STRUCTUAL VARIANCE IN MACROECONOMICS OF DEVELOPING AND DEVELOPED COUNTRIES: IMPLICATIONS FOR GROWTH, DEVELOPMENT, AND STABILITY

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Abstract.
Macroeconomics was primarily conceived and meant for industrial nations which were later on adopted by developing countries without any significant variations. In particular, conservative macroeconomic theories and models based on contractionary fiscal and monetary policies put too much stress on inflation, and too little on growth, employment and the effect on poor. In addition, more open and liberalized capital markets, thanks to globalization, make developing countries experience added economic volatility than developed countries, which make the significance of stabilization particularly relevant. Unfortunately, much of the advice given to developing countries i.e. 'one-size-fits-all' approach, failed to identify the differences between developed and developing countries, resulted in crises in Asia and Latin America during most of the 1990s. The objective of this paper is to highlight those differences which result in varying effects of similar macroeconomic policies in developing and developed countries.

Getting insights from Stiglitz et al., (2006), it is recognized that although basic macroeconomic aggregates and variables are similar, however, relationships and causalities between them need consideration for context and setting. Structural characteristics of developing and developed countries are different from each other; sources of growth, relative importance of agriculture vs. industrial and services sector, significance of physical capital investment, scope of financial institutions and institutional arrangements for handling risk, degree of openness of capital markets etc., all have their implications which are discussed at length in this paper. Keeping these variances in view, it is established that effectiveness of macroeconomic tools available to policymakers also differ between developing and developed countries. While arguing about these variances, particular attention has been given to historical events during 1970s-1990s (Fuel crisis of 1970s, liberalization, IMF conditionalities, Asian crisis of 1990s etc). The 'qualified success' of macroeconomic policies for short-term stabilization and 'failure' for medium to long-term growth in developing countries of Latin America and Asia set out the case for considering 'institutional' context and realities.

Keywords: Macroeconomics, Liberalization, Institutions, Developing countries

JEL Classification: E02, E50, E60, G18, G20, O19

Introduction:

The development of macroeconomics was primarily conceived by and meant for industrialized and developed countries[1]. Theory as well as policy seemed to be concerned with the usage of monetary and fiscal policies in industrialized economies for attaining full employment, controlling inflation, and stabilizing economic activity. Although the basic macroeconomic aggregates (i.e. output, employment, inflation etc.) along with basic identities and equilibrium conditions are same for both developed and developing economies. However, macroeconomic systems cannot be understood unless these identities are joined with the determinants of behaviors – behaviors of firms, households and governments. This is the point from where the differences start appearing.

Macroeconomic models are based on various equations and variables which are selected differently by different schools of thought - Classical/Neo-classical, Keynesians, Monetarists. In order to initiate any macroeconomic analysis, exogenous and endogenous variables or autonomous and induced changes are distinguished from each other. This distinction is vital in macroeconomic theorizing that strives for analyzing policy implications. It is imperative to know that this distinction is not a derivative of the analytical structure rather it results from the institutional setting of models. This idea can be strengthened by seeing "investment" in Keynesian and Monetarist perspectives. According to the Keynesian school, investment is an independent i.e. exogenous variable to which saving adjusts as a dependent i.e. endogenous variable. Investment is autonomous which is determined by profit expectations of firms whereas saving is induced which is determined by income of households. This distinction is based on the institutional assumption according to which firms have access to credit from banks/financial institutions, depending on anticipated profitability of their projects along with their own creditworthiness, instead on the level of savings by households in the economy. So, it is the institutional setting which Hicks (1974) considered as an 'overdraft economy' – an economy which allows investment to be financed in advance of, and independent of, the level of saving in the economy[2]. If we turn our side from main issue, an interesting inference can be made. That is, if credit is endogenously determined by demand, it means that independence of the investment function of firms determines effective demand (and ultimately 'output'), where the financial system only plays an accommodating role without affecting demand (and ultimately 'output'). Contrary to this, if credit is exogenously determined by the financial system, the monetarist perspective emerges as critical, where banks play key role in influencing the investment decisions of firms by relaxing or tightening credit facilities to firms. Thus, the distinctions and relationship among variables in macroeconomic models are derived from the institutional setting of the model, in order to analyze events and policies. Much can change when institutional settings, and ultimately the determinants of causation, change (Nayyar, 2003). It establishes the notion that macroeconomics developed in the context of industrialized countries cannot be copied 'as it is' in developed countries. Macroeconomic theories and models can be erected on the basis of pure economic reasoning, but they must recognize institutional facts and distinguish different contexts. The nature of relationships between variables and the direction of causation are both a function of the setting and the context (Stiglitz et al, 2006). However, almost up to 1980s, there was a perception that developing countries were not different from developed countries except for levels of per capita income etc. The developed country represented to the developing country

