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UDK: 336.748.12(4-12)
DOI: 10.1515/jcbtp-2016-0007

Journal of Central Banking Theory and Practice, 2016, 1, pp. 141-157
Received: 29 July 2015; accepted: 25 August 2015

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Aggregate Demand–Inflation Adjustment Model Applied to Southeast European Economies

Abstract:Applying IS-MP-IA model and the Taylor rule to selected Southeast European economies (Albania, Bosnia and Herzegovina, Macedonia and Serbia) we find that the change of effective exchange rate positively affects output, while the change of the world interest rate negatively affects output or it does not affect the output at all, and additional world output would help to increase output of the selected economies.

A lower ratio of government consumption spending to GDP would also increase the output of the selected economies. Hence, fiscal prudence is needed, and the conventional approach of real depreciation to stimulate exports and raise real output does not apply to the selected Southeast Europe economies.

When private household consumption is employed in the model, the coefficient on government spending to nominal GDP is insignificant implying that Ricardian equivalence does hold for the selected countries.

JEL Classifications: D05; E05; F04; G28; H05; P02

Keywords: IS-MP-IA, Taylor Rule, inflation targeting, monetary policy function, government spending to nominal GDP, world interest rates

Introduction

David Romer (Romer 2000) proposed an alternative to the IS-LM model and AS-AD model. This model makes assumption that central banks in the world