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The Significance of Rational Expectations Theory

An accurate understanding of how expectations are formed leads to the conclusion that short-run macroeconomic stabilization policies are untenable.

Ever since the "Keynesian Revolution" in the 1930s and 1940s, it has been widely agreed that a major responsibility of any national government is to utilize monetary and fiscal policy actively in an effort "to promote maximum employment, production, and purchasing power," as stated in the U.S. Employment Act of 1946. Most economists, in other words, have accepted what Franco Modigliani terms "the fundamental message of [Keynes'] *General Theory*: that a private enterprise economy using an intangible money *needs* to be stabilized, *can* be stabilized, and therefore *should* be stabilized by appropriate monetary and fiscal policies."

There have been recent developments in macroeconomic theory, however, that suggest that the activist stabilization policies favored by Keynesians will be unsuccessful—not because of inept behavior on the part of policy-makers, but for more fundamental reasons.

These developments have resulted from a revised conception of the way in which individual economic agents—consumers, workers, and firms—form their expectations about future values of economic variables relevant for current behavior. The revised conception, usually referred to as the hypothesis of rational expectations, was formally proposed by John F. Muth in 1961. It was adopted by analysts of financial markets during the 1960s but had little impact on general economic thinking until the present decade. The principal contributions in macroeconomics were made by Robert E. Lucas, Jr. between 1970 and 1973. Some profound implications

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