Chapter II

SURVEY OF LITERATURE

I. INTRODUCTION

The macroeconomic concepts have been in discussion among many subject experts. The economy must be open without controls but there were different opinions by different schools of thoughts. Many differ on the views proposed by some. Some with the ideas proposed by a few some of these few scholars do not hesitate in showing the reasons for disagreement but they prefer that whatever they feed or state, should be accepted by the others. Every one has some or less disagreement on the macroeconomics strategies and policies. But all of them agree on one point that the root of all the issues that arise in the economy are due to the money and its functions. They excessive use of function of money by the group of society to any group in the society viz. households, business or anywhere else function of money would create problems in any economy.

These difficulties or problems, an individual alone cannot solve. The government provides money in different forms and quantity (generally based on the
market and societies needs). Under-use or overuse of money or the method of using money in conformity, will lead to monetary distributions within the economy. To bring the economy back from distortions, the government has to adopt a strategy (take some decisions) which it takes through monetary policy, by reducing the quantity of money or pumping more money as the case may be or as the economy may be stable.

If the quantity of money is increased it gives rise to inflation prices of general commodities increase and just the opposite if the quantity is decreased. There is a need for both the forms of distributors, as it leads to various economic constraints. Inflation (high prices) may be good for businessmen and investors but troublesome for wage earners or people with fixed income. Therefore, quantity of money in any economy should be such that it equates the demand of society and market. This situation is said to be a stable point.

But looking to the economy as a whole, economic compensation some economic spadework is required for any economy. GDP growth, employment opportunity interest rates exchange rate, inflation, are a few factors, which should be spontaneously dealt rigorously and with vigor and if it is found to be weak due to certain reasons or pressures fiscal policy intervention of the government becomes a necessity. The economy when runs with open market it is the condition where it is said the fittest would survive. But for those who are poor and not fit to survive, they should be provided economic help from what is at their reserve.

Monetary policy is the main theme of this study, but hypothesis the theories or models always suggest how and in which way economic stability can be maintained. How full employment can be attained? Which factors and to what extent the targeted results can be achieved by the economy? These questions from the external look
appear to be simple, and have clues for them. But the results that are derived by applying such policies (clues may neither be similar in different economies nor would be results equal among two different countries. The studies carried out by different, scholars, in different countries, no two studies shall agree to a single outcome of the study. But it is necessary that there would be some principle or a study, which someone has tried or done should be referred, so that something can be gathered from its outcome, that can be applied in the directive form or with some additions or subtractions so that the economy for which the monetary policy is applied some favorable results may come and accepted by many experts in the subject.

For this purpose in mind and to suggest some thing more in the new form, the studies undertaken by the researchers and their outcome is discussed in this chapter.

Many aspects put together form the wholesome macroeconomic concept discussion. A few aspects relevant to macroeconomics are discussed below.

II. VARIOUS ASPECTS RELEVANT TO MACRO ECONOMICS

Various aspects pertaining to macroeconomics are the basic factors, which are to be dealt with the subject matter is given a factual shape. They are Gross Domestic Product, Growth rate, inflation, VE, CA/GDP, saving investment, export, import, budget, etc.

All the above aspects focusing macro economic policy for economy may be formulated on the basis of actual issues and problems that exist in that vary economy.
III. STABILIZATION AND GROWTH

In this study as the major concern is stabilization and growth, some of the factors mentioned above become of lesser use but they would be reverted as and when required. As from the title of the study the main aspect is Money-prices to give proper justice to the subject it becomes necessary that all the aspects which are relevant to money and prices the role of money, its impact to prices, effect on production and distribution. This becomes the issue subject relevant to the market.

After earmarking the above one sort of limitation becomes necessary in the form of measure and mature aspect which effect the economy thus giving up the subject macro economic condition and policy of Indian economy. India has adopted planning for fastening the process of developments.

IV. PLANNING AND GROWTH

India has adopted planning the main-stay for its development, here it should be noted that Indian government has followed procedure of creeping liberalization that was followed by consecutive Indian government till the 7th decade. After 1985 many studies on the aspect stabilization and structural adjustment, liberalization, change in policy agriculture and industry, change in agriculture policy, exchange rate policy, financial liberalization where full concentration is made face during lack of confidence much of the pressure has become on finance and currency. Economic and social aspects in cooping up with the subject some views of the scholar taking into consideration stabilization and economic growth some studies shown below:
V. CONTROVERSIES - DEVELOPMENT & MONETARY POLICIES

There have been certain controversies among development and monetary policy one of such policies highlighting their controversies on the effectiveness and controversy for the development of economy Keynesian and monetary though focus on structural aspect of macro policy.

