Macroeconomics II

7. Expectations, Output and Policy

BSc in Economics

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April 11, 2024

Expectations and Decisions: the channels

Consumption

- Human wealth:
  - Future after-tax labor income.
  - Future real interest rates.
- Non-human wealth (stocks and bonds):
  - Future real dividends.
  - Future interest rates.

Expectations and Decisions: the channels

Investment

- Present value of after-tax profits:
  - Future after-tax profits.
  - Future real interest rates.

Expectations and Decisions: the new IS Curve

- The IS curve taking expectations into account:

$$Y = A(Y, T, r, Y'^{e}, T'^{e}, r'^{e}) + G$$

- The IS curve is drawn for the current period, for given values of current and future expected taxes, T and T'^{e}, expected future output, Y'^{e}, and expected real policy rate, r'^{e}.

Expectations and Decisions: the new IS Curve

- Shifts of the IS curve:
  - $\uparrow T \Rightarrow \downarrow (Y - T) \Rightarrow \downarrow C \Rightarrow$ the IS curve shifts to the left.
  - $\uparrow G \Rightarrow$ the IS curve shifts to the right.
  - $\uparrow Y'^e, \downarrow T'^e \Rightarrow$ future income is expected to be higher, consumers feel wealthier and spend more $\Rightarrow \uparrow C \Rightarrow$ the IS curve shifts to the right.
  - $\uparrow Y'^e, \downarrow r'^e \Rightarrow$ future income is expected to be higher, investors expect profits to increase and invest more $\Rightarrow \uparrow I \Rightarrow$ the IS curve shifts to the right.
- If there is a change in r or Y without changing r'^e or Y'^e, the effect in investment will not be strong:
  - Firms don't change investment if they do not expect future interest rates to be lower as well.
- Changes in Y that are not expected to last will not have a strong effect on consumption.
  - Consumers increase consumption, but by much less than the increase in their income.

Rational and adaptive expectations

- Rational expectations: the formation of expectations based on rational forecasts, rather than on simple extrapolations of the past.
  - The consumers deliberating about how much to save for retirement form expectations about the future by evaluating the probable trajectory of future policies and subsequently deducing the related implications. They also consider the information from media, or access public information online, all of which rely on the forecasts provided by public and private forecasters.
- Adaptive expectations: a backward looking method of forming expectations by adjusting for past mistakes.
  - If individuals' projection for a specific variable during a certain timeframe proved to be too conservative, they were presumed to 'adjust' by elevating their anticipations for the variable's value in the subsequent period. For instance, encountering a higher inflation rate than anticipated prompted individuals to upwardly revise their future inflation forecasts.

References

- Blanchard, O. (2017). *Macroeconomics. Global Edition.* (7th ed.). Routledge.