

# RATIONAL EXPECTATIONS THEORY: A CRITIQUE

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While considering this article I pondered the following question: Is it better to have fellow believers in your cause, who believe in it for the wrong reasons, then not to have them on your side at all? Rational Expectations monetarists (or proponents of 'New Classical Economics') are in favour of free markets, but I consider them to be so for the wrong reasons. The answer depends on the precise nature of their errors. I will, therefore, explain my objections to rational expectations and then return to the question.

## RATIONAL EXPECTATIONS AND ITS CONTRIBUTION

The theory of rational expectations is based on the apparently reasonable idea that individuals, in deciding how to act, will make use of currently available information - previous neoclassicists had usually assumed action to be based on past information: expectations were formed adaptively. Accordingly, individuals will acquire information up to the point where its marginal benefit will be equal to the marginal cost of collecting it. So, the aggregate predictions made by economic forecasters will be used to make preparation for any coming changes in the economy - accurate predictions will be made of the 'objective' probability distributions of outcomes, and behaviour regulated so as to maintain an equilibrium 'state of rest' in spite of the changes. From this, rational expectations proponents derive their laissez-faire policy conclusions. Pre-announced expansion or contraction will simply have no effect on the real economy. For RE theorists people can't be fooled: with their accurate anticipation of changes they can't be taken in by the money illusion on which Keynesianism is based. Monetary policy will affect only money variables, so is effectively 'irrelevant' (this is the 'irrelevance hypothesis'). Illusion can only result from unsystematic policy, and even then will only be short-lived.

Before explaining why I think this is wrong, I should acknowledge the positive contribution that enunciation of rational expectations has made. Firstly, it has focused the attention of economists on expectations, a subject frequently

neglected in the past. And, secondly, the aspect of the theory which recognises that decisions are based on the decisions of others has finally seen off the 'cobweb theorem'<sup>1</sup> - the theory that in markets with inelastic supply (such as agricultural markets) prices will not tend to converge on equilibrium. If suppliers take into consideration what other suppliers are doing then they won't blindly make consistent errors in deciding how much to produce. The same argument would also apply to the Keynesian concept of an 'accelerator' between consumption and investment expenditure.<sup>2</sup>

## EXPECTATIONS IN UNCERTAINTY

A fundamental insight of the Austrian school is that individuals in the free market operate in an environment of uncertainty.<sup>3</sup> The concept of equilibrium is viewed with suspicion, it being impossible that such a situation could ever prevail in a dynamic economy. Assumptions of equilibrium, as David Butler has explained, assume away competition.<sup>4</sup> Since there is uncertainty there can be no equilibrium: In a particular market any individual cannot be certain of how others in that market will act and react, so some plans must be frustrated, and subject to re-adjustment. If equilibrium did exist then market signals would function properly. In the absence of equilibrium, and indeed in the face of movements away from equilibrium, the market information conveyed by prices will not be wholly correct. In all this the implications for rational expectations are not some (or maybe most) of the information gleaned from market prices will be false.

Taking the question of uncertainty a stage further, Frydman, O'Driscoll and Schotter<sup>5</sup> consider monetary policy when faced with a public trying to form rational expectations about that policy. A policy maker with control of the money supply must engage in cross-guessing: the public are attempting to anticipate policy, but if they succeed the policy is ineffective. This leads to there being no optimal policy, and hence no firm basis for the public's formation of rational expectations.

This is part of a more general analysis of uncertainty, along the lines of who do the same. Essentially, the problem faced by any decision maker is that in attempting to anticipate the actions of others, they will do the same, so he must anticipate their anticipations of him, and so on. Frydman makes the point in reference to rational expectations, that each individual has an incentive to take advantage of others' rational expectations, by holding non-rational expectations. It would seem irrational, as RE does, to assume that self-seekers will *not* behave in this way:

Such collective adherence to individually nonoptimal forecast rules conflicts with the traditional conception of individual behaviour ...<sup>6</sup>

## Economic Notes No. 8

ISSN 0267 7164 ISBN 0 948317 83 3

An occasional publication of the Libertarian Alliance,  
25 Chapter Chambers, Esterbrooke Street, London SW1P 4NN  
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This article first appeared in *The Moderate*, No. 2, the journal of the York University Freedom Society, under the title "Rational?"  
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Finally, as Haberler contends,<sup>7</sup> a division of policy into systematic or unsystematic is not realistic. It follows from what I said above that the enactment of policy cannot be certain. Libertarian economists have frequently drawn attention to the perverse effects of government intervention. A good example of this in monetary policy is Goodhart's Law - that whichever measure of money government seeks to control will soon become useless as banks find ways of holding liquidity in a different form. The present government has encountered this difficulty: the "corset" being abandoned in 1980 after being rendered impotent by avoidance.

### IS FORECASTING POSSIBLE?

Actors in the RE scenario are endowed with the fantastic ability to decide which is the 'correct' model of the macroeconomy, and are then capable of deciding what numbers to feed into the model. This alone seems improbable, but a further point can be added. It is not just that the parameters exist, but cannot be distinguished, but that these future parameters do not exist at all in the present. To think otherwise is to misconceive the nature of real time (the future does not exist at all in the present) and to ignore the uncertainty inherent in economics.<sup>8</sup> This also means that "... individual guesses of the average opinion cannot be known or modeled by an 'outside observer' ...".<sup>9</sup>

Where does this leave forecasting? It is evident that this case is antithetical to the use made by RE economists of macroeconomic aggregates (Patrick Minford's "Liverpool Model" is one of these). Although uncertainty is prevalent, there are still common factors between periods, otherwise co-ordination would be impossible. Therefore, while exact forecasting is not reasonable, predictions can be made of the class of events that will occur - 'pattern' predictions.

