

# “Inflationary Expectations and the Demand for Money: The Greek Experience

## A Comment and Some Different Results”

### A Reply

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*Himarios's* comments on our article refer first to our implementation of the rational expectations approach and second to our empirical result that the market for  $M1$  is segmented from the markets for financial and real assets. In this note we purport to clarify a few points in our article and show that *Himarios's* criticisms are not well founded.

To avoid misunderstanding of what our assumptions about rational expectations are, we should note that the expected rate of inflation to be used as an opportunity cost variable in the demand-for-money function is defined as the rate of inflation expected to prevail between time  $t$  and time  $t + 1$  and should perhaps be written with two subscripts, i.e.  ${}_t\dot{P}_{t+1}^e$ . Thus the expected rate of inflation and the actual rate of inflation in our paper do not refer to the same time period. In this way the approximation used bypasses the estimation problem mentioned by *Himarios* which is associated with the rational expectations approach. On the other hand, *Himarios* erroneously uses the “weakly” rational predictor  $\dot{P}_t^* = E(\dot{P}_t/\dot{P}_{t-1}, \dot{P}_{t-2} \dots)$  as a second proxy for the expected rate of inflation. The correct proxy would be  ${}_t\dot{P}_{t+1}^* = E(\dot{P}_{t+1}/\dot{P}_t, \dot{P}_{t-1}, \dots)$ .

As regards our conclusions that the market for  $M1$  is segmented from the markets for either financial or real assets, these are based on the results for the subperiod 1964 - 1978 and not for the whole period 1955 - 1978. It seems that our stability tests showing that the demand function is unstable over the period 1955 - 1978 (p. 564) went unnoticed by *Himarios*. The introduction of the dummy variable for 1967 does not remove the problem of instability as indicated by the application of the *Chow* test to his equation (3). Also, the equations of Table II if estimated for the period 1964 - 1978 yield the same conclusion, namely that the interest rate is not

significant. As an example, the first equation of Table II estimated for the period 1964 - 1978 is as follows:

$$\ln (M/P)_t = - 0.70 + 0.52 \ln Y_t + 0.06 DUM - 0.004 \ln RS_t + 0.461 \ln (M/P)_{t-1}$$

(1.14) (2.75) (2.05) (0.07) (2.25)

(*t* values in parentheses)       $\bar{R}^2 = 0.99$        $h = - 1.60$

Similarly, the expected rate of inflation proxied by the current rate of inflation is found to be insignificant in the real partial adjustment model over the period 1964 - 1978, i. e.

$$\ln (M/P)_t = - 0.91 + 0.50 \ln Y_t + 0.06 DUM - 0.16 \ln (P_t/P_{t-1}) + 0.50 \ln (M/P)_{t-1}$$

(1.56) (2.95) (2.11) (0.94) (2.96)

(*t* values in parentheses)       $\bar{R}^2 = 0.99$        $h = - 1.12$

Therefore our conclusions that in the period 1964 - 1978 the demand for *M1* is not sensitive to changes in opportunity cost do not seem to be affected either by the introduction of a dummy variable for 1967 or by the use of the real partial adjustment model.