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**THE RATIONAL EXPECTATIONS HYPOTHESIS
AND
ITS MACROECONOMIC IMPLICATIONS**

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INTRODUCTION

A salient feature of nearly all economic decision-making is that it is inherently forward looking : most economic decisions and actions are based on anticipations of the future which is only imperfectly known. Furthermore, the actual values of economic variables and their evolution over time are sensitive to expectations of economic agents and the changes therein. Hence, economic theorists investigated the alternative processes of expectations formation and tried to assess and analyse what the expectations are at a given moment of time, how they would change and thence cause changes in the economic processes.

The Rational Expectations Hypothesis is one of the most recent developments in expectations - theory. Building up from the principle of rational behaviour, it postulates that expectations of rational economic agents are based on an information set including a clear outline of the structure of the economic system, the ways in which the variables are inter-related, the policies proposed and adopted by the government, and so on. The hypothesis has been applied in several areas of economic theory - in analysing the production and inventory decisions of firms in response to price and sales expectations, in agricultural markets, forward markets, stock - market speculation, in analysing exchange rate expectations and

and balance of payments problems, and has been applied to the Natural Rate Hypothesis to examine its macroeconomic implications.

One of the most dramatic implications of the Rational Expectations Hypothesis is that all systematic macroeconomic policy rules are futile, that they can have no impact on the real variables in the economy such as employment, output, real wages, real interest rates, etc. Because of the importance of these policy conclusions we have focussed on the macroeconomic implications of the hypothesis. Also, the literature on the other applications of the Rational Expectations Hypothesis is fairly vast and extensive, making a comprehensive study a difficult task.

Accordingly, Ch. I of the dissertation discusses the role of expectations in economics and the alternative approaches to expectations - formation which preceded the Rational Expectations Hypothesis. Ch. II presents and discusses the Rational Expectations Hypothesis and Ch. III, its macroeconomic implications. Ch. IV gives a broad outline of the major empirical tests of the Rational Expectations Hypothesis and its macroeconomic implications. The conclusions drawn from the study are discussed in Ch. V.

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