James Ramsey recognises this, along with its political unattractiveness:

Since economics is a stochastic science, and macroeconomic variables are observed with error, sometimes large, predictions about the economy can be put only in terms of conditional probabilities, not of the definite occurrence of particular events ... Unfortunately such macro-economic forecasts by government (or private) economists are rarely put in this form but in the more impressive but spurious form of single figures.<sup>10</sup>

Economics has of late become impregnated with maths. From the student level upwards the stress is on empirical precisions - analysis by computer. Given the investment in human capital this has involved there is no prospect of rapid acceptance of such cautious economics.

### NEGLECT OF MICROECONOMICS

In this section assume that new classical microeconomics is right. Now imagine that the government has announced the intention of increasing the money supply by ten per cent during the coming year, and subsequently does so. If we now turn to microeconomics, rational expectations are flawed again. Firstly, the monetary expansion will not affect all markets at the same time: some will adjust their expectations and then find that the effect of the increase will not emerge until the following year. Secondly, the forces of supply and demand will continue to operate during this time: in some markets they will outweigh the inflation, so that prices fall; in others they will supplement the increase

so that prices rise by more than ten per cent. The impact of inflation will be indistinguishable from other influences, so that any agent with rational expectations will be unable to rely upon his expectations of ten per cent inflation. And thirdly, individual attempts to analyse changes in economic variables will vary - interpretations of the causes of a price rise will differ - so that plans will not mesh. Disequilibrium once again.<sup>11, 12</sup>

### THE QUESTION AGAIN

One of the points made against perfect competition by Alexander Shand in *The Capitalist Alternative*<sup>13</sup> is that students find it unrealistic, and so find no reason to support the free market. Applying this logic to rational expectations, we could say that it provides a straw man to be knocked down by opponents, i.e.: "Here's the case for non-intervention, and here's why it's wrong." Of course, for this to be true the students must be unfamiliar with other free market economics. And at the moment the analogy does not strictly apply since RE is not generally taught below undergraduate level, and has about as much prospect of penetrating our dated syllabuses as Austrian economics.

The influence of RE is really in the policy market, and here no definitive answer to the question can be forthcoming. In its favour we can say that since this market is dominated by statist interest groups it is better to have someone voicing a sound line, than to provide no voice at all. Against this must be weighed the effect that RE has in reinforcing the implicit scientism of interventionists, and all the policy implications following from that. Because the future is uncertain we cannot know whether this latter consequence will occur.<sup>14</sup>

### NOTES

1. Steven M. Sheffrin, *Rational Expectations*, Cambridge University Press, Cambridge, 1983, pp. 151-170.
2. For the destruction of this concept see William Hutt, *The Keynesian Episode: A Reassessment*, Liberty Press, Indianapolis, 1979, ch. 17, and Murray Rothbard's *America's Great Depression*, 3rd edn., Sheed and Ward, Kansas City, 1975.
3. See Gerald O'Driscoll and Mario Rizzo, *The Economics of Time and Ignorance*, Basil Blackwell, Oxford, 1985, for a detailed analysis of uncertainty inherent in time.
4. D. Butler, "Why Austrian Economics?", *The Moderate*, No. 1, York, 1986, pp. 4-5.
5. R. Frydman, G. O'Driscoll and A. Schotter, "Rational Expectations of Government Policy: An Application of Newcomb's Problem", *Southern Economic Journal*, vol. 49, 1982-83.
6. R. Frydman, "Towards an Understanding of Market Processes: Individual Expectations, Learning, and Convergence to Rational Expectations Equilibrium", *American Economic Review*, vol. 72 1982, p. 653.
7. G. Haberler, "Critical Notes on Rational Expectations", *Journal of Money, Credit and Banking*, 1980.
8. See O'Driscoll and Rizzo, op. cit.
9. Frydman, *ibid.*, p. 662.
10. James B. Ramsey, *Economic Forecasting - Models or Markets?*, IEA, 1977, p. 18.
11. See Ludwig M. Lachmann, *Capital, Expectations and the Market Process*, Sheed, Andrews & McMeel, Kansas City, 1977, pp. 71-73.
12. Something I did not discuss is the issue of whether fully anticipated monetary changes can have real effects. For an argument that they do, by altering the relative yield of money, see W. H. Butler, "The Macroeconomics of Dr. Pangloss: A Critical Survey of the New Classical Macroeconomics", *The Economic Journal*, vol. 90, 1980.
13. Alexander H. Shand, *The Capitalist Alternative: An Introduction to Neo-Austrian Economics*, Wheatsheaf, Hassocks, Brighton, 1984.
14. A similar argument is employed by Ellen Frankel Paul in an attempt to show that utilitarians contributed to the encroachments of the state at the end of the nineteenth century; "Laissez-Faire in Nineteenth-Century Britain: Fact or Myth?", *Literature of Liberty*, Winter 1980, pp. 33-34.