Keynesians thought of structural aspect had already under criticism in the fifth decade of the 20th century.

VI. BALANCE OF PAYMENT

There after discussion on balance of payment for which inflation and rate of interest become target and discussion for the monetary policy maker thereafter to bring the economy at the balance it becomes necessary that controversies of monetary policy varies fiscal policy should subsidize.

It was the period, when it was said that monetary policy allow or fiscal policy by itself would be sufficient in melding the distortion in the economy particularly in balance of payment. Thus, the whole discussions lead the economy to target rate of inflation and other variables.

Stabilization and Growth aspects:

Andres Solimano - (1990)

In his study highlights various experiences are revived with stabilization it examine stabilization progress in context of hyper inflation looking at the experiences of Australia and Germany 1920s and Bolivia in 1985 and then interprets result's of

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1 Andre Solimano (1990), “Inflation and the costs of stabilization, historical and recent experience and policy lesson”. The World Bank Research observer, Vol. 5 no. 2 (July 1990), pp. 167-85

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orthodox stabilizing plan (applied in Chile, Argentina, Uruguay during mid 70s and early 80s) and those heterodox programs and astral plan in Argentina and the crusade plane Brazil with the glance of the Mexican and Israeli experience the paper concluded with conceptual issues and implications for the design of stabilization.

**Transitory economics**

*Simon commander- (1992)*

In his paper focusses on European socialist economies, found out that they were acratrised by low or negligible open inflation, full employment and stable relative prices and real income. Associated features where significant repressed or hidden inflation disequilibria in goods market move recently as economic and political reform has advance attention shifted to translating repressed into open inflation where such reforms have proceeded against a background of monetary overhang the implication of that overhang for demand side policies have figured prominently in all instances however the key underlining issue has been the transmission mechanism for inflation once the initial impulses associates with price liberalization has been imparted.

A) In his study Poland and Yugoslavia with high inflation was preceded by fight from domestic money that would have increase income velocity of domestic M1 and eroded the inflation tax base, thus, rising equilibrium inflation (Coricelli and Rocha 1991).

The accelerated dollarization characteristics of these cases reflected basic uncertainty regarding the direction of economic policy and the apparent lack of rules in determining price changes by the government. Anticipation of the further price

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changes resulted in upward adjustment to market prices thus, widening the gap between administered and market price adversely acting on the fiscal deficit and resulting in over shooting.

B) In Yugoslavia currency depreciations triggered by choosing access to external credit to finance current account deficit and defector wage indexation proved a powerful inflationary channel. The inflationary spiral was triggered and imparted by nominal exchange rate and wage increase consistent with real exchange rate and real wage targets and with the inflation with the tax generated by the foreign exchange target however although the central government accounts show no major fiscal imbalances, enterprise claims on the banking system claims on the banking system expanded significantly interest rate subsidies (Mats - 1990 Rocha-1990) real exchange rate shocks further resulted in enterprises being unable to service there foreign dept consequently socialization of external liabilities and credit subsidies fueled expansion quasi-fiscal deficit and was a major factor behind monetary expansion.

**Interest Rate - (IS-LM Model)**

**Guillermo A. Calvo (1992)**

This study highlights high interest rates are considered an effective tool for stopping high inflation. The case for a policy of high interest rates is developed in terms of a conventional IS-LM model however, among other things; the model ignores some central aspects of the modern credit markets. In particular high interest rates may give rise to nonperforming bank loans, thus seriously policy. Examples are developed in which it would be optimal to aim for equilibrium of low, rather than

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3 Guillermo A. Calvo, in his paper are high interest rates effective for stopping high inflation some skeptical notes. Page 55 to 69 the World Bank economics review volume 6. January 1992 November.
high, interest rate. One of these examples hinges on the existence of no indexed domestic debt.

**Disinflation and Exchange Rates**

*Miguel A. Kiguel and Nissan Liviatan*

This study examines the effects of disinflation on economic activity in countries characterized by chronic inflation. Such countries have a long history of inflation at rates exceeding those in industrial countries as well as labour and capital markers that have adjusted to function in an inflationary environment. A sample of disinflation programs in several Latin American countries and in Israel demonstrates that stabilization efforts in several countries with chronic inflation often do not induce the usual Phillips curve trade-off in the medium run. Specifically, stabilization programs that use the exchange rate as the main nominal anchor are often associated with a business cycle that begins with a boom and ends with recession. Stabilization programs that use money supply as the nominal anchor generally induce the expected Phillips curve result: lower inflation is accompanied by a recession after the program is implemented.

