

COPYRIGHT NOTICE:

P. Agénor & P. J. Montiel: Development Macroeconomics, Third Edition

is published by Princeton University Press and copyrighted, © 2008, by Princeton University Press. All rights reserved. No part of this book may be reproduced in any form by any electronic or mechanical means (including photocopying, recording, or information storage and retrieval) without permission in writing from the publisher, except for reading and browsing via the World Wide Web. Users are not permitted to mount this file on any network servers.

Follow links for Class Use and other Permissions. For more information send email to: permissions@press.princeton.edu

DEVELOPMENT MACROECONOMICS

Introduction and Overview

ATTENTION to short-run macroeconomic issues in the developing world emerged largely in the context of the monetarist–structuralist debate about the sources of inflation in Latin America during the late 1950s and 1960s.¹ Whereas the early literature in this area was essentially nontechnical, a growing analytical literature has developed since the early 1970s to address a succession of macroeconomic woes that have afflicted developing countries. This literature has reached a level of rigor and sophistication comparable to that which characterizes industrial-country macroeconomics. Much of it, however, is written at an advanced level and is scattered over a wide range of professional economic journals.

Partly as a result of this, the existing teaching material on developing economies has largely ignored these recent developments in macroeconomic analysis. Consequently, existing texts in development economics and macroeconomics do not meet the needs of those concerned with macroeconomic issues in developing nations. Economic growth, rather than short-run macroeconomic policy, remains the dominant concern in existing texts on development economics. Attention is often concentrated on the contribution of aggregate supply to economic growth, in terms of either the productive use of unlimited supply of labor or the removal of particular supply constraints, such as a shortage of domestic saving or foreign exchange.² Similarly, in standard textbooks in macroeconomics (or open-economy macroeconomics) the analysis is generally conducted in terms of advanced, industrialized economies. When issues relevant to developing countries are raised, there is often no attempt to adapt the theoretical framework to the particular conditions and structural characteristics of these countries.³ A series of influential books by Lance Taylor (1979, 1983, 1991) does attempt to provide a systematic analytical treatment of developing-country macroeconomic issues. However, Taylor is more concerned in these books with presenting the “new

¹ Many of the issues that were raised at the time are still the focus of considerable interest among economists and are discussed in various parts of this book.

² For instance, two of the most popular textbooks in the field of economic development, those of Gillis et al. (1992) and Todaro (1994), devote only a few pages to short-run macroeconomic issues.

³ To a large extent, this is also the case for recent books attempting to focus on development macroeconomics, such as Cook and Kirkpatrick (1990) and Ross (1991). Although some of these books provide ample factual information on developing economies, from an analytical point of view they hardly go beyond simple open-economy models developed for an industrial-country setting.

Structuralist” approach to macroeconomics as a challenge to the “orthodox” approach, rather than presenting a balanced overview of the field. Consequently, many of the areas in which “orthodox” thinking has provided much insight (and, ironically, even strengthened new structuralist arguments in some cases) tend to be ignored in these books, and the fundamental complementarities that often exist between rival schools of thought are lost.

Development Macroeconomics, 2nd edition, provides a more balanced approach to the macroeconomics of developing nations. It presents a coherent, rigorous, and comprehensive overview of the analytical literature in this area. It reviews attempts to formulate and adapt standard macroeconomic analysis to incorporate particular features and conditions found in developing economies, and uses a variety of models to examine macroeconomic policy issues of current concern to these countries. Empirical evidence on behavioral assumptions as well as on the effects of macroeconomic policies in developing countries is examined systematically, in light of the predictions of the analytical models. The book’s level of rigor makes it suitable for teaching graduate students in development economics, macroeconomics, and international economics, or advanced undergraduates with a solid background in standard macroeconomics and international economics. It should also be of interest to policymakers (and their advisors) in developing countries. The book provides extensive references to the literature, with the objective of making this material more easily identifiable to students and researchers, and eventually of helping to establish development macroeconomics as a coherent and legitimate subfield of development economics and macroeconomics.

1 Overview of the Book

We set the stage by attempting to define the scope and objectives of development macroeconomics. Traditional approaches to development macroeconomics (as exemplified by the monetarist–structuralist debate of the 1950s and 1960s) are reviewed in Chapter 1. Our discussion emphasizes the need to take structural factors systematically into account in macroeconomic analysis. The chapter goes on to describe the structural features that, in our view, distinguish most developing countries from the textbook industrial-country model. Among the distinctive aspects of development macroeconomics are the usefulness of a three-good (exportables, importables, and nontradables) disaggregation of production and the roles of financial repression, informal markets, public sector

production, imported intermediate goods, working capital, and labor market segmentation.

The rest of the book is organized into five parts. The first part focuses on macroeconomic relationships and differences in market structure between industrial and developing nations. Chapter 2 focuses on the accounting framework and some key aspects of macroeconomic modeling for developing countries. Essentially, macroeconomic modeling consists of giving economic content to a set of aggregate accounting relationships by adding behavioral equations and equilibrium conditions. The accounting relationships that are relevant for a particular case depend on the structure of the economy. Thus, this chapter describes a “benchmark” accounting framework that can be adapted for specific uses later in the book. Next the chapter turns to particular modeling issues, the first of which involves alternative choices of commodity disaggregation. The particular role played by the structural features of the labor market and the degree of development of the financial system are also reviewed.