[1] Industrialized and developed countries are meant one and same, for the purpose of this paper

[2] Overdraft economy: Firms and Households pull on their lines of credit with private banks when they require new financing means. Banks borrow from central bank, instead of purchasing it by selling government securities. Overdraft economy is defined by "double level of indebtedness i.e. that of the firms to banks and that of the banks to central bank (Rennersez, 1996, P. 475)

a mirror image of its future (Jha, 2003). This was the belief on basis of which IMF conditionalities on developing countries were devised i.e. one-size-fits-all philosophy. But the reality is completely different. Developing countries are very much different from developed ones when it comes to macroeconomics.

This paper is divided into two main parts. The first part focuses on fundamental differences in macroeconomies of developing and developed countries. The second part will present historical events and ensuing failure of macroeconomic policies 'designed by developed for developing' without paying any consideration to institutional realities.

Part 1. Fundamental Differences in Macroeconomy of Developed and Developing countries:

1.1 Stiglitz et al. (2006) have discussed in detail the structural differences which exist between developing and developed countries. Some of the differences are quite obvious which are as follows:

i. <u>Major real sectors</u>: Most of the developing countries, especially the poorest ones, are agriculture-based economies, dominated by family farms and sharecropping whereas industrial economies are dominated by large and corporate farms. The industrial sector in developing countries is less diversified and highly concentrated than in an industrial economy. Unlike developed countries, the larger proportion of the service sector in developing countries is comprised of informal activities.

ii. <u>Sources of growth</u>: In developed countries, growth normally emerges from the development of innovations and their introduction into the economy. While for developing countries, growth is generally related to importing or copying economic activities and technical innovations previously developed in industrial countries along with investing in physical capital. They also try to shift resources from less productive sectors (e.g. agriculture, urban informal activities etc.) to more productive sectors.

iii. <u>Demand vs. Supply constraints</u>: An important difference emerges from the significance of physical capital investment and growth in developing. The main short-run macroeconomic concern for developed countries, as per Keynesian perspective, is the sufficiency of demand. If there is adequate demand, the economy can attain full employment. Although, these stresses are also observed in many developing countries, however, their main problem is different. Despite of full utilization of productive capacity or capital equipment, it is not possible for economy to fully absorb the existing labor force. It can be inferred that it is the deficiency of productive capacity, not its underutilization, which poses key problem for many developing countries. Under many circumstances, the availability of foreign exchange may also become crucial in limiting economic activity. There exist demand constraints, but more important are supply constraints which are generated either by the availability of capital or of foreign exchange.

iv. <u>Development of financial institutions</u>: Advanced industrial countries have more developed financial institutions than developing countries. Especially due to development of equity markets in developed countries, firms are moving away from bank lending towards securitization i.e. borrowing from the market by issuing commercial paper or bonds. While in developing countries, firms rely more on self-financing whereas for outside financing, they rely largely on bank finance as equity markets are particularly underdeveloped as a source of finance for new investments. This has some clear implications: when firms self-finance their investments, changes in interest rates are likely to have meager effect on investment, consumption, and aggregate demand than they do in standard macro-models for developed countries. When firms only rely on banks and banks are weak, sufficiently large shocks to the economy give rise to a banking crisis and ensuing recession.

v. Risk-management: The institutional arrangements for handling risk are different in developed and developing countries. Transferring and absorbing risk is an important function of financial markets, underdevelopment of which is one reason why developing countries are not as able to absorb shocks like developed countries. Risk-sharing is better in equity markets than debt markets, but developing countries rely more heavily on debt. Countries with very high debt-equity ratios (e.g. many East Asian countries before the 1997 crisis) are highly susceptible to shocks and the process of adjustment is also difficult because of recapitalization of financial institutions. Social security and social protection systems are also weaker in developing countries.