It is generally believed that stabilization programs aimed at stopping inflation involve an initial cost in loss of output because of rigidity in past nominal contracts (as in Fischer 1988 and Taylor 1979) or because of credibility problems. The classical recessionary scenario is also observed in chronic inflation economics that implemented orthodox stabilization programs, which used money as the nominal anchor of 1974-75, in which tightened monetary and fiscal policies led to a depression.

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Equilibrium Model
Edward F. Buffie

This article highlights a dynamic, dual economy general equilibrium model that can be adopted to analyze the short-and long-run effects of a variety of fiscal policies. The model provides a complete description of how the private capital stock, underemployment, and real wages evolve during the adjustment process. The main policy message conveyed by the result is that the method by which the fiscal deficit is lowered is important. There is a strong presumption that higher price for publicity produced intermediate inputs and cut backs in government expenditure to support social infrastructure will reduce private investment real wages in both the labor force employed in the high-wage manufacturing sector. By contrast, lay offs in the final goods and service can potentially improve the external balance without sacrificing output and employment growth.

A central dilemma facing policy makers in developing countries today is how to revive economic growth while maintaining debt service after the debt crisis in 1981, 82 I.M.F. type.

Two striking aspects of the adjustment after 1982 in many developing countries have been the collapse of investment (both public & privates and the sharp increase in underemployment.

High rates growth and investment have been accompanied by rising employment- in country like India.

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5 Edward F. Buffie the World Bank economic review vol. 6 No.2 page 331-351. Article may 1992. The short and the long-run effect of fiscal policy
Price Stability and Growth

Alex Cukierman, Steve B. Webb, and Bilin Neyapti

Focus on making the central bank an agency with mandate and reputation for maintaining price stability is a means by which a government can choose the strength of its commitment to price stability. This article developed four measures of central bank independence and explores their relation with inflation outcomes an aggregate legal index is developed for four decades in 72 countries. Three indicators of turnover of central bank governors, an index based on a questionnaires answered by specialists in 23 countries and an aggregation of the legal index and the rate of turnover.

Legal independent in inversely related to inflation in industrial, but not in developing countries, in developing countries the actual frequency of change of the chief executive officer of the bank is a better proxy for central bank independence. An inflation based index of overall central bank independence contributes significantly to explaining cross country variations in the rate of inflation.

Institutions cannot absolutely prevent an undesirable outcome nor ensure a desirable one, but the way that they allocate decision making authority within the public sector makes some policy outcomes more probable and others less likely. Making the central agency with the mandate and reputation for maintaining prices stability benefits the economy and the government itself in various ways central bank independence is one of the means by which a government can choose the strength of its commitment to price stability (Cukierman 1992a, chapter 23, and 1992b Lehman 1992)

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6 Alex cukierman Steven B Webb and Bilin Neyapti in his paper measuring the independence of central bank and its effect on policy outcome the World Bank Economic Review vol.6 No.3 September 1992 page 353-398.
Inflation and Imperfect Information
Alex Cukierman and Nissan Liviatan

Advocates inflation inertia may be quite tenacious because of the simultaneous interaction between policy actions and inflationary expectations under imperfect-credibility this result is particularly relevant for understanding in South America. There it is deal with the issue of inertia in the framework of imperfect information about the type of the policy makers and extends the existing models to an infinite horizon because policy makers do not have perfect control of inflation a "frivolous stabilizer" may deviate from the policies of "serious stabilizer" without necessarily being unmasked immediately when the difference in the ability of "strong and weak" policy makers to control inflation is large, unexpected inflation may be persistently negative for quite a while, thus causing reduced economic activity and giving the indication that credibility is low if the policy maker persists with the stabilization, the pattern gradually disappears as his reputation rises. But before this final stage the serious policy maker has to compromise his inflation objective in view of adverse expectations about his type and pay the cost of imperfect creditability.

