Macroeconomics in Emerging Markets

Second Edition

The macroeconomic experience of emerging and developing economies has been quite different from that of industrial countries. Compared to industrial countries, emerging and developing economies have tended to be much more unstable, with more severe boom-bust cycles, episodes of high inflation, and a variety of financial crises. This textbook describes how the standard macroeconomic models that are used in industrial countries can be modified to help understand this experience and how institutional and policy reforms in emerging and developing economies may affect their future macroeconomic performance. The second edition differs from the first in offering

- extensive new material on themes such as fiscal institutions, inflation targeting, emerging-market crises, and the Great Recession
- numerous application boxes
- end-of-chapter questions
- references for each chapter
- more diagrams, less taxonomy, and a more reader-friendly narrative
- enhanced integration of all parts of the work

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To Jana, Ruthie, and Alex

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Preface

Since the publication of the first edition of *Macroeconomics in Emerging Markets* in 2003, I have used the book in my master's-level courses at Williams College and have lectured from it to a wide range of policy audiences, particularly at international financial institutions. In doing so, I became aware of several potential opportunities for improving the book that held the promise of both rendering it more user-friendly for students and substantially increasing its current policy relevance. This new edition incorporates changes that are intended to clarify and enrich the exposition in the first edition and to introduce a substantial amount of new material. The changes relative to the first edition are of six types, as follows.

I. CLEARER LANGUAGE, MORE DIAGRAMS, LESS TAXONOMY

The first edition was closely written, and frankly, many of my students found it to be terse in places. The new edition reflects a substantial amount of rewriting to make the language less terse where that seemed indicated and to develop ideas in a more gradual, step-by-step fashion. As part of this process, this new edition makes more extensive use of diagrams than the first, and the diagrams are presented more clearly (e.g., by including arrows to denote the direction of curve shifts).

An important expositional change involves the development of the baseline short-run macroeconomic model in Part 2. That model is a very rich one. It can be used to analyze the effects of shocks to the economy that are either anticipated or unanticipated and that emerge under various assumptions about the home country's degree of integration with world financial markets as well as about the alternative monetary policy regimes that the country may be operating. All of these are important considerations in the real world. Consideration of the various combinations of these factors that may arise in practice gave the analysis of the model in the first edition something of a taxonomic flavor and was sometimes confusing to students. To clarify the development of the baseline short-run model, the second edition develops the model under a single reference case (featuring anticipated shocks, imperfect capital mobility, and domestic credit targeting) that can readily be modified to consider alternative assumptions about the degree to which the domestic economy is integrated with international financial markets and about the monetary policy regime that it operates.

To clarify the model, I have also changed the description of financial market equilibrium. In the new edition, domestic financial market equilibrium is described by analyzing the domestic bond market rather than the money market. The financial-market equilibrium (FM) curve of the first edition is therefore replaced by a new bond-market equilibrium (BB) curve. Though the two approaches are equivalent, and the money market approach is undoubtedly more familiar to instructors, I have found that this change greatly simplifies the analysis for students because it allows the model to be developed without having to keep track of the effects of capital flows on the money supply, which can be complicated under imperfect capital mobility. In the new edition, the role of capital flows can be given a simple graphical interpretation. The intent of the change is to make the development of the baseline model itself much cleaner and less cluttered.

II. Application Boxes

The first edition contained empirical applications that reported on econometric research into various topics considered in the book. These have been retained, and several new ones have been added. In addition, however, the new edition contains a generous sprinkling of boxes focusing on more immediate and topical *policy* applications intended to help the material come to life for both students and instructors.

III. End-of-Chapter Questions

To facilitate the use of the book as a textbook, I have included end-of-chapter questions in all but the first and last chapters of the new edition. The end-of-chapter questions are of two types: review questions and exercises. The review questions are intended to call attention to the most important concepts in each chapter. The purpose of the exercises is to induce students to think more deeply about the material by asking them to apply it in a nonmechanical way, often by analyzing hypothetical real-world situations. Answers to the exercises are available for instructors at www.cambridge.org/us.

IV. References for Each Chapter

In addition to end-of-chapter questions, each chapter contains suggested additional readings in "References and Further Reading" sections. These reflect a mix of policy applications, empirical work, references to the original papers from which the analysis of each chapter was developed (which are cited in the text of each chapter), and directions to more advanced work for the interested student.

