

Preface to the Fourth Edition

A significant analytical literature began to develop in the early 1970s to address a succession of macroeconomic woes that afflicted developing countries. By the 1980s, this literature had reached a level of rigor and sophistication comparable to that characteristic of macroeconomic analysis for high-income countries. However, these developments were not typically reflected in standard textbooks in macroeconomics (or open-economy macroeconomics), where the analysis was generally conducted with analytical frameworks designed for high-income economies. When issues relevant to developing countries were raised, there was often no attempt to adapt the theoretical framework to the particular conditions and structural characteristics of such countries.

The first three editions of *Development Macroeconomics* attempted to fill this gap. Their objective was to present a coherent, rigorous, and comprehensive overview of the analytical literature in this area. They reviewed attempts to formulate and adapt standard macroeconomic analysis to incorporate particular features and conditions characteristic of developing economies, and used a variety of analytical models to examine macroeconomic policy issues of concern to those countries. The analytical material was supplemented with empirical evidence on behavioral assumptions as well as on the effects of macroeconomic policies in developing countries.

The third edition was published in 2008, and was largely written during 2006 and early 2007. At the time, the Great Moderation was still ongoing in high-income countries, and the first indications of trouble in the U.S. housing market were just beginning to appear. For most developing countries the decade of the 2000s had been a prosperous one up to that point, with many countries experiencing rapid growth, low inflation, and favorable performance in their external accounts. Those positive outcomes were the results of the structural and macroeconomic reforms implemented during the 1990s (described in earlier editions of this book) as well as a very favorable external environment. Macroeconomic stabilization issues therefore tended to move to the background of policy concerns, giving way to concerns with structural issues such as poverty and income distribution, unemployment, reform of the legal system and the civil service, and improvements in accountability and transparency of government operations.

The outbreak of the Global Financial Crisis (GFC), which originated in the United States and reached its trough in late 2008 and early 2009, changed this situation dramatically.¹ The increased commercial and financial openness that most developing countries had embraced during the reforms of the 1990s in the successful pursuit of improved efficiency and growth had as its flip side heightened exposure to external real and financial shocks, and the shocks of both types generated by the GFC proved to be severe indeed. Once again, international turbulence aggravated the stabilization challenge for developing countries, and once again stabilization issues moved to center stage. Issues such as the appropriate management of the domestic financial system, policy responses to capital inflows and outflows, the formulation of exchange-rate policy, and the pursuit of monetary and fiscal policy regimes that simultaneously achieve medium-term credibility and short-run flexibility, have once again moved to the center of the policy debate. As in the past, these issues have emerged in distinctive form among developing countries, where greater commercial openness, more fickle capital flows, less well-established macroeconomic institutions and policy regimes, and significantly less confidence in macroeconomic management have all combined to produce especially acute challenges.

The new macroeconomic challenges developing countries are facing have made this an appropriate time to introduce a new edition of this book. In addition to a general updating of both empirical and analytical material, the third edition has been substantially revised to reflect the changed environment in which developing countries now operate. The coverage of issues such as public debt and the management of capital inflows has been expanded. New sections and chapters have also been added on fiscal discipline, monetary policy regimes, currency, banking and sovereign debt crises, currency unions, and the choice of an exchange-rate regime. In addition, the coverage of stabilization programs has been expanded to incorporate important recent experiences. A new chapter has been added on dynamic stochastic general equilibrium models (DSGEs) with financial frictions, to reflect how the new focus on financial issues in macroeconomics in the wake of the GFC has started to reshape our profession's thinking on the role of such frictions in both generating as well as propagating macroeconomic shocks. We have also added new material on macroprudential regulation as a tool to simultaneously preserve financial and macroeconomic stability.²

Instructors and students can visit the book's website at <http://press.princeton.edu/titles/10494.html> to find supplemental materials relating to the text.

¹ See Gorton and Metrick (2012) for an overview of the key facts and mechanisms behind the GFC.

² As in previous editions, we have refrained from discussing issues pertaining specifically to the reforming socialist countries of Eastern Europe and the former Soviet Union. In many regards, these countries share common structural features with developing countries, and as time passes since their initial stages of transition, this has become ever more so. Their current policy concerns (such as the management of capital flows, the stability of their financial systems, and the design of their monetary and fiscal policy regimes) are increasingly the same as those faced by policymakers around the developing world. The majority of the policy lessons derived in the book have therefore now become as pertinent to these countries as they are to countries that did not previously experience central planning.

In preparing this new edition, we have continued to benefit from comments and suggestions made by various readers of the first three editions. We also owe a special and continuing debt to our coauthors, current and former colleagues, and students, most notably Joshua Aizenman, Koray Alper, Nihal Bayraktar, Keith Blackburn, Otaviano Canuto, Jerry Caprio, Karim El Aynaoui, Eduardo Fernandez-Arias, Alejandro Izquierdo, Henning Jensen, Mohsin Khan, Prachi Mishra, Kyriakos Neanidis, Emmanuel Pinto Moreira, Luiz Pereira da Silva, Eswar Prasad, Carmen Reinhart, Issouf Samake, Murat Ucer, Nadeem Ul Haque, Carlos Végh, and Devrim Yilmaz, although none of them bears any responsibility for the views expressed in the book. Financial support from the University of Manchester and Williams College is also gratefully acknowledged. Finally, we would like to express our appreciation to the publishers of the *Handbook of International Macroeconomics*, the former *IMF Staff Papers*, the *International Journal of Central Banking*, the *Journal of Development Economics*, the *Journal of Economic Dynamics and Control*, the *Journal of International Money and Finance*, the *Journal of Macroeconomics*, the *Journal of Money, Credit, and Banking*, *Open Economies Review*, *Oxford Economic Papers*, and Princeton Essays and Studies in International Finance, for permission to use material from some of our previous contributions.