MACROECONOMIC POLICIES IN DEVELOPING COUNTRIES

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ABSTRACT. *The global economic crisis has created an opportunity to rethink macroeconomics for development. Such rethinking is both necessary and desirable. It is essential to redefine macroeconomic objectives so that the emphasis is on fostering employment creation and supporting economic growth instead of the focus on price stability alone. It is just as important to rethink macroeconomic policies which cannot simply be used for the management of inflation and the elimination of macroeconomic imbalances, since fiscal and monetary policies are powerful and versatile instruments in the pursuit of development objectives. In doing so, it is essential to the overcome the constraints embedded in orthodox economic thinking and recognize the constraints implicit in the politics of ideology and interests.*
Macroeconomic policies concern the way the public administration, the state, can influence the economy, processes and economic phenomena.
Macroeconomics was developed in, and for, the industrialized countries. Therefore, theories and policies were both concerned with how monetary and fiscal policies should be used in those economies and what might be expected of such policies in terms of obtaining full employment, controlling inflation or stabilizing economic activity. This accumulation of knowledge, with its competing schools of thought, is to be used in developing countries and without any significant modification. It is by no means clear that such application is either justified or appropriate.
Key words: developing countries, low-income countries, economic policy, fiscal policy, monetary policy.

JEL CLASSIFICATION: B22, E00, E60, E62, N10

1. INTRODUCTION

The global economic crisis has created an opportunity to rethink macroeconomics for development. Such rethinking is both necessary and desirable. It is essential to redefine macroeconomic objectives so that the emphasis is on fostering employment creation and supporting economic growth instead of the focus on price stability alone. It is just as important to rethink macroeconomic policies which cannot simply be used for the management of inflation and the elimination of macroeconomic imbalances, since fiscal and monetary policies are powerful and versatile instruments in the pursuit of development objectives. In doing so, it is essential to the overcome the constraints embedded in orthodox economic thinking and recognize the constraints implicit in the politics of ideology and interests.

Macroeconomic policies concern the way the public administration, the state, can influence the economy, processes and economic phenomena. In the first half of the 19th century, the economy was viewed by economists classics either as an "investigation of the nature and causes of the wealth of nations" (Adam Smith) or as "laws" of what regulates the distribution of what occurs on earth" (David Ricardo), or "the laws of capitalist mechanism" (Karl Marx). After 1870 the economy began to be regarded as one science that analyzes "human behavior as a relation between the purpose of actions and (limited) means and resources used to achieve the goals. Classical economic theory he dealt with both macroeconomics and microeconomics, while economic theory neoclassical (the one after 1870) was essentially oriented towards microeconomics. With Keynes, macroeconomics was reinstated in natural rights, yet passed to the other extreme, macroeconomics tending to be a priority over microeconomics. Economic theories modern - rational expectation theory, monetarism, welfare theory, neo-Keynesian theory – it also analyzes both macroeconomic and microeconomic processes.

Macroeconomics was developed in, and for, the industrialized countries. Therefore, theories and policies were both concerned with how monetary and fiscal policies should be used in those economies and what might be expected of such policies in terms of obtaining full employment, controlling inflation or stabilizing economic activity. This accumulation of knowledge, with its competing schools of thought, is to be used in developing countries and without any significant modification. It is by no means clear that such application is either justified or appropriate.