Poorer risk markets and weak social protection systems have significant implications for developing countries. Firms and households act in risk-averse manner so shocks to the economy are not ‘smoothed out’ i.e. the contraction of consumption or investment in one part of the economy can overdo the expansion elsewhere. It is likely to have weaker built-in stabilizers so shocks are likely to have larger effects. Moreover, as firms rely on debt finance, a negative shock (e.g. a drop is price or in demand) may be followed by a large contraction of production and investment as credit becomes more difficult to obtain (i.e. ‘financial accelerator[3]). Besides the degree of firms’ reliance on debt finance and the magnitude of leverage, other structural features of the economy also affect the extent to which shocks can be reduced or amplified e.g. price rigidities that put a larger burden on quantity (income or output) adjustments. Differences in the degree of rigidity across sectors suggest that in response to a shock, there can be large changes in relative prices which can have obvious consequences. Traditional macroeconomics has focused on the price of goods and services relative to money, however, the composition of output is determined by the relative prices between different goods i.e. between primary and manufacturing goods, between domestic and foreign goods (in which the exchange rate plays a key role), or between investment goods and consumption goods. Large changes in relative prices support large changes in composition of output because resources do not flow easily or costlessly among different sectors. Moreover, contractions normally progress far more quickly than expansions. So the short-run aggregate effect of large changes in relative prices is the lowering of employment and output.

1.2. Now we will come to macroeconomic policy objectives which differ in developed and developing countries. In industrialized countries, internal balance and external balance are traditionally considered to be the main focus of macroeconomic policy. Internal balance is composed of full employment and price stability, whereas external balance is defined as equilibrium in current account balance-of-payment. Apropos to high inflation of the 1970s, there started the decline of Keynesianism and the rise of monetarism leading to an insightful change. The idea of internal balance confined only to price stability and full employment was no more macroeconomic policy objective. This was partly founded on the belief that if the government achieves price stability, the market will automatically attain full employment. Since then, the concept of external balance has been gradually diluted in the domain of capital account liberalization. Contrary to this, the traditional concern of macroeconomic objectives

[3] Financial Accelerator in macroeconomics refers to the idea that adverse shocks to the economy may be amplified by worsening financial markets conditions. More broadly, adverse conditions in the real economy and in financial markets mutually reinforce each other, leading to a feedback loop that propagates the financial and macroeconomic downturn (Bernanke, Gertler and Gilchrist, 1996)

in developing countries was economic growth in the long term, subject to the restrictions that inflation remained within tolerable limits, and that the current account deficit remained within manageable size. Since employment and underemployment were assumed to be caused by lack of capital, therefore, the policy focus was on savings and investment. However, many economists and policy-makers started emphasizing short-term macro-management after the developing countries' crises of the 1980s and 1990s in Latin America and Asia. IMF stabilization policies focused on price stability and balance of payment adjustment, on the basis of their belief that if the government succeeded in achieving these objectives in the short run, long-run economic growth would follow. The presumption that full employment and economic growth would materialize as corollaries was contradicted by experience in developing countries (Nayyar, 2008).

Hence, until few years back, it was generally perceived that stability concern of macroeconomic theory was not very relevant to developing countries. It was felt that the most important issue in developing countries was medium and long term growth and not short term stabilization (Jha, 2003). Here, it can be recognized that short run stabilization presents a dilemma for most developing countries. Credit restraint and devaluation by restricting demand may result in lowering the industrial growth rate with inflation adjusting very slowly and with substantial delay. The resulting stagflation gives rise to sizable adversity in economies where most people are poor with almost absence of any social insurance or welfare schemes. Taxes and subsidies are reduced in order to reform output and factor prices which ultimately improve efficiencies of supply but may cause considerable industrial restructuring. But such adjustments seem to be crucial to ensure balanced and steady long-term. Such are the only choices for developing countries. Therefore, striking a balance between the requirements of short-term stabilization and long-term growth has been the focus of macroeconomic policy research during last several years … till today.