Fixed Exchange Rate and Nominal Exchange Rates
Stephen A. O'Connell

States, countries on fixed exchange rates sometimes use uniform tariff cum subsidy cuts schemes as a way of achieving a real depreciation without disturbing the nominal exchange rate. A potential draw back of this policy in relation to an across-the - board devolution is that a UTCs scheme provides incentives for illegal trade using an optimizing model with currency convertibility and illegal trade, it find that

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7 Alex Cukierman and Nissan Liviatan in his paper (study) the dynamics of optimal gradual stabilizations. The World Bank Economic Review vol. 6 No. 3 page 439-458 September 1992.
welfare is lower under a UTCs scheme than under a corresponding across-the-board devaluation and than in some cases the real exchange rate actually appreciates in response to an increase in the UTCs rate.

Laker (1981) studied the use of uniform trade taxes and closely related fiscal proxies for devaluation in France and federal republic of Germany (1968, 69).

In the literature about trade theory, the close formal relationship between UTCs scheme and revaluations was pointed out by Meade (1951) and later, by Bhagwati (1968) and Dixit and Norman (1980). A recent treatment is given by Adams and Greenwood (1985) who derive a precise equivalence result between uniform trade taxes and exchange rate changes.

They found that in a frictionless, competitive environment, UTCs scheme covering trade in goods and services is fully equivalent to a revaluation of the commercial rate in a dual exchange rate system.

**Exchange Rates, Interest Rates, Prices**

Stijn Claesens

His paper says the changes in exchange rates, interest rates and commodity prices during the past decades have had large impacts on revealing countries many developing countries have limited access to already incomplete international long term begging markets. Thus the question arises whether the currency composition of external debt can be used to minimize exposure to external price risk using a utility-maximizing framework, this article shows that, by choosing the optional currency composition, a country can indeed manage its external exposure to external price risk.

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9 Stijn Claesens in his paper the optimal currency composition of external debt. Theory and applications to Mexico and Brazil. *The World Bank Economic Review* vol. 6 No.3 September 1992 page 503-528
using utility maximizing frameworks, this article shows that, by choosing the optimal currency composition, a country can indeed manage its external exposure, the optimal, risk-minimizing currency composition depends on the relation between export receipts and the costs of borrowing in each currency and on the relations among the costs of borrowing in different-currencies a simple methodology can be used to derive the optimal shares of individual currencies and is applied to Mexico and Brazil the result shows that Mexico and Brazil could have lowered their external exposure to a limited degree by continuously altering the currency composition of their debts. The low correlation between the costs of borrowing and export and import prices makes the currency composition of debt a very imperfect hedging tool, and it is likely that hedging instruments directly linked to prices are preferable once external exposure is quantified one can try to manage it by using financial instruments to transfer exposures to other parties more able to absorb them.

This article shows that an integrated analysis of the external risks an economy is facing is necessary to measure external exposures correctly.

In general, the results indicate that the currency composition of debt is an imperfect hedging tool against external price uncertainty.

Urban Rural Output Compositions & Economics Growth

Martin Ravallion and Guarav Dutt\textsuperscript{10}

In his international using a new series of consistent, consumption based poverty measures spanning forty-years we access how much India's poor shared in the country's economic growth taking into account its urban-rural and output composition. Rural consumption growth reduced poverty in both rural and urban

\textsuperscript{10} In his paper how important to India's poor is the sectoral composition of economic growth? The World Bank Economic Review vol. 10 January 1996 page 1-23.
areas. Urban growth brought some benefits to the urban poor, but had no impact on rural poverty and rural to urban population on shifts had no significant impact on poverty decomposing growth by output sectors, we found that output growth in the primary and tertiary sectors reduced poverty in both urban and rural areas but that secondary sector growth did no reduce poverty in either.

It is sometimes claimed that the sectoral composition of economic growth is an important determinant of the rate of poverty reduction in developing countries but testing that claim in difficult.

There has been much debate about how much India’s poor have shared in the country’s economic growth some critics have argued that the gains in form output from the green revolution brought little or no gain to the rural poor, while other have pointed to the growth of farm output as the key to reducing rural poverty (Lipton and Ravailing (1994) review this debate in this article we report new empirical evidence that sheds light on the effects of the sectoral pattern of economic growth on poverty in India over forty-years. Despite the substantial sectoral shifts that have occurred over the last forty-year poverty in India is still over whelming rural.