2. THEORETICAL ASPECTS REGARDING MACROECONOMICS

Macroeconomic is a branch of economics dealing with the performance, structure, behavior, and decision-making of an economy as a whole. This includes regional, national, and global economies.[1]

Macroeconomic policy aims to provide a stable economic environment that is conducting to foster strong and sustainable economic growth. Thus, the key pillars of macroeconomic policy are the following: fiscal policy, monetary policy and exchange rate policy. Macroeconomic models and their forecasts are used by governments to assist in the development and evaluation of economic policy. They also develop models that explain the relationship between such factors as national income, output, consumption, unemployment, inflation, saving, investment, energy, international trade, and international finance.[2]

Macroeconomics descended from the once divided fields of business cycle theory and monetary theory. The quantity theory of money was particularly influential prior to World War II. It took many forms, including the version based on the work of Irving Fisher:

$$M*V=P*Q \quad (1)$$

In the typical view of the quantity theory, money velocity (V) and the quantity of goods produced (Q) would be constant, so any increase in money supply (M) would lead to a direct increase in price level (P). The quantity theory of money was a central part of the classical theory of the economy that prevailed in the early twentieth century. This study aims at providing a macro energy model for Iran's energy sector. Major parts of this model are Production sector including GDP, Consumption sector including private and government consumption, Investment sector including investment in energy and other sectors, and Energy consumption sector including oil, gas and electricity consumption.[3]

While the term "macroeconomics" is not all that old (going back to Ragnar Frisch in 1933), many of the core concepts in macroeconomics have been the focus of study for much longer. Topics like unemployment, prices, growth, and trade have concerned economists almost from the very beginning of the discipline, though their study has become much more focused and specialized through the 1990s and 2000s. Elements of earlier work from the likes of Adam Smith and John Stuart Mill clearly addressed issues that would now be recognized as the domain of macroeconomics.

Macroeconomics, as it is in its modern form, is often defined as starting with John Maynard Keynes and the publication of his book the general theory of employment, interest and money in 1936. Keynes offered an explanation for the fallout from the Great Depression, when goods remained unsold and workers unemployed. Keynes's theory attempted to explain why markets may not clear.

Prior to the popularization of Keynes' theories, economists did not generally differentiate between micro- and macroeconomics. The same microeconomic laws of supply and demand that operate in individual goods markets were understood to interact between individuals markets to bring the economy into a general equilibrium, as described by Leon Walras. The link between goods markets and large-scale financial variables such as price levels and interest rates was explained through the unique role that money plays in the economy as a medium of exchange by economists such as Knut Wicksell, Irving Fisher, and Ludwig von Mises.

Throughout the 20th century, Keynesian economics, as Keynes' theories became known, diverged into several other schools of thought.

The field of macroeconomics is organized into many different schools of thought, with differing views on how the markets and their participants operate.

Classical economists hold that prices, wages, and rates are flexible and markets always clear, building on Adam Smith's original theories.

Keynesian economics was largely founded on the basis of the works of John Maynard Keynes. Keynesians focus on aggregate demand as the principal factor in issues like unemployment and the business cycle. Keynesian economists believe that the business cycle can be managed by active government intervention through fiscal policy (spending more in recessions to stimulate demand) and monetary policy (stimulating demand with lower rates). Keynesian economists also believe that there are certain rigidities in the system, particularly sticky prices and prices, that prevent the proper clearing of supply and demand.

The Monetarist school is largely credited to the works of Milton Friedman. Monetarist economists believe that the role of government is to control inflation by controlling the money supply. Monetarists believe that markets are typically clear and that participants have rational expectations. Monetarists reject the Keynesian notion that governments can "manage" demand and that attempts to do so are destabilizing and likely to lead to inflation.

The New Keynesian school attempts to add microeconomic foundations to traditional Keynesian economic theories. While New Keynesians do accept that households and firms operate on the basis of rational expectations, they still maintain that there are a variety of market failures, including sticky prices and wages. Because of this "stickiness", the government can improve macroeconomic conditions through fiscal and monetary policy.

Neoclassical economics assumes that people have rational expectations and strive to maximize their utility. This school presumes that people act independently on the basis of all the information they can attain. The idea of marginalism and maximizing marginal utility is attributed to the neoclassical school, as well as the notion that economic agents act on the basis of rational expectations. Since neoclassical economists believe the market is always in equilibrium, macroeconomics focuses on the growth of supply factors and the influence of money supply on price levels.

