

A NOTE ON EXPECTED PRICE LEVEL CHANGES AND FISCAL POLICY EFFECTIVENESS

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IN recent years, there has been a considerable volume of work done in the economics literature on expectations. The work has been both theoretical and empirical in nature. Although the literature has been concerned with various forms of expectations,¹ the greatest attention has been directed toward expected price level changes.² This paper seeks to fill a void in the price expectations literature. In particular, it is the purpose of this paper to demonstrate that, if the price expectations of the private sector of the economy are at least in part dependent upon the way in which fiscal policy actions are financed, then the ultimate effect of the fiscal policy actions may be *a priori* indeterminate.

In Section I, we develop our basic model. Fundamentally, the approach will be to postulate a budget constraint for the government³ and to postulate further that expected price changes are a function of imbalances in the government's budget. In Section II, we analyze graphically the fiscal policy implications of endogenous expected price changes. Concluding remarks are provided in Section III.

I. The Expectations Model

The basic approach of this paper is to postulate that increases (decreases) in the aggregate price level are expected whenever the government budget is in a state of surplus (deficit). A state of balance in the government budget presumably will not be associated with expected price level changes, whereas any departure from a balanced budget will, *ceteris paribus*, induce expectations of price level changes. Given a budget constraint for the government sector of the economy, expected price changes are, in effect, endogenous to the system.

These relationships can be expressed in simple equation form. The government sector of the economy may be described by the following:

- (1) $G = G_0$,
- (2) $T = T_0$,
- (3) $G - T = \Delta B$,

where G is real government spending, T real taxes, and ΔB the real value of government bonds sold (purchased) the government to