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PART 1

The Macroeconomic Framework

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Introduction and Overview

As of 2009, the International Monetary Fund (IMF) had 192 member countries or territories. In each of these, as well as in several other countries or territories that are not members of the IMF, policy makers face the continuous need to make decisions about macroeconomic policies – decisions about fiscal policy, monetary policy, and exchange rate policy as well as about many other policies that affect the aggregate economy. The vast majority of the countries in which these decisions are made are developing countries – countries with incomes per person that are much lower than those in the advanced economies of North America, Western Europe, and East Asia. What this means is that most macroeconomic policy decisions around the world are actually made in the context of developing economies.

Though people may be the same everywhere, the economies in which they live are not. Among other things, economies differ with respect to their macroeconomic institutions, their production structures, and their economic links with the rest of the world. These factors, as well as many others that distinguish developing economies from advanced industrial economies, affect the way that economies work at the macroeconomic level. Moreover, developing countries themselves are far from homogeneous. Most important, a relatively small subgroup of such countries, typically at middle-income levels, has achieved *emerging-market* status – a term that is used to denote economies that have become closely linked financially with international capital markets. In both emerging-market economies and other developing countries, the economic environment in which macroeconomic decisions are made is quite different from the environment typically described in standard macroeconomic textbooks for advanced industrial countries.

This book is about macroeconomic analysis in emerging and developing countries. Although many of the analytical tools that we will use here are similar to those applied in industrial countries, a focus on macroeconomics in emerging and developing economies requires a change in emphasis along several directions. For example, in both emerging and developing economies, fiscal policy is often the source of macroeconomic shocks, and the solvency of the public sector (its ability to service its debt) is sometimes in question, a fact that has important macroeconomic implications. Such countries tend to be very open commercially but imperfectly (and sometimes sporadically) open financially. Similarly, only a small minority of emerging and developing economies maintains freely floating exchange rates, and the structure of financial markets in almost all of these economies is heavily dominated by commercial banks rather than securities markets. Finally, most of these countries enjoy very limited macroeconomic credibility, and their macroeconomic experience over the past several decades has been punctuated by severe instability and various types of crises, with problematic effects for their long-run growth prospects.

All these issues will be addressed in this book. As a point of departure, this chapter provides some background about the macroeconomic environment in which emerging and developing countries operate and describes some features of such economies that need to be taken into account when trying to understand how these economies work at the macroeconomic level.

I. COUNTRY CLASSIFICATIONS

When we draw distinctions, such as those referred to earlier, among different types of countries – that is, advanced industrial countries, emerging-market countries, and developing countries – to which countries are we referring exactly? One way to identify the specific countries that we might want to place in each of these groups is to make use of the classification systems employed by international organizations.

Three of the most commonly used classifications are those of the United Nations (UN), the World Bank (WB), and the IMF. The classification systems used by these institutions differ from each other because each system is designed to address the corresponding institution's specific operational needs. The UN, for example, works with economic groupings in which developing countries are classified into four main categories: least developed countries, landlocked developing countries, small-island developing countries, and transition countries (countries that recently undertook the transition from centrally planned to market economies). These categories do not exclude each other, so a country can belong to more than one category. The WB's analytical income categories, on the other hand, are based on the WB's operational lending categories, with countries divided into four groups according to their 2006 gross national income per capita: low income, lower middle income, upper middle income, and high income. The high-income category is in turn subdivided into high-income Organization for Economic Co-operation and Development (OECD) member countries and high-income non-OECD countries. Finally, the IMF's *World Economic Outlook* report divides the world into two major groups: (1) advanced economies and (2) emerging markets and developing countries. This last category is also classified according to analytical criteria that reflect the composition of

Table 1.1. *Country Classifications in Three International Organizations*

United Nations (for Developing Countries)	World Bank (Based on 2006 GNI Per Capita)	International Monetary Fund
Least developed countries	High income ($11,116 or more)	Advanced economies
Landlocked developing countries	Upper middle income ($3,596–$11,115)	Emerging-market and developing countries (subcategories by analytical group)
Small island developing states	Lower middle income ($906–$3,595)	
Transition countries [(1)]	Low income ($905 or less)	

[(1)] Countries in transition from centrally planned to market economies.

countries' export earnings, their net debtor-creditor positions, and whether they are part of the Heavily Indebted Poor Countries joint IMF-WB initiative. These classifications are summarized in Table 1.1.