The New Classical school is built largely on the Neoclassical school. The New Classical school emphasizes the importance of microeconomics and models based on that behavior. New Classical economists assume that all agents try to maximize their utility and have rational expectations. They also believe that the market clears at all times. New Classical economists believe that unemployment is largely voluntary and that discretionary fiscal policy is destabilizing, while inflation can be controlled with monetary policy.[4]

3. MACROECONOMIC POLICIES

3.1. Economic policy

Economic policy is the set of decisions taken by the public authorities, in order to orient the economic activity in a sense considered reasonable on the national territory. By constituting an arbitration between different types of objectives and instruments, the economic policy expresses the whole of the economic choices of the public authority, similar to the economic choices of the consumer, producer, investor. Because the state is the main responsible for economic policy, the theory of the state is a central element of the fundamentals of economic policy. An **economic policy** is a course of action that is intended to influence or control the behavior of the economy. Economic policies are typically implemented and administered by the government. Examples of economic policies include decisions made about government spending and taxation, about the redistribution of income from rich to poor, and about the supply of money. The effectiveness of economic policies can be assessed in one of two ways, known as **positive** and **normative** economics.

Positive economics attempts to describe how the economy and economic policies work without resorting to value judgments about which results are best. The distinguishing feature of positive economic hypotheses is that they can be tested and either confirmed or rejected. For example, the hypothesis that “an increase in the supply of money leads to an increase in prices” belongs to the realm of positive economics because it can be tested by examining the data on the supply of money and the level of prices.

Normative economics involves the use of value judgments to assess the performance of the economy and economic policies. Consequently, normative economic hypotheses cannot be tested. For example, the hypothesis that “the inflation rate is too high” belongs to the realm of normative economics because it is based on a value judgment and therefore cannot be tested, confirmed, or refuted. Not surprisingly, most of the disagreements among economists concern normative economic hypotheses. The goals of economic policy consist of value judgments about what economic policy should strive to achieve and therefore fall under the heading of normative economics. While there is much disagreement about the appropriate goals of economic policy, several appear to have wide, although not universal, acceptance.

These widely accepted goals include:

1. Economic growth: Economic growth means that the incomes of all consumers and firms (after accounting for inflation) are increasing over time.
2. Full employment: The goal of full employment is that every member of the labor force who wants to work is able to find work.
3. Price stability: The goal of price stability is to prevent increases in the general price level known as inflation, as well as decreases in the general price level known as deflation.[10]

As we know we have a variety of economic policies, as follows:

- Macroeconomic stabilization policy, which attempts to keep the money supply growing at a rate that does not result in excessive inflation, and attempts to smooth out the business cycle;
- Trade policy, which refers to tariffs, trade agreements and the international institutions that govern them;
- Policies designed to create economic growth;
- Policies related to development economics;
- Policies dealing with the redistribution of income, property and/or wealth;

- As well as: regulatory policy, anti-trust policy, industrial policy and technology-based economic development policy.

3.2. Budgetary-fiscal policy

Fiscal policy operates through changes in the level and composition of government spending, the level and types of taxes levied and the level and form of government borrowing. Governments can directly influence economic activity through recurrent and capital expenditure, and indirectly, through the effects of spending, taxes and transfers on private consumption, investment and net exports.

Under current institutional arrangements, fiscal policy is the only arm of macroeconomic policy directly controlled by government.

As an instrument for stabilization of fluctuations in economic activity, fiscal policy can reflect discretionary actions by government or the influence of the ‘automatic stabilizers’. A fiscal stimulus package is an example of discretionary action by government intended to support aggregate demand by increasing public spending and/or cutting taxes.