Here, it is imperative to shed some light on macroeconomic constraints on growth in the context of developing countries. According to literature on this issue, economic growth in developing countries is limited, at a macro level, by a: (a) savings constraint, (b) foreign exchange constraint, (c) wage goods constraint, or (d) fiscal constraint. The literature on 'gap models' debated that which of these constraints might be dominant – it helps to establish that given such macroeconomic constraints, irrespective of which particular constraint is dominant, any attempt to improve the rate of growth spills over into an acceleration in inflation rate or a difficult balance-of-payments situation. The point we are trying to make here is that an understanding of macroeconomic constraints on growth in developing countries is significant as it explains macroeconomic interactions between the short-run and the medium-term.

1.3. Now, we will turn to the effectiveness of macroeconomic tools available to policymakers which also differ between developed and developing countries. In this aim, we will look into fiscal policy and monetary policy.

(a) The governments in developing countries do not have much fiscal flexibility in either revenue or expenditure. In developing countries, tax revenues are largely taken from indirect taxes and much lesser from direct taxes (e.g. income tax, corporate tax) unlike developed countries. In addition to this, the tax base is considerably narrower in developing countries, and tax compliance is also lower (on one hand, it is due to tax avoidance and tax evasion, and due to a lack of information to be used to monitor tax compliance, on the other hand). Since Tax-GDP ratios in developing countries are much lower than in developed countries, therefore, it is cumbersome for governments to increase their income through tax revenues, and the scope for stimulating the economy through tax cuts is also meager.

As far as the expenditures are concerned, the share of investment in total public expenditure is higher in developing countries than in industrialized economies because private investment in infrastructure is not imminent. But in difficult times, it is hard for developing country governments to cut current expenditures, so they are left with no option but to cut the investment. As engaged in excessive fiscal stringency, these countries have to pay a high price in terms of lost growth. But there is policy space which can be used on the basis of idea of cumulative causation in the process of development. Public investment improves infrastructure and crowds-in private investment, both of which are advantageous to growth, while expenditure on social sectors (mainly health and education) is to be viewed as investment rather than consumption, which can increase productivity. It is the multiplier effect of government expenditure that creates revenue through buoyancy. With the development of institutions and with the acceleration of economic development, fiscal flexibility increases.

(b) In terms of reach of monetary policy, developed and developing countries have very distinct and noticeable differences due to underdeveloped and segmented money markets in developing countries. The monetary policy does not seem to be effective if it affects only a narrow part of the population. When fewer households are borrowing for housing and fewer firms are borrowing for investment, the effect of changes in interest rates or credit availability would be limited. Experience shows that beyond a certain point, higher interest rates do not combat inflation just as lowering interest rates does not stimulate investment. Traditionally, 'interest rate' is known as a strategic instrument to influence allocation of scarce investible resources. But 'credit volume' (rather than 'credit price') is also considered to be effective as an instrument of monetary policy. The deregulation of domestic financial sectors and capital account liberalization has reduced the space for monetary policy. Therefore, today's monetary policy should not be narrow in its objectives (i.e. managing inflation alone) and as an instrument (i.e. only interest rates).

Sometimes, the thinness of financial markets in developing countries might provide an additional policy instrument to governments. In developed countries, there is increasing reliance in market mechanisms and disbelief on the use of 'window guidance' (i.e. central bank's suggestion to domestic banks to curtail lending) and 'direct controls' because banks do not pay any attention to window guidance as they are simple cautions and direct controls are also ineffective as firms and financial institutions find out ways to evade them. But these instruments seem to be effective in developing countries. As previously described, the volume of credit in developing countries can be more effective instrument of monetary policy than the price of credit. In a banking system with few banks, the central bank can easily govern credit controls, or even oversee much targeted policy e.g. limiting credit to one particular sector etc. because the circumvention of direct controls is difficult in less developed financial sector.