V. BETTER INTEGRATION OF THE ANALYTICAL FRAMEWORK OF PART 2 WITH THE REST OF THE BOOK

The first edition did not sufficiently exploit the connection between the analytical model developed in Part 2 of the book and the rest of the material. The new edition does not lay aside the analytical model after Part 2 but rather continually revisits the model throughout the rest of the book. First, new chapters explore how the model needs to be modified to study floating exchange rates and a bank-based domestic financial system. Second, the model is explicitly used to explore some of the macroeconomic implications of the issues treated in Parts 3–7. For example, it is applied to an exploration of the macroeconomic consequences of the emergence of a sovereign risk premium (in Part 3), to an evaluation of the arguments in support of fixed or floating exchange rates (in Part 5), to an examination of how exchange rate bands work (also in Part 5), and to the study of the macroeconomic effects of the various types of emerging-market crises (in the new Part 7).

VI. NEW MATERIAL

Finally, I have used the opportunity provided by a second edition not only to update the existing material in the first edition but also to incorporate additional material into the book, some of which should have been in the first edition and some of which I have become aware of since writing that edition. The most important additions are as follows.

VI.1. The Introduction of Sticky Nominal Wages

The first edition described the nominal wage as fully flexible and explained deviations of real output from potential as the result of unanticipated shocks using a Lucas-type supply function. In the new edition, that function is treated as a special case of a more general model in which the supply wage may be sticky in the short run, allowing for the possibility of Keynesian unemployment in response to anticipated negative aggregate demand shocks.

VI.2. The Incorporation of Exchange Rate and Inflation Expectations

To understand how sustained inflation can arise in an emerging-market economy that maintains an officially determined exchange rate, Chapter 8 extends the short-run model to the medium run. To do so in an internally consistent fashion, inflation expectations are now incorporated into the GM and BB curves more explicitly than was done in the first edition of the book. To avoid new complications when these curves are first derived, however, I initially assume no inflation and then introduce it only in Chapter 8.

VI.3. Fiscal Institutions

The first edition contained a discussion of alternative means for emerging-market economies to produce a credible fiscal adjustment and to implement a sustainable fiscal policy. However, it did not deal with the political economy of fiscal policy formulation and the possible role of fiscal institutions and/or fiscal rules in securing a sustainable fiscal policy. These issues have received a substantial amount of attention in emerging-market economies in recent years, and they are included in this edition, thus rounding out the book's treatment of alternative means to achieve fiscal credibility. The new Chapter 11 is devoted to these issues.

VI.4. Monetary Transmission with Banks

Because most students from industrial countries are familiar with the intermediate-level IS-LM model, which analyzes monetary transmission in a world in which there are no banks and in which financial assets consist only of currency and interest-bearing securities, Part 2 of the book develops the benchmark model under a similar setup. However, banks are important players in most emerging-economy financial markets, and there are interesting issues posed for the channels of monetary transmission when financial intermediation is dominated by banks. The first edition contained a thorough discussion of the role of banks as financial intermediaries but did not revisit the issue of monetary transmission in the presence of banks. This edition remedies that omission by incorporating banks into the benchmark model in Chapter 23, thus providing a fairly realistic description of monetary transmission in developing and emerging economies.

VI.5. Floating Exchange Rates

Part 5 in the first edition contained an extensive discussion of exchange rate management, but the first edition did not provide a floating exchange rate version of the benchmark model. Because many emerging-market economies indeed maintain floating exchange rate regimes, the new edition provides a floating exchange rate version of the benchmark model in Chapter 17.

VI.6. Inflation Targeting

Inflation targeting has become the dominant monetary policy regime in emerging-market economies in recent years. The first edition of the book, however, did not include an extensive discussion of this topic. The new edition contains a separate chapter on the topic (Chapter 15), building on the analysis of monetary policy credibility presented in the first edition.

VI.7. Varieties of Emerging-Market Crises

A new Part 7 is devoted to various types of emerging-market financial crises. There was some material on crises in the first edition, but I have chosen to bring it together into a separate part of the book both to call attention to the importance of the topic and to give it a unified treatment. Accordingly, the second edition contains chapters on sovereign debt crises (Chapter 25), banking crises (Chapter 26), and exchange rate (currency) crises (Chapter 27) as well as a chapter on the lessons that the many crises of the last two decades have taught us about macroeconomic management in emerging and developing economies (Chapter 28).

VI.8. The Great Recession

At the time of writing (2010), the international economy is undergoing its most significant downturn since the Great Depression. Though emerging and developing economies have by no means avoided the crisis, the experience of several such economies has been more favorable this time around than in past international crises. This provides an opportunity to explore how the institutional and policy reforms explored in this book have contributed to these countries' resiliency in the face of the crisis. The book's final chapter takes up this issue.

A large number of students who have passed through the master's program at the Williams College Center for Development Economics have helped me develop the material in this book, and I am grateful to all of them. I am especially grateful for comments and excellent research assistance from George Bakradze, Mamadou Barry, Pablo Cuba, and Daniel Hernaiz.