The ‘automatic stabilizers’ refers to certain types of government spending and revenue that are sensitive to changes in economic activity, and to the size and inertia of government more generally. They have a stabilizing effect on fluctuations in aggregate demand and operate without requiring any specific actions by government. For example, if the economy slows, on the revenue side of the budget the amount of tax collected declines because corporate profits and taxpayers’ incomes fall; on the expenditure side, unemployment benefits and other social spending increases. The effects of these changes tend to offset part of the decline in aggregate demand that would otherwise occur. This cyclical sensitivity makes fiscal policy automatically expansionary during downturns and contra dictionary during upturns in economic activity.

At least conceptually, the operation of the automatic stabilizers over the economic cycle should have no effect on the underlying structural position of the budget. A short-term cyclical deterioration in the budget bottom line should be reversed as economic conditions improve.

As well as having a short-term stabilization role, fiscal policy can also be framed against longer-term objectives. This can include ensuring the long-term sustainability of the budget and its capacity to meet future challenges, such as population ageing, and seeking to increase the long-term growth potential of the economy, through investments in areas such as infrastructure and education.[5]

Fiscal policy refers to changes in government expenditure and taxation. Government expenditure, also called public expenditure, and taxation occur at two main levels – national and local. Governments spend money on a variety of items including benefits (for the retired, unemployed and disabled), education, health care, transport, defense and interest on national debt. A government sets out the amount it plans to spend and raise in tax revenue in a budget statement. A budget deficit is when the government’s expenditure is higher than its revenue. In this case, the government will have to borrow to finance some of its expenditure. In contrast, a budget surplus occurs when government revenue is greater than government expenditure. A balanced budget, which occurs less frequently, is when government expenditure and revenue are equal. A government may deliberately alter its expenditure or tax revenue to influence economic activity. If a government wants to raise aggregate demand in order to increase economic growth and employment, it will increase its expenditure and/or cut taxation by lowering tax rates, reducing the items taxed or raising tax thresholds. For example, a government may cut income tax rates. This will raise people’s disposable income, which will enable them to spend more. Higher consumption is also likely to raise investment. Figure 1 shows the effect of a reflationary fiscal policy (also called an expansionary fiscal policy).

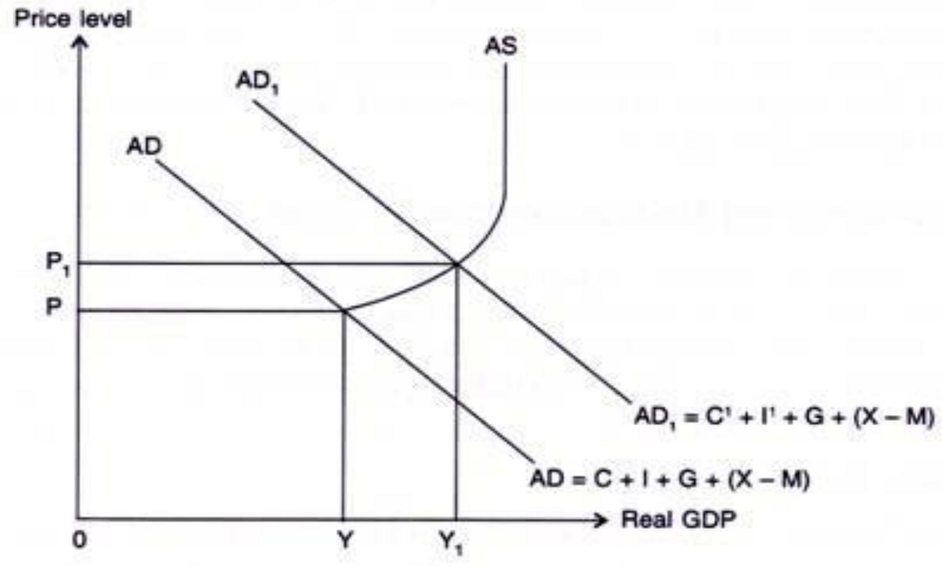

Figure 1. The effect of a reflationary fiscal policy

A government may implement a deflationary fiscal policy (also called a contractionary fiscal policy) to reduce inflationary pressure. A cut in government expenditure on, for instance, education would reduce aggregate demand. Such a reduction may lower the rise in the general price level.