Chapter 3 focuses on behavioral functions, exploring in particular how the specification of standard macroeconomic functions must be altered to reflect structural features that are either specific to or more pronounced in the developing world. This includes liquidity constraints in aggregate consumption; credit and foreign exchange rationing as well as debt overhang effects on production and private investment; uncertainty and irreversibility effects on investment decisions; and the effects of financial repression, currency substitution, and informal financial markets on money demand. In each case we present a critical overview of the recent empirical and analytical work.

The second part of the book focuses on fiscal, monetary, and exchange-rate policies in developing countries. It begins, in Chapter 4, by documenting a wide range of regularities in macroeconomic fluctuations for a large group of developing countries. The data examined cover a wide range of variables and include industrial output, prices, wages, various monetary aggregates, domestic private sector credit, fiscal variables, exchange rates, and trade variables. The relationship between economic fluctuations in these countries and two key indicators that proxy for economic activity in industrial countries—an index of industrial country output and a measure of the world real interest rate—are also discussed. Among the findings are that output volatility varies substantially across developing countries, but is on average much higher than the level typically observed in industrial countries. The results also suggest that supply-side shocks play a predominant role in driving business cycles in developing countries.

Chapter 5 examines the nature and implications of fiscal rigidities and the effect of fiscal deficits on a variety of macroeconomic variables. An

inadequate tax base and administrative difficulties in tax collection are key macroeconomic problems in the developing world and typically lead to inefficient systems of taxation in which high tax rates are levied on a narrow base. In addition, these structural features, coupled with political and other constraints on the level of government expenditures, result in heavy reliance on revenue from financial repression and multiple-currency practices, on the inflation tax, and on excessive debt financing, both external and (less familiarly) domestic. Actual or prospective fiscal insolvency has been at the heart of many macroeconomic problems in such countries, such as debt crises, capital flight, excessive domestic real interest rates, and hyperinflation. The chapter presents an overview of fiscal issues, summarizing key empirical facts and drawing on the analytical relationships among the various macroeconomic problems described above and fiscal rigidities.

Financial repression is a central macroeconomic phenomenon in many developing countries. Yet the theory of short-run macroeconomic management—as opposed to that of efficiency and growth issues—under financial repression is not well developed. In Chapter 6 we analyze the tools of monetary policy and the monetary transmission mechanism under financial repression in the context of an economy that is at least semi-open financially. We present empirical evidence on financial openness in developing countries, on government revenue from financial repression, and on the effects of financial repression on saving, investment, the degree of capital mobility, and the extent of capital flight. Alternative analytical approaches to modeling informal credit and foreign exchange markets at the macroeconomic level are also discussed, with an emphasis on the role of portfolio factors and expectations in the determination of informal interest rates and parallel exchange rates in these models. The last part of the chapter examines how informal financial markets affect the dynamic response of the economy to various types of macroeconomic policies. The issue is important because such markets are forward-looking and will thus bring to the present the effects of anticipated future policy changes. Thus, the consequences of credibility—or its absence—will often be transmitted through such markets in developing countries. A medium-size general equilibrium simulation model with both informal credit and foreign currency markets is also used to study the effects of alternative policy shocks.

Chapters 7 and 8 discuss various issues related to exchange rate management in developing countries. The primary message of Chapter 7 is that exchange-rate systems in the developing world differ from those in industrial countries. Fixed official rates have been much more prevalent, but these have often been accompanied by foreign exchange rationing

and the emergence of parallel markets. Both of these phenomena have profound macroeconomic implications. The chapter also emphasizes the effect of credibility—and the lack thereof—on inflation under a fixed exchange-rate regime. In addition, the management of the official exchange rate raises a number of important macroeconomic issues, such as the possibility that devaluation may have contractionary effects on output or that targeting the real exchange rate may destabilize the price level. Chapter 8 provides an extensive review of the analytical issues involved in these controversies, as well as an overview of the empirical literature.

As discussed in Chapter 2, the analysis of labor markets in development economics has focused traditionally on issues such as the determinants of rural to urban migration, the growth of the urban labor force and the associated rise in urban unemployment, and the effects of education on levels of earnings. The role that the structure of labor markets may play in determining the long-run effects of trade reforms and structural adjustment policies has also been long recognized. In the past few years, however, there has been much interest in the role of labor markets in the context of short-run macroeconomic adjustment in developing countries. Chapter 9 examines the role of labor market segmentation and sectoral wage rigidity in the transmission of macroeconomic policy shocks.

The third part of the book focuses more closely on short-run stabilization issues in light of the features of developing economies described previously. Because high inflation has been the central problem confronting many well-known stabilization episodes in the developing world, we begin Chapter 10 by reviewing attempts at stabilizing high inflation in developing countries. We classify stabilization attempts into the categories of money-based and exchange-rate-based programs, and we draw on the voluminous existing literature to summarize experience with alternative approaches to stabilization, including the literature on “heterodox” programs. Whereas Chapter 9 is mainly descriptive in nature, Chapters 11 and 12 are mainly analytical. Chapter 11 presents alternative models of the inflationary process, focusing on differences between “orthodox” and “new structuralist” approaches, and examines the macroeconomic dynamics associated with monetary and exchange-rate policy rules in a context where international capital mobility is imperfect. Chapter 12 then discusses three important sets of issues that have arisen in the context of exchange-rate-based disinflation programs (the behavior of output, real interest rates, and real wages) and presents an extensive discussion of the role of credibility factors in disinflation programs. We examine, in particular, several alternative proposals to enhance the credibility of stabilization plans.

