14.9: Rational Expectations

Learning Objectives

- Explain how the theory of rational expectations means that demand management policy is ineffective

Adaptive versus Rational Expectations

The natural rate hypothesis, which we learned about in an earlier section, argues that while there may be a tradeoff between inflation and unemployment in the short run, there is no tradeoff in the long run. In other words, the long run Phillips Curve is vertical. The natural rate hypothesis assumes that economic agents make their predictions based on **adaptive expectations**, basically extrapolating past values of inflation to predict future values of the variable. This scheme means that expectations will always lag behind reality, which allows expansionary fiscal or monetary policy to have short run positive effects on GDP and unemployment.

New Classical Economists ask why people don't learn that they consistently underestimate inflation? Shouldn't they learn from their mistakes? If individuals are rational, shouldn't they use all available information to improve their predictions of inflation, not just past values of it? Moreover, if inflation is determined through some systematic process, shouldn't finding out the process and using it to forecast improve one's predictions? These questions led to the theory of rational expectations.

Rational expectations says that economic agents should use all the information they have about how the economy operates to make predictions about economic variables in the future. The predictions may not always be right, but people should learn over time and improve their predictions.

These ideas were formalized by John Muth, who said expectations are rational if they produce predictions equal to the predictions of the underlying economic model. For example, if people know that expansionary fiscal or monetary policy will cause inflation in the long run, they will factor that into their expectations. In other words, when an expansionary policy occurs, people will immediately expect higher inflation. Thus, people will not be fooled even in the short run, so there will be no trade-off between inflation and unemployment. Expansionary policies will simply cause inflation to increase, with no effect on GDP or unemployment. What this means is that there is no Phillips Curve tradeoff in either the long run or the short run.

In sum, if economic agents have rational expectations, since the economy never diverges from the long run aggregate supply curve, **demand management policy**–using monetary and fiscal policy to influence aggregate demand, and thus, real GDP and employment–can never be effective.

Try It

Click through the slides in this presentation to review the distinction between adaptive and rational expectations.

A link to an interactive elements can be found at the bottom of this page.

Try It

https://assessments.lumenlearning.co...sessments/7663

Learning Objectives

[glossary-page][glossary-term]adaptive expectations:[/glossary-term]
[glossary-definition]the idea that people extrapolate from past values of some economic variable to predict future values of that variable [/glossary-definition]
[glossary-term]demand management policy:[/glossary-term][glossary-definition]using monetary and fiscal policy to influence aggregate demand, and thus, real GDP and employment [/glossary-definition]
[glossary-term]rational expectations:[/glossary-term]
[glossary-definition]idea that individuals will make decisions and predictions based on economic models and past trends[/glossary-definition][/glossary-page]

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