We can use these classification systems to determine which specific countries fall into the advanced, emerging-market, and developing categories. Using the WB's criterion for identifying advanced countries and the IMF's criterion for separating emerging-market economies from among the remaining group of developing countries yields 34 advanced economies, 24 emerging economies, and 134 developing countries.[1] However, among the advanced economies in the WB classification, the four Asian tigers of Korea, Hong Kong, Singapore, and Taiwan are typically considered emerging economies because they reached their high-income levels relatively recently and still share many macroeconomic features with other emerging economies. Reclassifying these four countries as emerging-market economies yields the country classification presented in Table 1.2. Notice that of the 192 countries classified in the table, only 30 are advanced industrial countries. Thus the vast majority of countries (162 out of 192) are actually emerging and developing countries. Of these, 28 are emerging economies, including the large and systemically important Brazilian, Russian, Indian, and Chinese economies (collectively known as BRIC) as well as several other economies – such as Argentina, Chile, Mexico, Indonesia, Korea, and Turkey – whose recent macroeconomic histories have received a substantial amount of international attention.

II. ECONOMIC STRUCTURE AND MACROECONOMIC PERFORMANCE

Of course, the observation that macroeconomic policy decisions are primarily made in an emerging-market and developing-country context would not be very significant analytically if that context were quite similar to that for which most

[1] Emerging-market economies are developing economies that are included in the Morgan Stanley Capital International Index.

Table 1.2. *Advanced, Emerging, and Developing Economies*

Advanced Countries	Emerging Markets	Developing Countries		
Australia	Argentina	Afghanistan	Gambia, The	Niger
Austria	Brazil	Albania	Georgia	Nigeria
Belgium	Chile	Algeria	Ghana	Oman
Canada	China	Angola	Grenada	Panama
Cyprus	Colombia	Antigua and Barbuda	Guatemala	Papua New Guinea
Denmark	Czech Rep.	Armenia	Guinea	Paraguay
Finland	Egypt, Arab Rep.	Azerbaijan	Guinea-Bissau	Romania
France	Hong Kong, China	Bahrain	Guyana	Rwanda
Germany	Hungary	Bangladesh	Haiti	Samoa
Greece	India	Barbados	Honduras	Sao Tome and Principe
Iceland	Indonesia	Belarus	Iran, Islamic Rep.	Senegal
Ireland	Israel	Belize	Iraq	Serbia
Italy	Jordan	Benin	Jamaica	Seychelles
Japan	Korea, Rep.	Bolivia	Kazakhstan	Sierra Leone
Kuwait	Malaysia	Bosnia and Herzegovina	Kenya	Slovak Rep.
Luxembourg	Mexico	Botswana	Kiribati	Solomon Islands
Malta	Morocco	Bulgaria	Kyrgyz Rep.	Somalia
Netherlands	Pakistan	Burkina Faso	Lao People's Democratic Rep.	Sri Lanka
New Zealand	Peru	Burundi	Latvia	St. Kitts and Nevis
Norway	Philippines	Cambodia	Lebanon	St. Vincent and the Grenadines
Portugal	Poland	Cameroon	Lesotho	Sudan
Qatar	Russian Federation	Cape Verde	Liberia	Suriname
Slovenia	Singapore	Central African Rep.	Libya	Swaziland
Spain	South Africa	Chad	Lithuania	Syrian Arab Rep.
Sweden	Taiwan	Comoros	Madagascar	Tajikistan
Switzerland	Thailand	Congo, Democratic Rep.	Malawi	Tanzania
United Arab Rep.	Turkey	Congo, Rep.	Maldives	Togo
United Kingdom	Venezuela, Bolivian Rep.	Costa Rica	Mali	Tonga
United States		Côte d'Ivoire	Marshall Islands	Trinidad and Tobago
		Croatia	Mauritania	Tunisia
		Djibouti	Mauritius	Turkmenistan
		Dominica	Micronesia	Uganda
		Dominican Rep.	Moldova	Ukraine
		Ecuador	Mongolia	Uruguay
		El Salvador	Montenegro	Uzbekistan
		Equatorial Guinea	Mozambique	Vanuatu
		Estonia	Myanmar	Vietnam
		Ethiopia	Namibia	Yemen
		Fiji	Nepal	Zambia
		Gabon	Nicaragua	Zimbabwe

Source: Rogoff et al. (2004).

advanced-country macroeconomic models are designed. That turns out not to be the case. In general, economic theory gives us good reason to expect macroeconomic performance to be affected by a large number of country characteristics that differ significantly among advanced, emerging, and developing economies. Such characteristics include, for example, income per capita, economic size, the structure of production and trade, the composition of balance of payments flows, the degree of integration with international financial markets, the structure of the domestic financial system, the mechanism for formulating fiscal and monetary policies, the exchange rate regime, and the structure of labor markets.[2] In the rest of this section, we examine why each of these may matter.

1. Income Per Capita

The most obvious difference between advanced economies and the others is, of course, the definitional one that the former have much higher levels of per capita income than the latter. Indeed, the per capita income gap between the world's richest and poorer countries amounts to a factor of about 40! Differences in income per capita affect macroeconomic performance in a variety of ways.

