Expectations, Output and Policy

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Recall IS Curve without Expectations

- The IS relation:

$$Y = C(Y - T) + I(Y, r + x) + G$$

- Assume aggregate private spending A, equals the sum of consumption and investment spending:

$$A(Y, T, r, x) = C(Y - T) + I(Y, r + x)$$

so the IS relation becomes:

$$Y = A(Y, T, r, x) + G$$

IS Curve Taking into Account the Expectations

	Without Expectation	With Expectation
consumption	$C(Y-T)$	$C(\underbrace{Y-T}_{+}, \underbrace{Y'^{e}-T'^{e}}_{+})$
investment	$I(Y, r+x)$	$I(\underbrace{Y}_{+}, \underbrace{r+x}_{-}, \underbrace{Y'^{e}}_{+}, \underbrace{r'^{e}+x}_{-})$
aggregate private spending	$A(Y, T, r, x)$	$A(Y, T, r, Y'^{e}, T'^{e}, r'^{e})$

The "new" IS relation becomes:

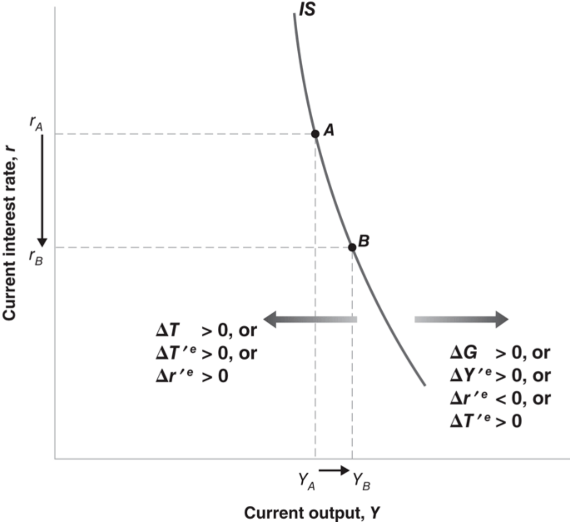
$$Y = A(Y, T, r, Y'^{e}, T'^{e}, r'^{e}) + G,$$

in which $A(\underbrace{Y}_{+}, \underbrace{T}_{-}, \underbrace{r}_{-}, \underbrace{Y'^{e}}_{+}, \underbrace{T'^{e}}_{-}, \underbrace{r'^{e}}_{-})$. That is,

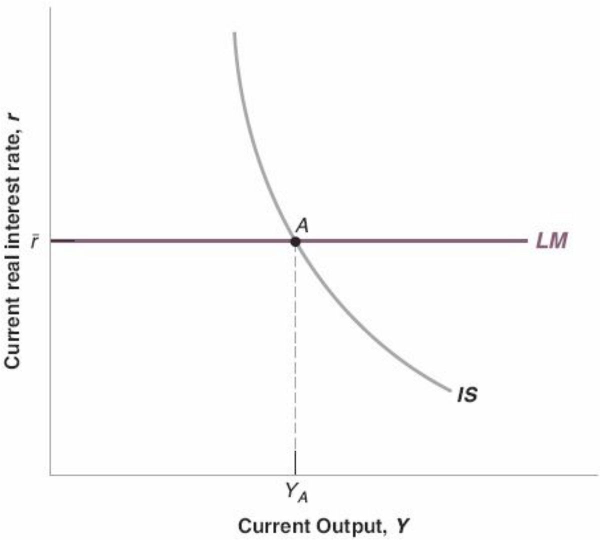
- increases in either current or expected future income increase private spending.
- increases in either current or expected future taxes decrease private spending.
- increases in either current or expected future real policy rate decrease private spending.

New IS Curve

A decrease in the current real policy rate, **given unchanged expectations** of the future real policy rate, does not have much effect on private spending. The new IS curve is thus **much steeper** than the IS curve in previous chapters.

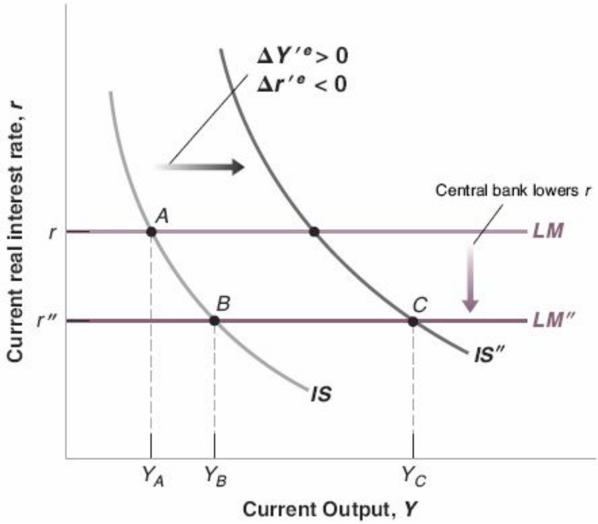


New IS-LM Curve



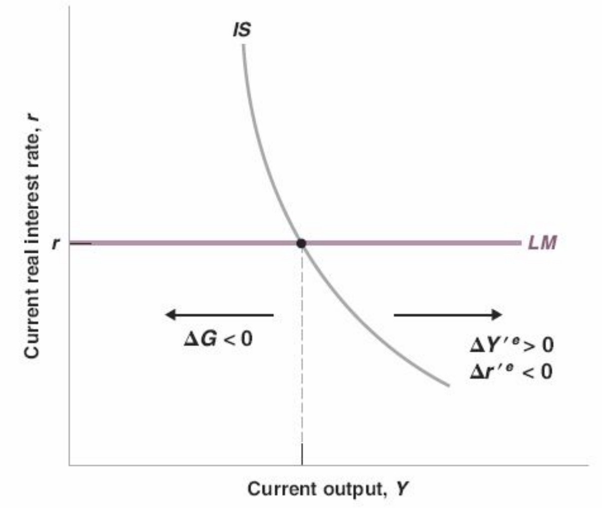
The Effects of an Expansionary Monetary Policy

The effects of monetary policy on output depend very much on whether and how monetary policy affects expectations.



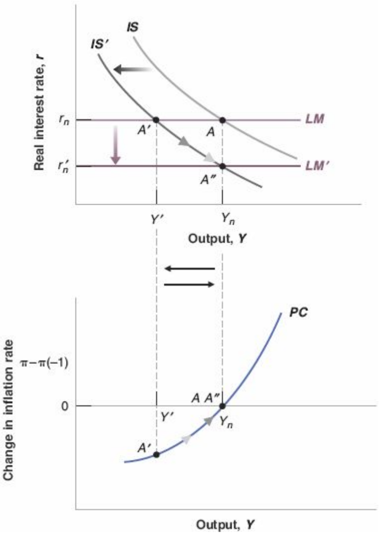
The Effects of a Deficit Reduction on Current Output

When account is taken of its effect on expectations, the decrease in government spending need not lead to a decrease in output.



recall median run

Fiscal Consolidation



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