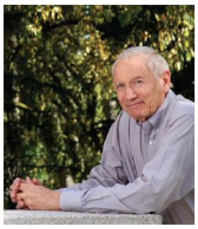
Trade-off may exist, BUT cannot be exploited : **Rational Expectation and New Classical Economics.**

Thomas Sargent

Robert Lucas



Neil Wallace

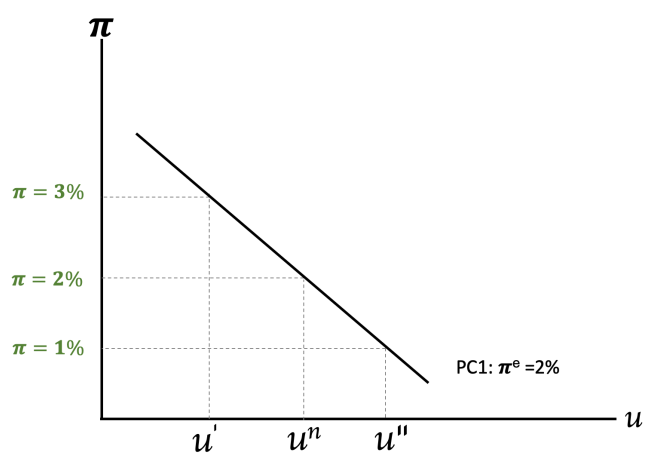
Robert Barro

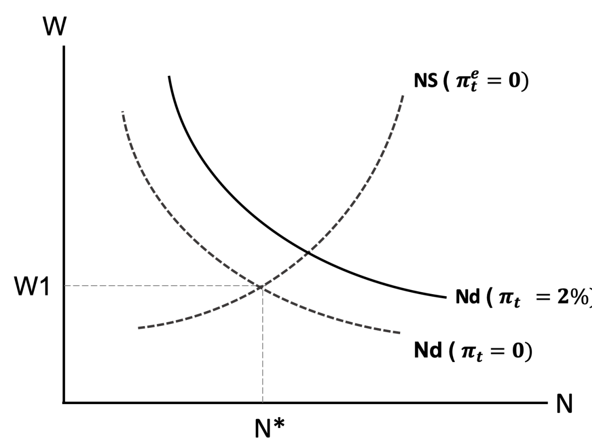
- Friedman (1968) argued for this statement, however, it had recieved little response.
- This was until mid of 1970s when Friedman's concept was further formalized by team of economists - i.e. Sargent, Lucas, Wallace and Barro.
  - Later, they are called a group of "New Classical economists"
- They believed and advocated in the concept of rational expectation (forward looking expectation) in economic analysis, and seek for behavioral implication of rational expectation on policy effects.

$$\boxed{\text{Given the rational expectation, the first implication is that anticipated policy will be neutral.}}$$

- An anticipated demand management policy will not matter to the real output.
  - Consider for example an anticipated change in the level of money growth from 2% to 3%
    - Given the new high money growth, workers expected the inflation to change from 2% to 3%
    - With rational expectation, they already incorporated this information into the wage-setting.
    - Once the policy is implemented, it will not generate any real-effect.

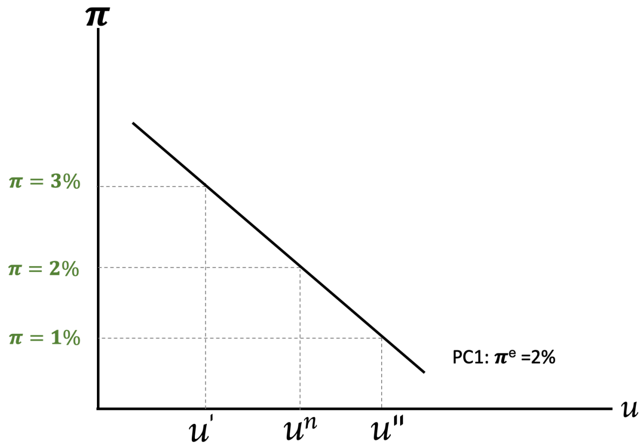
$$\boxed{\text{"Anticipated policy is neutral; workers fully incorporate the information into their wage setting decision.}}$$