**Private Capital and Economic Development**

*Micahael Dooley, Eduardo Fernandez-Arias, and Kenneth Kletzer*

Study focus on the outlook for economic development for an important group of middle-income countries has once again been buoyed by substantial private capital inflows in the 1990s, as in the 1970s this development has been made with cautious optimist this empirical study finds that although debt reduction and policy reforms in debtor countries have been important determinants of renewed access to international capital inflows to developing countries. *The World Bank Economic Review*. Vol 10. January 1996 page no. 27-50
capital markets, changes in international interest rates have been the dominant factor. We calculate the effect of changes in international interest rates for a typical debtor country. We conclude that increase in interest rates associated with a business cycle upturn in Industrial countries could depress the secondary market prices of existing debt to levels in consistent with continued capitals inflows.

The turnaround in the external financial position of many debtor countries since 1989 has been phenomenal. Today the recovery in real economic activity and capital formation in debtor countries is just beginning but a financial recovery issue; under way.

Secondary market prices may be move informative as a barometer of the financial strength of a debtor country as compared to the volume of observed private capital inflows. There have been important permanent improvements in many in many debtors' financial positions.

Global Financial Crisis and Financial System

Joseph E. Stiglitz

His paper says economists seeking explanations for the global financial crisis of 1997-99 are reaching consensus that a major factor was weak financial institutions which resulted in part from inadequate government regulations. At the same time many developing countries were struggling with an overregulated financial system—one (of the) that stifles innovation and the flow of credit to now entrepreneurs and that can stunt the growth of well-established firms. In particular too many countries are relying excessively on capital adequacy standing. Which are inefficient and sometimes counter-productive, the author argues that financial systems can be

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reformed successfully using a dynamic portfolio approach aimed at managing the incentives and constraints that effects not only financial institution’s exposure to risk but also their ability to cope up with it the article ability out general principles of financial regulation and shows how the dynamic portfolio approach can help countries deal with the special problems that arises during the transition to a move liberalized economy as well as those that arise in dealing with financial crisis similar to the 1997 crisis in east Asia.

As dramatic as it was the global financial crisis of 1997-99 was only most recent in a rash of crises that have devastated market economic over last 25 year.

Financial crises have become move sever and more frequent in the last quarter of a century. With respect to regulation two financial observations about financial restructuring are worth noting.

First, the costs of restructuring can be divided into two components.

The second component of the cost of restructuring involves the capital requires to restart the banking system.

One arises from the negative network recorded by many banks because, of the high level of bad loans.

**Theory on Foreign Trade & Investment on Equality**

Richard N. Cooper\(^\text{13}\)

His paper informs that this article, a survey of theory and evidence, addressed the influence of foreign trade and investment on inequality, with a focus on

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developing countries since growth affect the level of poverty and the distribution of income the trade growth nexus is also addressed. The finding are inconclusive perhaps leadings to antagonistic view of the relationship of foreign trade and investment to world economic growth and distribution there are no compelling theoretical reason to believe, in general, that trade promotes. Growth (as disguised) from an increase in real income and the empirical work purporting to make a connection at the country level has been criticized on methodological grounds the theoretical case that foreign investment should stimulate growth and diminish world and host country inequality of income is stronger and some aggregate evidence credits foreign direct investment (F.D.I.) with a significant growth-enhancing impact. Despite the ambiguity of theory and evidence it strains credulity to believe that trade liberalization did not play a significant role in the growth of the world economy in the last 350 years and hence in the great reduction of poverty. The article suggests the rebut tables presumption that a country wanting to develop should ensure that exports remain competitive and that domestic production not be insulted from foreign competition.

Global inequality should not be focus of great interest or research undesirable consequences may well flow from greater inequality in particular circumstances, especially if the growth in inequality, on the usual measures is a natural consequence of uneven growth and uneven growth is better than none. The key question is whether people lives are improving. The result of this survey of theory and evidence are inconclusive, perhaps leading to an agonistic view on the relationship of foreign trade and investment with world economic growth and its distribution.

There are no compelling theoretical reasons to believe, in general that trade promotes growth (as distinguished from an increase in real income) and the empirical
work purporting to make a connection the country level has been heavily criticized methodology around.

**Trade Policy and Business in Developing Countries**

*Will Martin*\(^{14}\)

Study says recent years have seen substantial reduction in trade policy and other barriers inhibiting developing country participation in world trade. Lower barrier have contributed to a dramatic shift in the pattern of developing country trade-away from dependence on commodity exports to much greater reliance on manufactures and services. In addition exports to other developing countries have profound implication for the role played by developing countries in the world economy and trade system.