(c) The interaction of fiscal and monetary policies brings different macroeconomic implications in developing countries. For example, the monetary impact of fiscal policy is possibly greater in developing countries because a large chunk of fiscal deficit is financed by borrowing from the central bank as the alternatives are few and far between in a thin and narrow capital market. Moreover, borrowing from the central bank is the principal source of reserve money in developing countries so it is the most important determinant of monetary expansion. This is no longer the case in some Latin American economies, but remains the reality in many other developing countries. Similarly, the fiscal impact of monetary policy is also greater in developing countries. For example, when public debt is large as a proportion of

GDP and interest payments on these debts are large as a proportion of government expenditure, even a mild change in interest rates put a strong impact on fiscal flexibility.

With the deregulation of domestic financial sector in developing countries during last 30 years, more vibrant markets for financial assets are emerged. This should have made interest rates a stronger and more effective instrument, but, paradoxically, it hasn't. Capital market liberalization, which permits free inflow and outflow of capital, has constrained the use interest rates as a monetary policy tool, as lowering interest rates can result in capital outflows. Even developed economies are not immune to the restraints of international financial markets, but the reach of their monetary policy is still greater. Empirical evidence seems to suggest that the developing countries, especially the emerging market economies, can augment the effectiveness of their monetary and fiscal policies by regulating capital flows. China, India, Chile, Colombia, Malaysia, and Taiwan have all been successful at this (Stiglitz et al, 2006).

In order to strengthen the ideas on fundamental variances between developing and developed countries presented in this part, we will elaborate and analyze the historic events from 1970s through 1990s in the second part.

Part 2. Historical Events from 1970s through 1990s – Liberalization, Adjustments and Crises:

2.1. Since markets in developing countries were flawed as being shallow and weak, it provided impetus to astute government intervention for mitigating these flaws. This initiated the upsurge of financial repression in developing countries, first catalogued by Mckinnon (1973) and Shaw (1973). As result of these flaws, financial intermediaries failed to provide socially-optimal levels of capital and this shortage of capital was seen as principal reason for underdevelopment. So capital provision needs to be prioritized, keeping in consideration the government development plans and government budget deficits, which push governments to intervene in domestic financial markets – both in terms of the price and the direction of credit. The most dominant feature of this period was very low, often negative, interest rates on deposits and loans (Sikorski, 1996).

As result of these controls in combination with corruption and non-benevolence, a number of distortions, rent-seeking and inefficiencies could be seen into all aspects of financial markets. Direct money controls and the resulting disintermediation resulted in more fragmented and dualistic financial sector (i.e. co-existence of formal and informal financial sector). Capital flew from the country and savers declined to hold domestic financial assets, which governments in these developing countries failed to 'undo'. This scenario set out the case for financial liberalization. The logic was that since government controls on the financial system were 'repressing' it and triggering market failures, therefore the solution to this "financial repression" should be "financial liberalization" i.e. the removal of government controls. The theory of financial liberalization theory was founded on extraordinary faith in markets which called for the 'removal of government'. Therefore, policy prescription asked for the freeing of financial markets from government's shackles to let the forces of market-clearing work. Identified as the main culprit of repression, 'ubiquitous interest rate ceilings' were removed on the basis of this reasoning that permitting interest rate to reach its market-clearing level would increase both the quantity and quality of investment and ultimately growth, as significantly higher interest rates would attract greater amount of savings to be used in investment projects. Moreover, as credit is allocated at a higher price on basis of its 'market' worth, only those investments would be undertaken which were productive enough to meet payment obligations. On these foundations, McKinnon-Shaw prescriptions became new orthodoxy and got enormous academic interest with the passage of time. A growing body of literature is marked by elaborate theoretical justifications and empirical examinations of this orthodoxy.