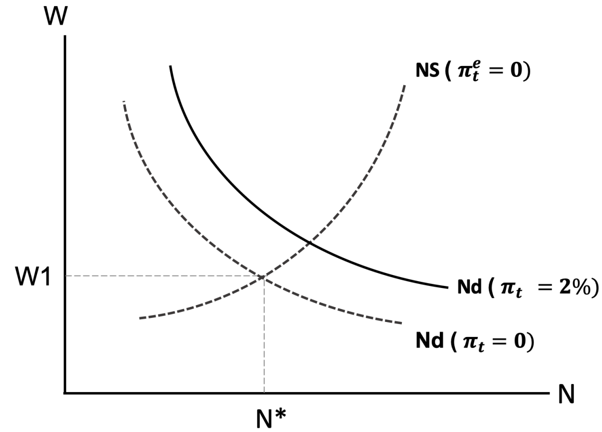




Surprised policy matters

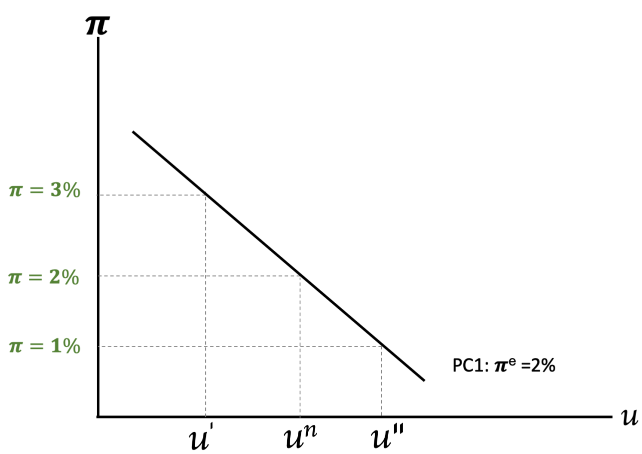
- Suppose workers expected a 2% money growth policy, and hence expected 2% inflation.
  - Central bank surprisingly increases the money growth to 3%
  - Workers then underpredict the inflation, and hence setting their nominal wage for too low.
  - Firms benefit from this, can choose to hire more labor.
  - The final outcome is the increase in output in the equilibrium.

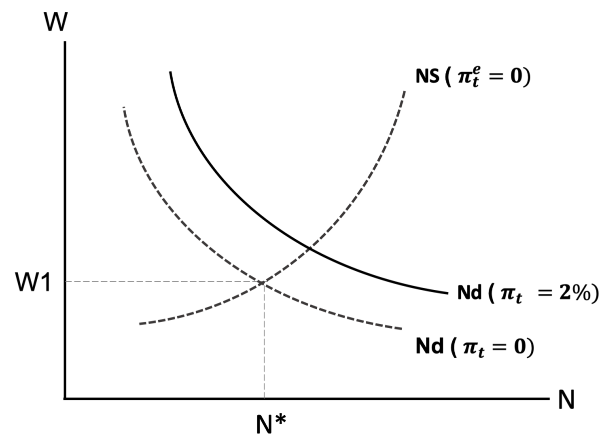




Surprised policy matters .. BUT does not last long.

- Workers will soon realize the error, they will revise their inflation expectation upward
- Cost of production will rise, and hence discourage firms from choosing to overly produce its output beyond the natural level
- The self-correction mechaism revisits.





Neither anticipated nor surprised policy are good for long-term; the damage lasts long.

* ∗ Anticipated policy ⇒ inflation pushed up suddenly.
* ∗ Supprised policy will result in lower unemployment rate (short-term gain) and higer inflation (short-term loss)
  * · the tradeoff should not be exploited. (Phillips curve is vertical in the long-run)
  * · Inflation expectation will play role, and do the initial real effect.
  * · What only left behind is the thigher sustained (or trend) inflation rate.
  * · At the end, we only have long-term loss, without any gain.
  * · Oppotunistic policy will result in the "accelerating" inflation spiral.