Over the past 50 years, trade's role in the world economy has increased dramatically. Trade was grown much faster than output and most of the countries that have achieved the fastest economic growth have done so by rapidly increasing their participation in the world trade.

Until the mid 1980's most developing areas relied primarily on commodity exports. By the late 1990's about 80 percent to (dramatically increase manufactured) exports from developing economies were manufactured goods greatly easing earlier concerns about the role at trade.

The world has been rapidly integrating in recent decades. Although this process appeared to have broad support in the early mid 1990s it has recently come under sustained attack. An important feature of the integration process has been the

major shift in trade relations between industrial and developing countries. This shift, from dependence on export of commodities to much creator reliance on exports of manufactures and services, is sufficiently pronounced as to require rethinking of old views of trade developments.

Trade and Role of Technology Transfers

Kamalfaggi\textsuperscript{15}

Study shows what role does trade play in international technology transfer do technologies introduced by multinational firms diffuse to local firms? What kinds of polices have proved successful in encouraging technology absorption from abroad and why? Using these questions as motivation, this articles surveys the recent transfer, paying particular attention to the role of foreign direct investment the literature argues that trade necessarily encourages growth only if knowledge spillover is ambiguous several recent empirical plant level studies have questioned earlier studies that argued that foreign direct investment has a positive impact on the productivity of local firms yet at the aggregate level, evidence supports the view that foreign direct investment has a positive effect on economic growth in the host country.

Economic growth result from accommodation of factor of production or from improvement in technology or both, to encourage the generation of new knowledge industrial countries have elaborate system of intellectual property rights in place and conduct the majority of the world's research and development. This article\textsuperscript{16} has covered a rather large terrain. This section highlights the seven main points.

\textsuperscript{15} Kamalfaggi. "Trade foreign direct investment, and international technology transfer", a survey. \textit{The World Bank Research Observer} volume 17. No.2 (fall 2002) pg. 191-235

\textsuperscript{16} Studies by argy (1970) Kirkpatrick and Nixon (1976) and Struthers (1981) show that food and agriculture supply bottlenecks, export instability and budget deficit adjustment play an important role in inflation in the developing economies. The conclusion regarding contribution of monetary variables contradictory while Kirkpatrick and Nixon's study suggests a significant contribution of monetary variables.
1. Role of trade in encouraging growth
2. Relative role of trade and F.D.I.
3. Existence of several channels of international technology transfer raise.
4. A well-developed paradigm seeks to explain the emergence of multinational.
5. Local policy often cause foreign firm to opt for licensing or joint ventures over F.D.I.
6. Policies designed to lure in F.D.I, has proliferated in recent years.
7. Several studies indicate that absorptive capacity in the host country is crucial for obtaining significant benefit from F.D.I. empirical evidence supports the argument that IPRS are trade related and the asymmetric IPR protection across countries distorts that pattern of world trade.

Budget Deficits and Inflations

Whereas Congdon (1987) through a (U.S.A.) comparison of the U.S. and Brazil shows that large budget deficits are actually the cause of inflation. Also, a well-developed government debt market grants better maneuverability to the fiscal policy according to the study.

Raj (1966 model), which is within the demand pull framework on the one hand, and pandit (1973,1978), Krishnamurti Pandit and Palanives (1995) are within the cost-push framework on the other not running out the possibility of demand-pull inflation, Balakrishna (1992) argue that growth in money stock has no impact on inflation.

Linkage between increase in money stock and aggregate demand move rather than the impact of money stock on inflation is criticized. Result of these studies show that exclusive structuralism explanation of inflation does not fit the Indian case according to Mundell (1965) and Ghatak (1981), it such growth of money supply result in the transfer of real resources into more and more productive investment channels, there will be a positive impact on economic growth.
Buiter (1986) the study on for developed economies like U.K. or Japan gain in revenue due to inflation varies between - 0.47 and 3.40.

In case of developing economies this range is much wider and varies from 2.44 for Senegal to 17.52 for Egypt.

Study by Aghevci and Khan (1978, 1980) conclude that government expenditure increase with an increase in inflation while government revenue declined in real terms due to the operation lags. Since widening the tax base or improvement in revenue collection mechanism is difficult increasing government expenditure and expansion in money supply in case of the developing countries.

Three observations stand out this context:

One, public sector investment leads to a general crowding in phenomenon

Two, as the role of public investment in creation of infrastructure decline, the crowding in phenomenon weakness as well.

Three, a crowding out effect through the financial markers and due to the price level changes.