First, differences in income per capita are associated with very large differences in institutional quality across countries (Easterly 1999). Many development economists in fact perceive a causal relationship between institutional quality and income per capita and attribute a large share of existing cross-country differences in income per capita precisely to differences in institutional quality (Acemoglu et al. 2004). Though these differences apply to broad institutions, such as the role of democracy versus autocracy, property rights, the rule of law, and the prevalence of corruption, they also apply to more narrowly macroeconomic institutions such as the quality and credibility of the central bank, the efficacy of budgetary institutions, and the efficiency of the civil service in administering the tax system and enforcing economic regulations.

Second, differences in income per capita are systematically related to differences in important macroeconomic relative prices such as the price of foreign goods in terms of domestic goods (the *real exchange rate*) or of today's goods in terms of future goods (the *real interest rate*).

Third, differences in income per capita should also be expected to affect the spending behavior of the different types of agents that macroeconomists typically study. Consider, for example, the behavior of the largest component of aggregate demand: private consumption. At low levels of income per capita, where households may have limited ability to save, private consumption is much more likely to track current household income than would be true at higher income levels, where households may have more discretion about when they consume.

[2] For an advanced treatment of this issue, see Agenor and Montiel (2008).

Finally, there are systematic differences across income levels in the macroeconomic role of government. In low-income countries, for example, government tends to play a much larger role in production and a much smaller role in income redistribution than it does in advanced countries. This may have implications for how the government budget responds to fluctuations in the prices of the country's export commodities or in the level of domestic economic activity.

2. Economic Size

A second important characteristic is economic size. Among both advanced and developing economies, most countries (excluding the United States, the European Union, China, and possibly Japan) are sufficiently small that they must essentially take the international economic environment as given to them and not as susceptible to being influenced by their own actions. However, the vast majority of emerging and developing countries are quite small, even by these small-country standards. Small economic size means two things:

1. Small countries tend to be quite specialized in their structures of production.
2. They also tend to be relatively open commercially in the sense that they trade extensively with the rest of the world; that is, the sums of their exports and imports are large relative to the sizes of their economies. Box 1.1 shows that by this measure, emerging and developing countries have typically been more open than advanced countries.

Specialized production and openness to trade make emerging and developing economies particularly susceptible to external shocks in the form of variations in external demand for their products, which often show up in the form of fluctuations in their *terms of trade* (the relative price of their exports in terms of their imports) that are much more substantial than those typically faced by more advanced and diversified economies.

3. Structure of Production and Trade

In addition to specialization in production and commercial openness, the specific structure of production (i.e., the nature of what is produced) in emerging-market and developing countries also differs from that in advanced industrial countries. The service sector, for example, tends to be smaller in emerging-market and developing countries, and because services are typically nontraded, this means that a larger proportion of domestic output in such countries tends to be exposed to international competition.

The composition of exports also tends to be quite different. Though many emerging-market economies have become exporters of manufactured goods, such goods are typically less sophisticated than those exported by advanced industrial

Box 1.1. Real Openness in Developing and Emerging Economies

Openness to the exchange of goods and services with the rest of the world is an important feature of developing economies. Table 1.3 uses a standard measure of openness to demonstrate this: the ratio of the sum of a country's exports and imports of goods and services to its total gross domestic product (GDP). The first five rows present the average openness ratio for emerging and developing economies by region during the 1980s, the 1990s, and the period 2000–2006, whereas the sixth row presents the OECD average.

Table 1.3. *Ratios of External Trade to GDP for Five Developing-Country Regions and the OECD*

	1980–1989	1990–1999	2000–2006
East Asia and Pacific	36.5	56.0	76.0
Europe and central Asia		60.0	76.6
Sub-Saharan Africa	54.2	56.3	66.4
Middle East and North Africa	51.8	55.4	60.9
Latin America and Caribbean	27.9	35.1	45.1
OECD	35.1	36.8	43.7

Source: World Development Indicators, World Bank.

As you can see, the openness ratio for emerging and developing countries is higher than the OECD average in every period and every region, except for Latin America and the Caribbean. But by 2000–2006, that region also exceeded the OECD in its openness measure.

countries (see Hausmann and Klinger 2006), and many lower-income developing countries still have a high concentration of their exports in primary commodities. Moreover, both emerging-market economies and developing countries do much of their trade with industrial countries, implying that economic developments in such countries have a large impact on the economies of emerging-market and developing countries.

4. Balance of Payments Flows

The structure of balance of payments flows also tends to be different in emerging-market and developing countries from the structure in advanced countries. Flows such as *concessional loans* (loans offered on terms that are more generous than those generally available in the market) from bilateral and multilateral sources and receipts of workers' remittances loom much larger in the balance of payments of emerging-market and developing countries than they do in most advanced industrial economies. This again ties macroeconomic stability in such countries to external developments, because both workers' remittances and budgetary allocations for foreign assistance tend to be sensitive to economic conditions in the advanced economies.

