EXPECTATIONS AND MACROECONOMIC POLICY

CHANNELS:

1. Spending depends on current *and expected future* income (and taxes) (permanent income hypothesis, life cycle considerations)

2. Spending depends on current and expected future interest rates (discounting)

Therefore *expectations can shift IS curve*

What about LM curve? To first approximation, demand for money depends only on current variables

“REDUCED FORM” MODEL (a prime’ on a variable means “expected future”)

IS curve: Y = A(Y-T, Y’-T’, r, r’) + G

Notice: multiplier is

$$\frac{dY}{dG} = \frac{1}{1-\frac{\partial A}{\partial Y-T}}$$

It is probably pretty small, because current income doesn’t have that much effect on spending.

And the slope of the IS curve is

$$\frac{dY}{dr} = \frac{\frac{\partial A}{\partial r}}{1-\frac{\partial A}{\partial Y-T}}$$

which is probably quite steep, because effect of current interest rate also pretty small

So effects of current fiscal and monetary policy sort of weak

But: effects of *expected* policy can be large

1. A tax cut that is regarded as permanent can have large effect on demand

2. So can a monetary expansion that is regarded as permanent

Immediate application: temporary policies less effective than permanent

(Hence Japanese call for a *permanent* tax cut as opposed to temporary)

Stranger applications: effects of expected future policies may be opposite of current

Case in point: What is the effect of an expected future cut in gov't spending?

Depends on expected response of Fed. Suppose that the public expects that Fed will cut interest rates enough to prevent any decline in Y.

Remember A(Y-T, Y'-T', r, r') +G

Current G has not changed

Expected future Y'-T' has not changed.

But expected future r' has fallen.

Hence expected future cut in gov't spending is *expansionary* for current economy