Rational Expectations, by Steven M. Sheffrin. Cambridge Surveys of Economic Literature, edited by Phyllis Deane and Mark Perlman. New York: Cambridge University Press, 1983. x + 203 pp. $29.95 (cloth); $8.95 (paper)

This book is a selective survey of the rational expectations literature, with its main focus on macroeconomics. The approach is generally low-tech, with the objective of making important recent theoretical developments accessible to a broad range of economists. Sheffrin does an excellent job of providing clear and concise summaries of difficult technical articles; he makes a special effort to include a significant number of empirical papers.

Whereas Sheffrin definitely tries to sell the reader on the virtues of models with internally consistent (rational) expectations, he does not evangelize any particular school of thought within the rational expectations camp. Rather, he attempts to present the main arguments and articles by each side and allow the reader to form his own judgment. This is not always an easy balance to strike, especially when alternative viewpoints sharply differ, such as over the role of activist stabilization policy. Nevertheless, Sheffrin manages to maintain a remarkably detached viewpoint.

The book is divided into six chapters. The first chapter traces the early development and philosophical foundations of the rational expectations school. Sheffrin discusses how two Carnegie Mellon University scholars, Herbert Simon and John Muth, chose alternative approaches to the problem of analyzing how individuals form expectations in a complex world. Simon argued that economic agents cannot possibly find the optimal solutions to the complicated problems they face, so instead they “satisfice” by using simple rules. Simon viewed satisficing as externally consistent, that is, consistent with reality. Both Muth and Simon viewed the models of economists as simple approximations which hopefully yield interesting positive results. But Muth argued that the models themselves should at least be internally consistent. In particular, Muth proposed that expectations should be modeled in a manner consistent with the rest of the model. It is interesting how these two approaches are now recognized as being completely different. The second chapter discusses how in the late 1960s, expectations began to play an increasing role in macroeconomic theory, particularly after the development of the Friedman-Phelps natural rate hypothesis. This chapter addresses questions such as: Does the existence of nominal wage contracts imply a role for monetary stabilization policy? Can models in which monetary policy shocks have only information-theoretic effects explain persistence? The new neoclassical “equilibrium” economists view models in which agents sign nominal wage contracts as inconsistent with rational behavior. They suggest alternative monetary transmission mechanisms that imply no role for activist monetary stabilization policy. The neo-Keynesians view their models as having greater external consistency and maintain that the transmission mechanisms in the new neoclassical models are utterly implausible. Sheffrin contrasts these opposing views in an extremely careful and balanced fashion.

The third chapter is entitled “Further Topics in Macroeconomics.” One class of models considered is that with instantaneous financial market adjustment but sluggish goods market adjustment (as in Rudiger Dornbusch’s celebrated overshooting article, “Expectations and Exchange Rate Dynamics,” Journal of Political Economy 84 [December 1976], 1161–76). In an unfortunate choice of terminology, Sheffrin describes such models as “partly rational.” It seems to me that you either are or you
aren't. This chapter also deals with the time-consistency literature and the question of rules versus discretion:

The basic counterargument in this debate is that "discretion" has been narrowly caricatured. Discretionary policies have been associated with actions that myopically break long-honored rules and commitments. Advocates of discretion could argue that discretionary policies work best in a stable framework of rules. For example, in actual patent policy, there are many discretionary decisions that have to be made in applying the general rules of policies. Indeed, it is hard to conceive of rules that could exist without discretionary interpretation. Congress can certainly not write simple rules for tax policy—otherwise the Internal Revenue Service would not have to issue volume(s) of regulations. Even less imperfect sources than Congress face this problem—the Ten Commandments had to be supplemented by the volumes of the Talmud. (p. 99)

Finally, the third chapter explains the "Lucas critique" of econometric policy evaluation. It is curious if not amusing to read the many recent articles in which an author models one aspect of microeconomic behavior and declares that he has developed a model "immune to the Lucas critique." The presumption is that one can estimate the "deep structural parameters" of such a model and produce indisputably superior policy analysis. We sometimes seem to forget Muth's original interpretation of simple rational expectations models as only crude approximations to a complex world.

The fourth chapter is on efficient markets and deals with empirical tests of market efficiency. It also covers the theoretical literature on how market prices serve to reveal private information. The fifth chapter, which is somewhat incompatible with the rest of the book, covers a small number of topics in empirical microeconomics, including housing prices. A final (short) chapter is entitled "Rational Expectations in Practice."

Sheffrin's book is one of a series entitled "Cambridge Surveys of Economic Literature," edited by Phyllis Deane and Mark Perlman. This series fills an important need, and one hopes that it will produce more simply expost surveys such as Sheffrin's.

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Conference volumes provide an excellent opportunity to present to a wider audience the latest work by leading economists. The present example contains nine papers presented at a National Bureau of Economic Research conference in November 1981, together with discussants' comments and an introductory essay by Jacob Frenkel. At their best, such collections transmit the intellectual excitement of the proceedings and point to new areas of research. The present volume, however, is simply a representative cross-section of work in the area, most of which is closely related to published papers by the same authors. But rather than succumb completely to the temptation to act as an ex post discussant of each paper, let me point out what I think are the highlights.