Open Economics and Devaluation

A study Gylfason and Schmid (1983) covering ten industrial and semi-industrialized, open economies suggests that devaluation resulted in expansionary effects on the economy in case of eight out of ten economies. Moreover, in a fixed exchange rate regime, the monetary authority attempt to maintain exchange rate against the speculative pressure causes balance of payments crisis.
Milne (1976) and Tahari (1978) share play suggests that budget deficit in developing economies is largely endogenous, and if might be the effect of a balance of payment deficit. Thus, the extent to which budget deficits cause instability in the balance of payments accounts of the developing economies remains to be examined.


Karras in his study (1999) has shown in a study of 37 economies including India, that the effects of monetary policy on the exchange rate are negatively affected by the economy's openness. Thus, the move open the economy is, the smaller the depreciation effects of a given increase in monetary growth rate especially in the short run.

**Capital Accumulation & Growth**

Klus Schhidt – Hebble this servel

Andresolimano\(^ {17}\) (1990)

In his paper the 1995 have seen a renewed interest in issues of capital accumulation and growth. New paradigms for saving, investment and growth have been advanced to address theoretical and empirical puzzles and to guide the design of better policies. This paper provides a policy oriented review of recent theoretical and empirical work on the determinations of saving and investment and on their links to growth. It takes stock of new findings as well as still attention to empirical regularities and to the policy issues relevant to developing countries.

The mid 1905 have seen a resurgence of interest in themes of capital accumulation technological progress, and economic growth.

\(^{17}\) Andresolimano. The World Bank Research Observer, Vol 11. Xo 1 (Feb 1996) pg 87-117
Although questions of capital formation technological progress and saving have been at the core of economic analysis for two to three centuries, the connections among them and the directions of causality are still far from clear. Several factors may start and support growth.

Despite the vireos circles of high saving, investment and rapid growth experience by some countries (notably in east Asia) the connections among these three variable are complex and causality may run in several directions.

Ensuring adequate levels of saving remains a central policy, concern not only to guarantee sufficient financing to capital accumulation, but to avoid an excess or investment over saving which may create inflationary pressures on balance of payments disequilibria. In his paper saving and investment paradigms, Puzzles.

Financial Markets & Stages of Development

Joseph E. Stiglitz$^{18}$

In his article says many factors contributed to the rapid growth of the economic of East Asia in the past quarter century. This article examines one important aspect of that growth commonly referred to as "East Asian Miracle" public policies affecting the financial markets East Asian Governments intervened extensively in financial markets at all stages of their development. What sets their actions a part from these of other developing countries that have not fared as well, we do not have the information to answer conclusively what effect particular actions had (that requires a counter factual lost of what growth would have been without the particular interventions. But we can identify the market failures the East Asia governments addressed, assess some of the theoretical reasons why each policy might be growth

$^{18}$ Joseph E. Stiglitz
enhancing and provide some data attesting to the impacts of the policy. Several characteristics of financial sector (investment) interventions in East Asian stand out: they incorporated design features that improved the chances of success and reduced opportunities for abscise interventions that did not work out ware dropped unresistingly and policies were adapted forefeet changing economics conditions.

The economic of East Asia, beginning with Japan and followed by the fourtiqers the republic of Korea, Hong Kong, Singapore and Taiwan (China) and then by Malaysia, Indonesia and Thailand and have growth so rapidly during the past quarter contrary that their growth has been called the “East Asian Miracle”.

Assuring that it was not really a miracle, but rather a consequence of some well designed programme and policies.

The main concern with activist policies such as those pursue in east Asia it abuse of political power: activist policies generally entail giving governments discretionary powers that can easily be abused.

In his paper Financial Markets public policy and the East Asia Miracle Joseph E. Stiglitz. 19

**Lags in Monetary Transmission**

Barring a few exceptions, not much has gone into the issue of measurement of monetary policy lags in case of the Indian economy, although the magnitude and variability of the lags has significant theoretical and empirical consequences.

The Classic Friedman Culbertson debate draws curios observations. Accordingly to these economists there could be historical mark-up from which a log

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can be measured. In a way a 'log' would mean a weighted average interval between
the action and its effects, Cargil and Meyor (1972) and Tanuer\textsuperscript{20} (1979) made an
attempt to develop a distribute lag model of long and short term interlot rates and
G.N.P. changes on money supply respectively these studies suggest that it is difficult
to estimate inside lags, that is, the time between the recognition that a change in
momentous policy is needed and an actual implementation of change in monetary
policy and the moment schedule change effects the economy can be estimated by
formal econometric evidence.

