



JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

Government of Rajasthan established

[Through ACT No. 17 of 2008 as per UGC ACT 1956](#)

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Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA (Hons) Economics 2nd Semester

Course – Macroeconomics II

Digital session name – Adaptive Expectation

Introduction:

Yet another approach to expectations formation, which can also be viewed as a special case of the extrapolative hypothesis has come to dominate much of the work done on expectations. This is the adaptive expectations hypothesis, first put forward by Cagan (1956) and Nerlove (1958). It states that expectations are revised in accordance with the last forecasting error; hence its alternative name, the error learning hypothesis.

Another variation of the extrapolative theme, which has received some prominence recently, is the regressive (effect-cause relationship)—extrapolative expectations hypothesis. This was first put forward by Duesenberry (1958) and expanded by Modigliani and Sutch (1966).

They suggest that there might be both extrapolative and regressive elements present in the process by which expectations are formed. The latter implies a reversion of expectations towards a long run 'normal' level, which may in itself be given parameter of the system, or a lagged function of actual price changes, where the lag may extend over several years. In the latter case, the hypothesis once more becomes a special case of the general extrapolative hypothesis.

This mechanism of adaptive expectations formation is more frequently used in economics. According to this mechanism of adaptive expectations agents revise their expectations in each period according to the degree of error in their previous expectations—hence the name adaptive expectations. The speed at which the expectations adjust to past error is called the coefficient of adaptations. This coefficient may fluctuate between zero and one. Thus, with adaptive expectations, the expected value in the next period is equal to the expectations for the current period plus or minus a proportion of the error in the expectations for the current period.

Until the idea of rational expectations was introduced in economics, adaptive expectations were the most common method of formulating expectations in economics. Its popularity was due to its conceptual simplicity and the ease with which, it could be implemented empirically. Statistical estimates for the coefficient of adaptive expectations can be easily obtained.

Moreover, according to Carter and Maddock the adaptive behaviour in the face of an uncertain environment appears intuitively very plausible and appealing. Adaptive expectations model worked well in a climate in which the change was gradual—a characteristics of the 1950s and the 1960s when the inflation rates were low and relatively stable and when inflation rates underwent fast changes and increased rapidly, adaptive forecasts were left behind.

Thus, adaptive expectations are effective when the variable being forecast is reasonably stable, but adaptive expectations' are of little use in forecasting trends. Moreover, there may be additional or supplementary information available to the forecaster which is highly relevant to the variable being forecast for example knowledge of which party has won a general election may be used to forecast the rate of inflation which is otherwise based only on past price data.

Mechanical application of an adaptive expectations mechanism, therefore, does not essentially make the best use of all the scarce information available. It is for this reason that this mechanism as a for caster of economic behaviour is not very dependable. Under some peculiar circumstances, it has been observed that the adaptive expectations mechanism

performs poorly. Rather than converging to zero, the expectations errors increased from year to year.

Course Outcome: The goal of this paper will be to expose the students to the basic principles of macroeconomics. The emphasis will be on thinking like an economist and course will illustrate how economic concepts can be applied to analyse real-life situations. In this course, the students are introduced to money and interest, theories of inflation, rate of interest, trade cycle and growth models.