3.3. Monetary policy

Monetary policy is a central bank's actions and communications that manage the money supply. That includes credit, cash, checks, and money market mutual funds. The most important of these forms of money is credit. It includes loans, bonds, and mortgages.

Monetary policy increases liquidity to create economic growth. It reduces liquidity to prevent inflation. Central banks use interest rates, bank reserve requirements, and the amount of government bonds that banks must hold. All these tools affect how much banks can lend. The volume of loans affects the money supply.

Central banks have three monetary policy objectives:

- The most import is to manage inflation.
- The secondary objective is to reduce unemployment, but only after controlling inflation.
- The third objective is to promote moderate long-term interest rates.

All central banks have three tools of monetary policy in common. First, they all use open market operations. They buy and sell government bonds and other securities from member banks. This changes the reserve amount the banks have on hand. A higher reserve means banks can lend less. That's contra dictionary policy.

The second tool is the reserve requirement. The central banks tell their members how much of their money they must have on reserve each night. If it weren't for the reserve requirement, banks would lend 100% of deposits. Not everyone needs all their money each day, so it is safe for the banks to lend most of it out. That way, they have enough cash on hand to meet most demands for redemption.

When a central bank wants to restrict liquidity, it raises the reserve requirement. That gives banks less money to lend. When it wants to expand liquidity, it lowers the requirement. That gives banks more money to lend. Central banks rarely change the reserve requirement because it requires a lot of paperwork for the members. The third tool is the discount rate. That's how much a central bank charges members to borrow funds from its discount window. It raises the discount rate to discourage banks from borrowing. That reduces liquidity and slows the economy. It lowers the discount rate to encourage borrowing. That increases liquidity and boosts growth.

Monetary policy is generally categorized as:

- Expansionary, which increases liquidity and demand, and consequently, drives economic growth.
- Contractionary, which restricts money supply to reduce inflation and slow the rate of economic activity.

Monetary policy is shaped around three economic objectives:

- Control of inflation.
- Employment level management.
- Maintenance of moderate interest rates for the long-term.[6]

Monetary policy includes changes in the money supply, the rate of interest and the exchange rate, although some economists treat changes in the exchange rate as a separate policy. The main monetary policy measure, currently used in most countries, is changes in the rate of interest. A rise in the rate of interest helps implement a deflationary monetary policy. It will be likely to reduce aggregate demand by lowering consumption and investment. Households will spend less due to availability of less discretionary income, expensive borrowing and greater incentive to save. Firms will invest less as they will expect consumption to be lower. Also the opportunity cost of investment will have risen and borrowing will have become expensive. A higher interest rate may also reduce aggregate demand by lowering net exports. Changes in the money supply, as with changes in interest rates, are implemented by Central Banks on behalf of governments. If the money supply is increased by the Bank printing more money, buying back government bonds or encouraging commercial banks to lend more, the aggregate demand increases. On the other hand, a decrease in the money supply reduces aggregate demand.

3.4. Supply-side Policies

Supply-side policies are policies designed to increase aggregate supply and hence increase productive potential. Such policies seek to increase the quantity and quality of resources and raise the efficiency of markets. These include improving education and training, cutting direct taxes and benefits, reforming trade unions and privatization. Improving education and training is designed to raise labour productivity. The intention behind cutting direct taxes and benefits is to make work more attractive, relative to living on benefits. If successful, this will make the unemployed search for work more actively and will raise the labour force by encouraging more people (including for instance married women and the disabled) to seek employment. Reforming trade unions may make labour more productive and privatization may increase productive capacity, if private sector firms invest more and work more efficiently than state owned enterprises.

Supply side policy includes any policy that improves an economy's productive potential and its ability to produce. There are several individual actions that a government can take to improve supply-side performance.