This philosophy was strengthened by historical turn of events in the 1970s[4]. The price of fuel oil abruptly quadrupled and a significant shock was apportioned by all world traders. Although developed as well as developing countries had to deal with unprecedented growing bills for imported fuel oil, however, developed countries were at better position to handle this shock for some reasons. First of all, developed countries produced goods which are needed by 'Organization of the Petroleum Exporting Countries' (OPEC) so prices of these goods could be increased to compensate high fuel prices. Moreover, OPEC deposited major portion of its revenues from fuel oil exports in banks of the developed countries. In addition, developed countries also had the technological capability to improve fuel-efficient processes and alternatives. On the other hand, conditions in developing countries were entirely different. For example, they cannot substantially increase the price of their exports. Therefore, the prices of their primary exports became stagnant; resultantly they have to face balance of payments positions, and they also have very limited technological abilities. The developing countries therefore faced a sharp deterioration in their terms of trade as the prices of fuel oil and goods imported from developed countries went up (Gilbert, 1987). The result was a severe fall in output potential, which these countries attempted to offset by expansion of domestic money supply. The subsequent inflation and large deficits in balance-of-payment lead these economies to deep crisis. They were forced to borrow from international banks and financial institutions, because borrowing in domestic markets was very limited.

Dollar-denominated debt at world interest rates left developing countries vulnerable to heavy indebtedness resulting in failure to meet payment obligations. Borrowings of developing countries from International Monetary Fund (IMF) to meet financial requirements started a new orthodoxy in macroeconomics where developing world could no longer borrow of its own accord. The IMF became responsible for stabilizing these economies and imposed severe conditions on developing countries mainly on the imperative of 'getting prices right'. For example, developing countries were required to devalue currencies, reduce import and other indirect taxes and reduce government domestic expenditure. Devaluation was deemed to be crucial to make the price of foreign exchange realistic. Devaluation was followed by reduction in credit to reduce inflationary tendencies by controlling aggregate demand. In addition, reduction in import and other indirect taxes would lead to more efficient allocation of resources, which would, in turn, improve aggregate supply. All of these steps would increase exports which could control inflation and the balance of payments deficit. This is the premise on which IMF conditionalities are established. The record of the performance of countries that had agreed to the IMF conditionalities, however, is somewhat mixed (Jha, 2003).

The crisis due to the oil shock helped to focus attention on the theoretical keystones of the IMF policy prescription. It is implied from IMF policies that it is not obligatory to develop a separate theory to understand the macroeconomic problems of developing countries. It was mainly focusing on demand side under the implicit notion that supply side responses would improve under structural reforms. The structuralist school came with entirely different

[4] The series of events during this period gave impetus to 'Structuralism' – a significant and distinguished line of theory. More recently, structuralism has been enshrined by significant contributions from economists such as sweder van wijnbergen and Lance Taylor.

theoretical perspective by arguing that the IMF-type demand stabilization would only intensify stagflationary tendencies in developing countries because supply conditions would be adversely affected. This point of view got support from the 'qualified' success of the IMF stabilization program in most developing countries. Consequently, the debate about whether a different theoretical approach is required to study the macro problems of developing countries gained credibility.

These events also had significant implications for understanding "adjustments" in developing countries. The process of adjustment at a macro level differs not only over time but also across space in different economies. In most of economic theory, the mechanism of adjustment must work either through prices or through quantities or through combination of both. Unlike developed countries, developing countries are more susceptible to income adjustment and less prone to price adjustment because of price rigidities prevalent in these countries. Hence, they mostly adjust through changes in output rather than changes in prices. Another significant difference between industrialized and developing economies lies in the speed of adjustment. Generally, the speed of adjustment in developing countries is slower than that in industrialized countries due to (i) absence of perfect mobility or substitutability of resources across sectors and (ii) inflexibility of prices, especially prices of factors-of-production. Hence, structural rigidities are basis due to which the mode and the speed of adjustment at a macro level in developing economies are different from those in industrialized economies.

2.2. The results from the periods of liberalization and stabilization during the 1980s were mixed, mostly dreadful, frequently leading to the periods of financial crash and chaos (Cho and Khatkhate 1989; Diaz-Alejandro 1985). From the consequential discontent emerged a response from the proponents of financial liberalization i.e. the implementation of reforms was held responsible, instead of logic of reforms. It propagated that reform are to be endeavored only after meeting some initial preconditions. This idea is not weird but the suggested preconditions failed to prove why financial crisis follows from liberalization. It misses the basic failings of financial liberalization which have great implications for policy prescriptions. These basic failings are severe enough to infer that it is not merely the issue of preconditions; rather it is liberalization which is inappropriate and unsuitable for developing countries due to their 'institutional realities' that are entirely different in developed countries (Sikorski, 1996).