5. Effective Degree of Financial Integration

However, a much more important difference in the balance of payments accounts of emerging-market and developing countries is the role of private capital flows. Advanced industrial countries have become highly integrated with each other financially over the past several decades, and private financial flows tend to dwarf trade flows in the balance of payments of such countries. The picture is much more mixed for emerging-market and developing countries. Standard economic theory suggests that because low-income countries are capital poor, the return to capital should be relatively high there, and such countries should be large recipients of capital inflows from advanced economies. Yet, although emerging-market economies, by definition, are active participants in private international capital markets, their participation in such markets has been sporadic in recent decades, characterized by periods of easy access to private external financing and periods when such access disappears in "sudden stops" of capital inflows, often resulting in macroeconomic crises in the countries that stop receiving such flows. The poorest developing countries, by contrast, have only very limited – if any – access to international private financial markets. Box 1.2 describes some contrasts in effective financial integration among advanced, emerging, and developing economies.

Because it has long been known that a country's effective degree of integration with world capital markets has important implications for how its economy works, this is an important difference between emerging-market and developing countries, on one hand, and advanced economies, on the other.

6. Institutional Framework for Finance and Structure of the Domestic Financial System

One of the reasons that international financial integration is so imperfect among developing countries is that the domestic institutional environment for financial intermediation is weak. Property rights are often poorly defined and weakly enforced, the legal system is unreliable (making it difficult to enforce contracts), accounting and disclosure standards are rudimentary, creditor rights are not clearly defined, and the macroeconomic environment is unpredictable. The upshot is that domestic financial intermediation is costly, and the absence of efficient intermediaries between domestic borrowers and foreign lenders restricts the domestic economy's access to private foreign capital.

Independent of its effects on the country's international financial integration, the limited development of the domestic financial system is a separate factor that affects the macroeconomics of emerging-market and developing economies. Though the

Box 1.2. Financial Integration among Advanced, Emerging, and Developing Economies

Measuring a country's effective degree of financial integration with international capital markets is not an easy task. Because financial integration involves two-way trade in financial assets between the domestic economy and the rest of the world, one way to do so is based on the extent to which domestic residents hold financial claims on the rest of the world (the domestic economy's *financial assets*) and foreign residents hold financial claims on the domestic economy (the domestic economy's *financial liabilities*). Scaling the sum of the domestic economy's financial assets and liabilities by the size of the economy provides one indication of the extent of such two-way financial trade and thus of the economy's degree of financial integration with world capital markets.

Unfortunately, this measure is imprecise, especially for poor countries, because such countries often borrow externally from nonmarket sources and because a large share of external lending by such countries is done by official agencies, especially their central banks. A refined measure of financial integration should exclude nonmarket financial transactions of these types. Such a measure of financial integration has recently been constructed by Dhungana (2008). Figure 1.1 shows his results. As is evident from Figure 1.1, ratios of private financial assets and liabilities to GDP tend to be much higher among advanced countries than among emerging and developing countries.

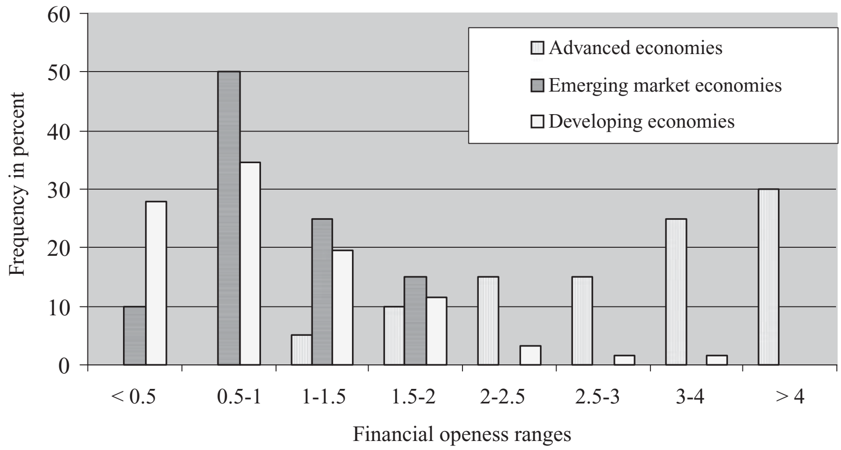

Figure 1.1. Financial openness in advanced, emerging, and developing economies. *Source*: Dhungana (2008)

financial systems of many emerging-market economies are relatively sophisticated, resembling those of advanced countries in having well-functioning banks, securities markets, and equity markets, those of developing countries are quite different. Many developing countries, for example, tend to have very limited securities markets, and their financial systems are dominated by banks. Policies adopted toward the banking systems in these countries often severely constrain the behavior of banks,