Measures to improve factor productivity, which is the marginal output generated by factors inputs, include the following:

- Using the tax system to provide incentives to help stimulate factor output, rather than to alter demand, is often seen as central to supply-side policy. This commonly means reducing direct tax rates, including income and corporation tax. Lower income tax will act as an incentive for unemployed workers to join the labour market, or for existing workers to work harder.

Lower corporation tax provides an incentive for entrepreneurs to start and so increase national output.

- Other supply-side policies include the promotion of greater competition in labour markets, through the removal of restrictive practices, and labour market rigidities, such as the protection of employment. For example, as part of supply-side reforms in the 1980s, trade union powers were greatly reduced by a series of measures including limiting worker's ability to call a strike, and by enforcing secret ballots of union members prior to strike action.
- Measures to improve labour mobility will also have a positive effect on labour productivity, and on supply-side performance. This improves labour market flexibility.
- Better education and training to improve skills, flexibility, and mobility – also called human capital development. Spending on education and training is likely to improve labour productivity and is an essential supply-side policy option, and one favoured by recent UK governments. A government may spend money directly, or provide incentives for private suppliers to enter the market. Government may also set and monitor standards of teaching, and force schools to include a skills component in their curriculum.
- The adoption of performance-related pay in the public sector is also seen as an option for government to help improve overall productivity.
- Government can encourage local rather than central pay bargaining. National pay rates rarely reflect local conditions, and reduce labour mobility. For example, national pay rates for Postmen do not reflect the fact that in some areas they may be in short supply, while in other areas there may be surpluses. Having different rates would enable labour to move to where it is needed most.[11]

4. THE INFLUENCE OF MACROECONOMIC POLICIES ON THE DEVELOPING COUNTRIES

4.1. The stubborn beliefs of the macroeconomic policies

Over the past three decades, the focus of macroeconomic policies, everywhere, has become narrower with the passage of time. In industrialized countries, the traditional objectives were internal balance and external balance. Internal balance was defined as full employment and price stability, that would be conducive to economic growth. External balance was defined as equilibrium in the balance of payments primarily with reference to the current account. Macroeconomic policy is guided by a focus on intermediate variables such as deficits in government finances. But this can be misleading if accounting frameworks are inappropriate. Even appropriate accounting frameworks are not enough. The reason is simple. Such measures are like a thermometer. If it shows that the body temperature is above normal, it signals that something is wrong. But a thermometer does not provide a diagnosis for a patient. Similarly, an accounting framework can never provide a complete diagnosis, let alone a prescription, for an economy.

The accounting frameworks in use for deficits in government finances are an almost perfect illustration of this problem. And the problem is compounded because different measures are used for different purposes in a manner that is far from consistent. For a meaningful analysis of policy, therefore, it is essential that the use of accounting frameworks is determined by their macroeconomic significance. If the objective is to measure the total borrowing needs of the government, the gross fiscal deficit is the most appropriate. If the objective is to consider the implications of a deficit in government finances for monetary expansion, as an index of inflationary pressures, the monetized deficit is the most appropriate. If the objective is to assess whether a fiscal regime is sustainable over time, the revenue deficit is the most appropriate. If the objective is to examine what governments can do, or have done, to improve the fiscal situation, the primary deficit is the most appropriate. Yet, there is an obsessive concern about deficits in government finances that borders on fetishism. It is essential to recognize the fallacies of such deficit fetishism.

The size of the fiscal deficit, or the amount of government borrowing, is the symptom and not the disease. And there is nothing in macroeconomics which stipulates an optimum level to which the fiscal deficit must be reduced as a proportion of GDP. Indeed, it is possible that a fiscal deficit at 6% of GDP is sustainable in one situation while a fiscal deficit at 4% of GDP is not sustainable in another situation. The real issue is the allocation and end-use of government expenditure in relation to the cost of borrowing by the government. Thus, government borrowing is always sustainable if it is used to finance investment and if the rate of return on such investment is greater than the interest rate payable. [7]

In developing countries, under normal circumstances, there already exists a pro-cyclical pattern to macroeconomic policies. This is particularly true of fiscal policy. During downswings of the business cycle, as the economy slows down, tax revenues fall, or do not rise as much as expected. The ability of the government to service public debt diminishes. The interest rate on government borrowing rises. And governments find it not only more expensive but also more difficult to borrow in order to finance expenditure.

