low actual inflation, brought about by an extended depression in economic conditions, in order to shift wage inflation downward by more than just the predicted cyclical response. There is no quantitative prediction about how large such an eventual shift down might be. If equations that rely on lagged inflation to capture long-run or expectational effects should overpredict in such a period, it would be evidence of a more favorable outcome than average past behavior would predict.

A key assumption underlying the use of rational expectations in macroeconomic models is that agents have enough information about the structure of the economy to make

unbiased forecasts of the relevant economic variables. This assumption may be unrealistic during the transition period immediately following a major policy change because agents have not had sufficient time to fully comprehend the implications of the new policy or become convinced of the policymaker’s commitment to maintaining it. Based on this view, we consider the possibility that agents’ forecasts during the transition to lower inflation do not make optimal use of all available information. This set-up can be viewed as a particular form of adaptive (or distributed lag) expectations.

Credibility has an important influence on expectations and, therefore, on the dynamics

of disinflation. When the central bank enjoys a high degree of prior credibility, rational

agents will quickly lower their inflation expectations in response to the announced change

in the inflation target. This shift in expectations helps to lower current inflation (via

forward-looking wage contracts) and thus contributes to a faster and less costly disinflation

episode. In contrast, when prior credibility is low, agents' expectations respond only

gradually as they become convinced of the central bank's commitment to reducing

inflation. In this case, the transition path involves learning and the use of Bayes rule so

that rational expectations can display some of the backward-looking characteristics of

traditional adaptive expectations.

References

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