Macroeconomic Expectations and Limited Awareness.

Abstract

This paper investigates how macroeconomic dynamics and policy transmission are altered when agents are unaware of some structural shocks hitting the economy. We show that LA rationalizes existing evidence about overreaction in economic expectations, and naturally give rise to a systematically biased perception of economic relationships—notably, a downward-biased inflation-output tradeoff. We validate this mechanism using actual and forecast data from the Survey of Professional Forecasters and Blue Chip Economic Indicators. Furthermore, LA significantly alters shock propagation. Within a standard New Keynesian model, where otherwise rational agents observe key macroeconomic aggregates but are not aware of the existence of certain supply shocks, we show that demand shocks have a larger effect on output and a smaller effect on inflation, while supply shocks may even lead to a positive co-movement between inflation and output, and thus look like demand shock. LA also challenges the desirability of strict inflation-targeting policies, as the misperceived Phillips curve implies a higher sacrifice ratio. Finally, a Structural VAR estimated with macroeconomic and survey data reveals that these misperceived supply shocks are quantitatively highly relevant, accounting for roughly 20 percent of aggregate GDP volatility.

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