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# Introduction

# 1

## 1.1 What the book is about

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This book is about monetary economics. This field searches for answers to important questions: How does finance affect economic performance? What is the link between money and economic growth? How are the actions undertaken by a country's monetary authorities transmitted to the rest of the economy? Our basic stock of knowledge in monetary economics is relevant to all economies, rich or poor. In this book, however, we emphasize issues that are particularly relevant for developing economies.

Why do these developing economies need a special focus? The main reason is that institutional peculiarities obscure the understanding of developing countries' problems if we simply employ models developed with more advanced economies in mind. Thus this book's plan entails addressing theoretical, institutional and empirical elements that are vital for understanding monetary and financial phenomena in developing countries, but are taken for granted or are not relevant when analysing developed economies.

Many of the key issues we shall be discussing are essential for understanding the process of economic development, and that is why they fall into the intersection between the fields of monetary economics and development economics. Early important contributions to the field are McKinnon's (1973) and Shaw's (1973) texts examining money's role in economic development. These authors emphasized the adverse impact on investment and growth of financial repression policies – for example, interest rate ceilings.

Banking soundness and financial depth, as well as rural- and micro-credit markets, will prove to be significant in fostering economic growth and development. An interesting example illustrating the latter point is Bangladesh's Grameen Bank – founded by Muhammad Yunus, an economist who won the Nobel Peace Prize for his path-breaking scheme. This initiative embarked on overcoming the market's failure to deliver much-needed financial services, and pioneered the micro-credit movement. It aimed originally at providing small loans to seemingly risky borrowers, and the experiment has resulted

in remarkably high loan recovery rates (see, for example, Armendáriz de Aghion and Morduch, 2005).

For this finance–growth association to operate, restraining inflation and maintaining overall macroeconomic stability is vital, though not on its own sufficient, because inflation and instability distort the private sector’s decision-making process. In this context, institutions to safeguard macroeconomic and financial stability are central.

The broad issues described here constitute the book’s driving themes. In further elucidating the volume’s scope, what remains of this chapter proceeds as follows: section 1.2 overviews the chapters ahead; section 1.3 highlights key features characterizing monetary and financial conditions in developing economies; and section 1.4 continues on these lines by discussing some empirical facts about monetary phenomena in developing countries.

## 1.2 An overview of the book

The text is organized as follows. Chapter 2 analyses theoretical insights and empirical evidence on banking, financial structure and stock markets. The exposition focuses on why these institutions are critical to support economic growth and development.

Chapter 3 focuses on rural credit markets and microfinance in developing countries. These institutions are of great relevance in the absence of the more advanced markets likely to be found in developed economies, generally because of relatively high transaction costs. For example, there are asymmetric information problems in lender – borrower relationships (for example, a lender may know the distribution of borrowers, but not a particular borrower’s probability of success) which may be addressed via peer monitoring in group lending agreements. This type of arrangement effectively allows the kick-starting of otherwise financially unfeasible projects – notably in the absence of more standard collateral.

Chapter 4 explains theories linking money and growth, starting with James Tobin’s neo-classical monetary growth model, and then moves on to more recent contributions. It is worth pointing out that the literature of Chapter 4 is related closely to, but provides a different angle from that mentioned in Chapter 2. Chapter 5 deals with basic Keynesian and monetarist approaches to monetary economics.

Chapter 6 reviews the literature on empirical money demand studies. These functions are essential in theoretical and empirical macroeconomic models. This role is heightened in particular in developing economies, where monetary policy is generally based on a monetary programme. For this reason, money demand remains an important policy and research topic in developing countries.

Chapter 7 explains the institutional framework under which monetary policy-making operates in developing countries. This chapter pays special attention to issues such as central bank independence and policy outcomes. In this context, weak institutions, lack of central bank independence and a paucity of monetary instruments can make monetary control extremely difficult.