During upswings of the business cycle, the opposite happens. Government revenues recover. So does government expenditure. And governments have more access to cheaper credit. The social costs of pro-cyclical fiscal policies are high. In downturns, cuts in public expenditure squeeze investment in infrastructure and reduce allocations for social sectors, which can only dampen growth in the long-term. In upturns, readily available finances may be used for investments that yield low returns or even for unproductive consumption expenditure. In general, stop-go cycles are bound to reduce the efficiency of government spending. Yet, there are strong, embedded, incentives or disincentives for governments to adopt pro-cyclical fiscal policies. In a downturn, therefore, such pro-cyclical policies can only accentuate difficulties in the short-run and dampen growth in the medium-term. The probability of such outcomes increases with orthodox stabilization and adjustment programmes, which advocate pro-cyclical macroeconomic policies: a restrictive fiscal policy and a tight monetary policy. This is just the opposite of anti-cyclical macroeconomic policies adopted as a rule by governments in industrialized countries. It is also counter-intuitive in so far as it is the opposite of what students of macroeconomics learn across the world. As a result, growth is dampened, if not stifled. [8]

4.2. Impediments to modify

It is bound to be said that governments in developing countries do not have much fiscal flexibility in either revenue or expenditure. Tax revenues are based less on direct taxes and more on indirect taxes. The base for taxation is not broad enough. Tax compliance is low, which is attributable to tax avoidance and tax evasion. Thus, governments find it very difficult to increase their income through tax revenues. Orthodoxy does not help matters. For, typically, tax rates are lowered without any systematic effort to improve compliance or broaden the base for taxation. In the sphere of expenditure, governments find it difficult to cut consumption expenditure, so that the axe falls on public investment, which constrains growth, and on social sectors, which hurts the poor. But there is policy space which must be used and not given up. And things change for the better, through a cumulative causation, in the process of development. Public investment develops infrastructure and crowds-in private investment, both of which are conducive to growth, while expenditure on social sectors, education and health, is more investment than consumption, which can raise productivity.

Government expenditure has multiplier effects that also creates revenue through buoyancy. As institutions develop and development accelerates, fiscal flexibility increases. Monetary policy in developing countries also has limits. Money markets are often segmented, if not underdeveloped. Effects of monetary policy are more narrowly directed. Its effectiveness is lower.

Open market operations are obviously a limited option in thin markets. Experience shows that beyond a point higher interest rates do not combat inflation just as lowering interest rates does not stimulate investment. Interest rates are a strategic instrument to influence allocation of scarce investible resources. And the volume of credit could be more effective than the price of credit as an instrument of monetary policy. But the deregulation of domestic financial sectors and capital account liberalization, taken together, have reduced the space for monetary policy. This needs correction.

Monetary policy should not be narrow in its objectives (managing inflation alone) and as an instrument (just interest rates). In fact, there is need to create space for monetary policy in the pursuit of development objectives. As financial markets develop, institutions evolve and instruments diversify, monetary policy can become more effective in terms of range and reach. It is also important to recognize the somewhat different macroeconomic implications of the interaction between fiscal and monetary policy in developing countries. For example, the monetary impact of fiscal policy is perhaps greater in developing countries because a much larger proportion of the fiscal deficit is financed by borrowing from the central bank. In a shallow capital market, the alternatives are few and far between. And, in developing countries, borrowing from the central bank is the principal source of reserve money which makes it the most important determinant of monetary expansion. This is no longer the case in most Latin American economies, but remains the reality in most other developing countries.