The most important institutional reality stems from the highly-leveraged industrial structure in developing countries because under repression, only those firms have access to credit in the official markets and associated subsidies which are linked to government's development programs of industrialization (Villanueva and Mirakor 1990). The banks conspire with these large industrial firms because lending to them comes with implicit guarantees of repayment from the government. Since banks are usually characterized by severe asymmetric information, adverse selection and moral hazard, which on one hand, impede them from serving the small and medium firms resulting in credit-rationing and on the other hand, results in high debt-equity levels in the economy. When developing countries start liberalizing, increasingly high interest rates put these leveraged firms into a Ponzi-game[5]. In this game, firms experience an increase in interest cost on outstanding debt which act as an exogenous

[5] A Ponzi-game is a situation in which a firm must borrow to meet an increase in payments on outstanding debt. The additional borrowing, however, serves to increase the debt load, worsening the financial position of the firm. The firm borrows to survive, but in doing so makes its own position more hazardous (Minsky, 1986)

shock to the firms because it was not a part of past expectations on which borrowing was made. Commercial banks go through a vicious moral hazard in which their loan portfolios are highly exposed to these firms and it is a matter of solvency for banks to keep lending to these firms even though these loan portfolios are becoming non-performing. Since the failure of the firms would cause the failure of the bank, therefore, the bank continues to lend to stave off its instant failure, in the weak faith that firms will ultimately start to perform on the loans.

Here comes the stance of monetary policy which may choose to fully accommodate the needs of Ponzi-boom which maintained the solvency of the system in short-run but it is unsustainable in long-run as it leads to additionally large build-up of non-performing debt in the system. Alternatively, the monetary authority may opt a policy stance to withdraw from the liberalization program by restoring interest rate controls and trying to retrieve the units in the economy through industrial and financial restructuring. Because of the large restructuring costs, government will need the banks, rather than industry, to absorb the losses by writing off substantial amounts of non-performing assets. This requires government to become more persistent in financial markets because it has to provide banks additional financial and administrative support to compensate them for absorbing the enormous adjustment costs. The net effect is increased financial repression in the economy and damaged credibility of the government. Hence, the whole tiering of financial claims under repression weakens the applicability of liberalizing policy prescription in developing countries. Even with macroeconomic stability and proper sequencing (as suggested by proponents of liberalization), financial liberalization leading to a rapid change in the price of credit is not feasible for a developing country with the stated institutional structure. However, there is a precondition which might damper this conclusion i.e. full industrial restructuring and overhaul of banks' portfolios. This precondition implies that these countries must stop showing the problematic characteristics that institute the obstacles to development. In simple words, the developing countries should stop being 'developing countries' – the applicability of this notion for policy prescription is vague.

Conclusion:

The prices of fuel during 1970s in combination with wave of liberalization in 1980s resulted in high indebtedness of developing countries of Latin America and Asia which left them with no option but to turn to IMF that forced them to follow their short-term stabilization program on unashamed faith that long-term growth will follow. Empirical evidence seems to suggest that the IMF stabilization packages have tended to reduce inflation and balance of payments difficulties at the cost of sacrifice of the rate of economic growth. As of yet, there is no consensus on what is the 'right' macro model for developing countries. The debate about whether a different theoretical approach is required to study the macro problems of developing countries gained credibility. But this debate is still unresolved. However, the financial crisis during 1990s, persistent recession and ensuing lowered growth provide a prospect to rethink macroeconomics in developing countries. The financial liberalization theory failed to outline various roles of government and the market due to faulty understanding of institutional structures. Due to the differences in the quality and maturity of institutions, the framework for macroeconomic policies in developing countries, in terms of objectives, instruments or stance, need to be different from that in industrialized economies.

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