Along closely related lines, Chapter 8 engages with the literature on the theory and findings on monetary policy's transmission mechanism in developing countries. This chapter also surveys monetary policy reaction function studies, which attempt to explain developing countries' actual central bank behaviour. Further, monetary policy rules and the inflation targeting debate – and particularly their relevance for developing countries – are central in this exposition. In this regard, note that in their quest to achieve macroeconomic stability, institutions throughout the developing world are moving away from traditional monetary and exchange-rate targeting and towards adopting an interest-rate orientated policy. In particular, adopting inflation targeting – a policy within which inflation is the monetary policy's overriding goal – is a common feature of many developing countries, such as, for example, Brazil. In this context, issues such as fiscal rules, and fiscal and monetary policy interactions, come forcefully into play.

Chapter 9 explains the relationship between money, inflation and growth. A key controversy is over the threshold level of inflation at which economic growth begins to slow down, and whether this level in fact differs between developed and developing economies.

Chapter 10 deals with exchange rate policies in developing countries. Even in the light of widespread developments such as inflation targeting – a policy framework that implies adopting a floating exchange-rate regime – choosing and administering an exchange-rate regime remain of consequence for policy-makers across the developing world.

Chapter 11 explains debt problems in developing countries. In reality, we see that, for example, several Latin-American countries succeeded in breaking away from the 1980s debt predicament only by restructuring part of their sizeable debt into tradable Brady bonds. The text will be examining related policies such as the joint IMF – World Bank Highly Indebted Poor Countries (HIPC) initiative that provides debt relief. A common trigger-point for reversing unsustainable debt dynamics in developing countries is the loss of access to international financial markets caused by financial crises. The rest of this chapter discusses the mechanisms linking macroeconomic fundamentals and financial crises. Developing economies tend to be liable to financial crises, principally because financial development and institutions for macroeconomic stability are fragile. Important matters related to financial crises include the impact of capital flows reversals ('sudden stops') and the role of firms' balance sheets in propagating crises.

Chapter 12 looks at the key international financial institutions, especially the International Monetary Fund (IMF), and at how they relate to developing countries. Policy and academic circles now largely agree that the international financial architecture is deficient, having reflected on the major crises that occurred during the 1990s in Mexico, Asia and Russia, and the subsequent efforts to cope with the aftermath of these events. For example, the *ad-hoc* International Financial Institutions Advisory Commission – the 'Meltzer Commission' – suggests that the IMF should focus on strengthening its roles of safeguarding international financial stability and acting as a quasi-lender of last resort.

### 1.3 Developing countries' idiosyncrasies

The monetary and financial challenges facing developing countries are often unlike those in advanced economies. Some of the related characteristics reveal themselves following transitory shocks to the economy, but others are structural or persistent in nature. What follows draws attention to some of these salient features without intending to provide an exhaustive list.

First, financial underdevelopment, and particularly weak financial institutions and a lack of adequate prudential supervision, prevail in developing countries. This is one reason why, in these economies, financial crises are usually more protracted and difficult to resolve. In developing countries, incomplete information is an important feature, often leading to financing shortages for otherwise potentially fruitful ventures; the development of rural credit institutions and other micro-finance schemes is a consequence of the aforesaid financial underdevelopment, and these schemes feature prominently in developing countries.

Second, poor fiscal management tends to amplify the problems characterizing monetary dynamics in developing countries, and this feature can lead to undesirable situations such as fiscal dominance. In the context of fiscal dominance, the central bank may find itself financing fiscal budget deficits and debt repayments by printing money, allowing the government to comply temporarily with an otherwise non-binding fiscal constraint. Such a mechanism often features in developing economies' policy-making – sometimes leading to hyperinflation, as in Bolivia during the 1980s.

Third, largely because of the factors explained above, like fiscal dominance, monetary institutions in developing countries tend to command low credibility with the general public. And in this context, additional matters come forcefully into play. These include the turnover rates of central bank governors, the lack of independence of the monetary authorities from the government, and deficiencies in the training of the central bank's staff.