Similarly, the fiscal impact of monetary policy is perhaps greater in developing countries, because, in situations where public debt is large as a proportion of GDP and interest payments on these debts are large as a proportion of government expenditure, even modest changes in interest rates exercise a strong influence on fiscal flexibility. In a changed international context, it is also important to recognize that countries which are integrated into the world financial system are constrained in using an autonomous management of demand to maintain levels of output and employment.

Expansionary fiscal and monetary policies – large government deficits to stimulate aggregate demand or low interest rates to encourage domestic investment – can no longer be used, as easily as in the past, because of an overwhelming fear that such measures could lead to speculative capital flight and a run on the national currency. The problem exists everywhere. But it is far more acute in developing countries. There are important lessons to be learnt from the experience of financial deregulation and capital account liberalization, in both industrialized countries and developing countries, about what should not be done. It is clearly essential to learn that financial deregulation, such as doing away with the distinction between banking and non-banking financial intermediaries, is fraught with risk. At the same time, in thinking of integrating with international financial markets, it is clear that it would be wise to hasten slowly with capital account liberalization. For the same reason, it would be unwise to rely on portfolio investment inflows to finance current account deficits because portfolio investment represents the intersection of two somewhat thin, very unstable, markets in developing countries: namely stock exchange markets, and foreign exchange markets. Indeed, wherever countries have moved to capital account liberalization, the option of introducing capital account controls must be retained.

Governments in developing countries find it very difficult to increase their income through tax revenues, because important political constituencies with a voice have the capacity not only to evade or avoid taxes but also to resist taxes. In contrast, governments in developing countries find it somewhat less difficult to decrease their expenditure, although there are asymmetries. It is easier to cut investment expenditure than to cut consumption expenditure, just as it is easier to reduce public expenditure on social sectors where the economic constituencies are not as organized as elsewhere and the consequences are discernible only after a time lag. There is a similar intersection of economics and politics in the sphere of monetary policy. The orthodox view does recognize this but the recognition is limited to the macroeconomic significance of monetized deficits and the independence of central banks. This understanding and characterization is much too narrow. Clearly, the dominance of one institution over another could be dangerous, for it takes away checks and balances. But autonomy or independence is not the answer.

Macroeconomic policies for development require partnership and coordination. In any case, there is more to the political economy of monetary policy. Constraints embedded in political economy reduce degrees of freedom in the use of interest rates. Property-owning democracies with extensive rentier interests, in developing countries, almost as much as in industrial societies, prefer higher interest rates not only because of higher income from financial assets but also because a wider middle class fears that inflation might erode the real value of their accumulated savings. In developing countries that have carried out capital account liberalization, sources of foreign capital inflows also prefer higher interest rates and lower inflation rates. It is not surprising, then, that any lowering of interest rates is resisted by an emerging rentier class in domestic financial markets which has a political voice, just as any lowering of interest rates is constrained by an integration into international financial markets which also become significant political constituencies for finance ministers.[9]

5. CONCLUSIONS

There are some obvious conclusions that emerge from the preceding discussion. It is essential to redefine macroeconomic objectives so that the emphasis is on fostering employment creation and supporting economic growth instead of the focus on price stability alone. It is just as important to rethink macroeconomic policies which cannot simply be used for the management of inflation and the elimination of macroeconomic imbalances, since fiscal and monetary policies are powerful and versatile instruments in the pursuit of development objectives. It is sensible to exercise restraint in the deregulation of domestic financial sectors. It is prudent to hasten slowly with capital account liberalization, or retain the option of introducing capital controls. It is necessary to stay prudent in macro-management so that there is some freedom to introduce counter-cyclical macroeconomic policies. In doing this, it is essential to the overcome the constraints embedded in orthodox economic thinking and recognize the constraints implicit in the politics of ideology and interests.

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