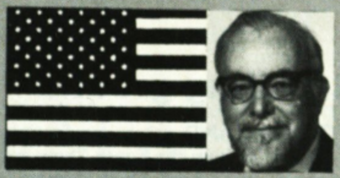
The four letter word the economists forget



ROBERT CLANCY reports from NEW YORK

WHAT'S NEW in the post-Laffer world of economic thought? One development is a concept called "rational expectations".

"Expectations" is a term that has come into currency in recent years. In 1969 I wrote an article for *Land and Liberty* on "Black Power", pointing to the increased restlessness for improvement among American Negroes. I referred to a term used more than a century ago by Lord Macaulay in a lengthy article in the *Edinburgh Review* in which he explained that revolutions were caused by *rising expectations.*

Since then, I have seen this term used by writers on the social scene. I don't know if my article in some way caught somebody's attention and the term was picked up and passed around. I'm willing to be disabused of this idea if I learn that the expression was used in years prior to 1969! At any rate, the credit belongs to Macaulay for coining the phrase.

The "rising expectations" theme in social analysis was followed by "falling expectations". In the 1970s the idea of growth and progress did not appear compatible with economic, social and political troubles in the world. Prospects for an era of peace and prosperity were dim; the best that could be expected was to hold the line, "zero growth" was preached, recession lowered performance, "stagflation" set in, and the decline of civilization – whether by bang or whimper – was foreseen.

This disillusionment also harks back to the "black power" theme. At a big rally in Washington in August, Negroes and other minorities commemorated the demonstration at the same place twenty years ago when Martin Luther King Jr. gave his famous "I have a dream" speech.

Although the dream was valiantly upheld, disappointment – "falling expectations" – was widely acknowledged and persistent poverty and unemployment, especially among blacks, was noted. It will take more than speeches and rallies to solve this problem.

NOW WE HAVE "rational expectations". This is a term circulating among economists in an attempt to refine economic analysis which has not done very well either in advising or forecasting. This school of thought is outlined in the book *Rational Expectations* by Steven M. Sheffrin (Cambridge University Press, 1933).

The idea, according to economist Herbert A. Simon, is to provide "satisfactory solutions for the real-world decision problem ... unattainable optimization is sacrificed for in-practice attainable satisfaction". And since economists love to coin words and phrases, this is called *satisficing* behaviour.

"Conditional expectations" is another variation of this theme. This school notes that people make economic decisions based on the incomplete information available to them. Furthermore, their expectations involve past experience; something that happened under previous similar conditions is likely to be a guide to present decision-making. Yet Jude Wanniski could argue that the totality of decisions involves all the information available – "the world electorate is always right".

Mr. Sheffrin would like to apply the theory to such a volatile institution as the stock market, but he muses: "If changes in information about dividends cannot explain movements in stock prices, what can?"

Perhaps the well-known economist, Eliot Janeway, gave the best answer. In a radio commercial for AT&T, as a final fillip his "interviewer" asked: "Will the stock market go up or down?" Mr. Janeway, replied: "Yes, but not right away."

Not untypical of economists' prognostications on the economy!

Another economist, James Tobin, is quoted by Mr. Sheffrin as criticizing the "rational expectations" school as follows: "They are all inspired by faith that the economy can never be far from equilibrium ... With such faith the orthodox economists of the early 1930s could shut their eyes to events they knew *a priori* could not be happening ... Keynes might say this is where he came in."

Yes, this is where Keynes came in – but his theories also used assumptions which eventually did not hold up.

THE "rational expectations" school concentrates on the same parameters used by most contemporary economists – interest rates, tax rates, inflation rates, money supply – so there's no breakthrough here. Not necessarily identifying with any particular school – whether Keynesian, supply-side or neo-classical – they feel that rational expectation formulas can refine economic analysis in general.

But it would seem that economic analysis needs not merely a refinement but an overhauling.

Most economists today "shut their eyes" to the influence of land, land prices, land speculation – "the power in the land". The nearest Sheffrin comes to it is when he makes a passing reference to "inelastic supply". Otherwise we encounter unsatisfactory explanations that we've seen before – that supply outstrips demand, causing a recession; that labourers may prefer leisure at certain times rather than accept a prevailing wage and so we have "unemployment"; that answers lie in tinkering with interest rates, etc. (Can we speak of "irrational expectations"?)

In speaking of "expectations", economists are ignoring a big one – the expectation of a higher return for land, causing it to be held out of use or underused. With the "inelastic supply" of land, increased demand escalates its price to dizzy levels – and many who cannot afford it are forced out of business.

This is the "information" missing from the calculations of today's economists and econometricians. This is the unnoticed obstruction that is upsetting the "equilibrium" dear to economists. This is why, while puzzling over their various factors and inputs and computerized data, they always seem to miss the boat.

This is the key to the overhauling needed in economic analysis.

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