In this regard, Fry *et al.*'s study of central banking in forty-four developing countries led them to state that 'we find that central banks in developing countries face environments that differ radically from the environments faced by central banks in the richer OECD countries' (Fry *et al.*, 1996, p. 1). Overall, these features complicate the monetary authorities' efforts towards achieving and maintaining macroeconomic stability – a necessary condition for growth and development to flourish.

Fourth, developing countries tend to be more subject to financial and assorted exogenous shocks than are developed economies. In the past, this susceptibility led them to request assistance from international financial institutions such as the IMF and the World Bank. But even though developing economies still frequently demand financial assistance, they are gradually breaking away from the boom–bust cycles of the past by making serious efforts to consolidate their institutions for macroeconomic stability.

Still, many challenges remain. For example, countries that have formally adopted an inflation-targeting regime face serious obstacles in their attempts to keep inflation within

the target range. This is largely because of the types of shocks they face on a frequent basis – such as exchange rate fluctuations and adverse terms of trade developments.

## 1.4 Some stylized facts

Examining some stylized facts from the relevant literature seems to be a useful step towards supporting our line of argument. Granted, there is not much systematic and comparable empirical evidence on micro-monetary issues in developing countries, but there is some reasonable evidence on the behaviour of basic macro-monetary time series in these countries.

A useful starting point is Fry *et al.*'s (1996) project on central banking in developing countries – which is examined further in Chapter 7. Drawing on data from forty-four developing countries (the 'Bank of England Group') they discovered the following statistical associations:

- Inflation and government deficits are positively linked to the ratio between reserve money and broad money,
- Commercial banks' reserves in relation to deposits are positively associated with both inflation and government deficits.
- The government's borrowing from the central bank and the proportion of that borrowing to total domestic credit is positively linked to inflation.
- Economic growth is negatively linked to the government's borrowing from the central bank and to the proportion of that borrowing to total domestic credit.
- Further, economic growth is negatively related to government deficits and to foreign debt,
- Inflation and growth are negatively related.

Agénor *et al.* (2000) studied a more compact sample of twelve developing countries (Chile, Colombia, India, the Republic of Korea, Malaysia, Mexico, Morocco, Nigeria, the Philippines, Tunisia, Turkey and Uruguay), but embark on characterizing their cyclical fluctuations in more detail. They show that output volatility in these countries tends to be larger than in advanced economies, and the empirical regularities they derive for money and credit are relevant to this book's theme. Agénor *et al.* show that the correlation between industrial production and money (for various definitions) does not generate consistent evidence that money causes output. Their conclusion is striking: 'These results may indicate the need to develop a different analytical framework for studying the relationship between monetary policy and macroeconomic fluctuations in developing countries' (Agénor *et al.*, 2000, p. 272).

The study also investigates the link between domestic, private-sector credit and economic activity. Banks in developing countries often play a heightened role because

capital markets are shallow or non-existent. Agénor *et al.* (2000) also find that private-sector credit and economic activity are positively related in some of the countries they investigate. This is an important (albeit statistically weak and thus preliminary) finding. In the light of this result, the authors hypothesize that an overly restrictive monetary policy could exacerbate the cost in reduced output of stopping or reducing inflation. Such results may prove to be particularly important in, for example, designing and implementing future macroeconomic stabilization programmes.

Despite the above results, many fundamental relationships seem to hold in the long run for both developing and developed countries – for example, the link between money growth and inflation. In testing this relationship, McCandless and Weber (1995) analysed 110 countries, considering sub-samples of OECD (Organisation for Economic Co-operation and Development) and Latin-American countries.

The authors' key findings are that money growth rates and inflation rates are highly correlated both before and after splitting their original sample into different country groups. Moreover, their results are robust for different definitions of money. This evidence endorses Milton Friedman's tenet that inflation is always and everywhere a monetary phenomenon; by contrast, McCandless and Weber find no systematic correlation between money growth and output growth.

A word of caution is in order before closing this chapter. As with all empirical evidence, the facts discussed in this section are not definitive, and interpreting them should proceed accordingly. It is our expectation that the chapters ahead will facilitate the shaping of an eclectic view of monetary phenomena in developing countries, and of how they interact with the rest of the economy.

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