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TESTING RATIONAL EXPECTATIONS HYPOTHESIS IN THE MANUFACTURING SECTOR IN MALAYSIA

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Abstract. The application of rational expectations hypothesis (REH) in macroeconomic research has marked a revolution in economic thinking, and the magnitude of its impact on the world of economics is undeniably significant. However, the extent to which REH applies in real-world settings is ambiguous even though the concept of REH is well established in economics literature because empirical evidence from previous studies is clearly mixed. This study used survey data on gross revenue and capital expenditures to examine the validity of REH in Malaysian manufacturing business expectations. Empirical results indicated that the manufacturers' expectations are being irrationally constructed in terms of gross revenue predictions but comply with REH properties in Muth's sense in the case of capital expenditures forecasts. Therefore, manufacturing firms in Malaysia are encouraged to incorporate more relevant information into their gross revenue predictions to provide more accurate and realistic forecasting.

Keywords: rational expectations hypothesis, unbiasedness test, non-serial correlation test, weak-form efficiency test.

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1. Introduction

The rational expectations hypothesis (REH) is a theoretically attractive framework for assessing the mechanism with which economic agents process information when formulating judgments about the real world (Krause 2000). REH is largely applied to the study of price forecasts, exchange rates, or interest rate expectations; it also serves as a methodology for understanding the expectations formation mechanism in monetary policy designs. Although the theoretical soundness of REH has been firmly established, its empirical support is an ongoing question. First, there are no conclusive and convincing arguments on how the theory of rational expectations should be tested. In other words, economists are ambiguous about whether to use direct tests based on survey data