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VOLBERT ALEXANDER / GEORGE D. DEMOPOULOS

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PREFACE

This study is the outcome of a research project financed by the German Volkswagen-Foundation for the period 1983-85. The project has been undertaken as a "joint product" of a "German-" and a "Greek"-Group. In this context we want to express our sincere appreciation for all the unbureaucratic help we received from the foundation.

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Needless to say we are responsible for all remaining errors and shortcomings.

Volbert Alexander George D. Demopoulos

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CHAPTER ONE

INTRODUCTION

The main purpose of this study is an analysis of influences running from Greek monetary and fiscal policy impulses to important macroeconomic variables, like real output, employment and inflation. The character of the Greek economy as a small open economy with intensive real and financial international relations implies, in addition, that aggregative effects must be considered affecting the Greek economy via different balance of payments mechanisms (external impulses).

Naturally the problem of aggregative effects of fiscal and monetary policy is as old as macroeconomic theory. After World War II it represents the central issue of the Keynesian stabilization policy approach. Up to the late sixties it was treated as a demand management problem according to the standard assumptions and conclusions of post-Keynesian-analyses.

The stagflation experiences in most Western economies at the beginning of the seventies shed some new light on the traditional Keynesian stabilization policy concept. New analytical concepts were developed to overcome the impotence of post-Keynesian-tools in explaining and dealing with the simultaneous problem of high inflation and unemployment: in addition to the demand oriented Keynesian analysis, the supply side of the aggregate goods market is considered more extensively. It is shown that the supply curve tends to be inelastic far before a full employment level. As a consequence, an increase in demand via expansionary fiscal or monetary policy measures has mainly inflationary effects. The discussion therefore shifts to economic relations of the supply side, namely to the labor and energy markets. "Supply-constraints" are incorporated explicitly into

macroeconomic models to reveal supply-determined consequences for an effective stabilization policy.

A second important development concerns expectations about future economic events. In particular, the incorporation of the rational expectations hypothesis into macroeconomic models shows some new insights into transmission processes from economic policy impulses to important economic aggregates. If transactors take into account all available information - a central characteristic of the rational expectations hypothesis - they also exploit information about strategies of economic policy authorities. In this situation no systematic economic policy can influence the economy without a systematic reaction of private transactors.

Both developments improve the explanatory power of economic theory according to a separation of output and inflationary effects of monetary and fiscal policy actions. As a result, a dramatic change in stabilization policy concepts occurred in many Western countries. Many central banks and governments have become very sceptical about the effectiveness of short run demand oriented policy actions. In contrast, they have followed more and more a long run supply side oriented policy concept with great emphasis on price stability [Alexander (1985)].

The theoretical foundation for the so-called stagflation models, which include supply constraints and rational expectations, was given by the work of Lucas, Sargent, Wallace, and Barro [Lucas (1973), Sargent (1976), Sargent/Wallace (1976), Barro (1977)] . In nearly all papers following this Lucas-Barro-Sargent/Wallace-approach (LBSW-approach), a strong concentration on monetary policy can be observed. In a second round, the analysis is extended to open economies with the consequence that in addition to monetary policy, external impulses affect real output, employment and inflation [Alexander/Loef (1979), Parkin (1981), Parkin/Bentley/Fader (1981), Loef (1984), Cozier (1986)]. Only little attention is paid to fiscal policy. The normal way fiscal policy enters these models can be described as follows: One or several alternative summary

measures of fiscal policy are constructed and treated as explanatory variables in the goods demand functions [Barro (1977), Neumann (1978), Wogin (1980), Wasserfallen (1981)]. In constructing the summary fiscal policy measures, well known concepts are used, like the fiscal stimulus, full employment budget surplus, etc., which implies that, by construction, these measures are dominantly demand oriented.

If we look to the basic characteristics of the LBSW-models the following aspects should be stressed:

(1) The demand side is specified in a very rudimentary form. The demand for output Y^d is explained by policy impulses and past values of Y^d. The compatibility with the Andersen-Jordan-equation representing the goods demand function is obvious [Andersen/Jordan (1968)].

(2) The supply side is given by a Lucas-supply function. The supply of real output Y^s is determined by a potential (Y^p) and a cyclical (Y^c) component, where Y^c depends on the difference between the actual and expected inflation rate ($\hat{P}$-$\hat{P}^e$).

(3) Rational expectations about the inflation rate $\hat{P}$ are modelled by treating the expected value of the inflation rate $\hat{P}^e$ as an endogenous variable.

(4) Real output and employment are only influenced by potential aggregates and unexpected policy impulses.

(5) The rate of inflation is determined by potential, expected and unexpected variables, where the expected impulses dominate the unexpected ones.

(6) The main focus of analyses of the LBSW-type lies on the explanation of the cyclical output component Y^c. Potential output Y^p and the corresponding natural rate of unemployment are treated as exogenous variables.