The actual lag depends on various transmission channels of monetary policy
and their predominance Friedman showed that shell momentary policy lag display
both inter cyclical and intra cyclical variability.

This is precisely dangerous for discretion stabilization policy.

Adding to this the difficulties of reversing the wrong discretionary measures
prompted Friedman to propose that automatic stabilization rules are better, the classic
instance that such variability can lead to disastrous momentous policy regime can be
drawn from the implementation of the same and contractions observed in the policy,
impact during the Volcker Greenspan era in the US economic, using the concepts of
causal lags and causal coherency as introduced by Granger (1969) Nachane and
\textbf{Lakshmi}\textsuperscript{21} (2001) have study the impact of monetary policy on outputs, and process
in India. The monetary policy lags are short contrary to the observations of Friedman
in theory.

\textsuperscript{20} Tanuer (1979)
\textsuperscript{21} Lakshmi (2001)
Further according to them money supply (M1) appears to have move impact on output in both pre and post liberalization era while M3 affects prices move and adjusts to output.

Exchange rate determination and degree of freedom (openness)

Theoretically monetary expansion in an economy leads to a decline in the value of money and hence depreciation of the domestic currency against currencies of the other economics, on the contrary monetary contractions will lead to appreciation of the domestic curial substantial empirical evidence seems to support this theory Exchange Rate Theory.

Bryant et al\textsuperscript{22} (1988) developed several econometric models to verify this theory through empirical analysis while Taylor (1993) tried to verify the same exchange rate theory for several economies.

However the impact of the monetary policy actions on the exchange rate depends much on the openness of the economic.

This is where some ambiguity eutors in the momentary policy analysis. It can be easily argued that in a relationally move open economy, depreciation of currency caused by momentary expansion results in a greater increase in the cost. This implies that momentary expansion in such an open economy caused greater variations in the price level rather than the output level.

Given the fat that the impact on the price level and the output level is necessarily in the opposite direct the final impact on the exchange rate, turns out to be ambiguous.

\textsuperscript{22} Bryant
Thus, a momentary expansion leads to currency depreciation but the degree of depreciation largely on the degree of openness.

**Short Term Impact of Monetary Policy**

A study by Carras (1990) for 37 economics of the world including India, shows that there exists a positive relation between monetary expansion and the depreciation of the domestic currency the long-term rate of depreciation closely follows the difference between the growth rates of money supply in the two economics under consideration. However the short term impact of monetary policy is negative, that is the more open the economy is the smaller is the depreciation effect.

**Expectations as Fundamental Economics**

Patric (1992) “Expectations are fundamental in Economics” By definition the future is unknowable the study of decision making therefore, is concerned with how people deal with the unknowable.

Economic decision is taken on the basis of future expectations e.g. decisions regarding capital formation sowing a particular crops are taken on the basis of certain expectations regarding future.

However, expectations are major obstacles in macroeconomic analysis. They do influence economic decisions. But the questions are how to incorporate them into a model. One way is to observe directly. But the outcome may be inaccurate as responses of the people may not be reliable. And such observations may not help up to understand how expectations are formed it is difficult to formulate theory of expectations and therefore. Neo Keynesians usually left them out of their models.

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23 Carras (1990)
24 Patrick Minford “Rational Expectation Macro-Economics” Black Well. 1992
Economists have put forward some postulates to explain the nature and process of expectations formations.

> The point

but in adoptive models both affect output. One of the assumptions required for anticipated monetary policy to have no effect on output in the S-W model is that agents be able to act on their information sold.

But if agents cannot respond to policy changes than systematic stabilization, policy will have real effects. This insight was developed by Fischer Class, by and Phelps and Tablor in the context of multi-period non contiguous rate of price counteracts Stanley Fickler 1977 as showed that, it is possible in RE for moderates policy to work when wage are sticky hence Keynesian policy may work.

**Adaptive Expectations**

**Nerione (1958) and Koyck (1954)**

Milton Friedman reintroduced the hypothesis of adaptive expectations that holding that people adjust their current expectations to correct expectation errors made in previous periods \( p_t = p_{t-1} - (p_t - p_{t-1}) \) basis of the past.

Macro-econometric models treated expectations by resorting to arbitrary on the basis of the past.

Proxies but only under the restricted set of circumstances where the previous relationship is unaffected will the proxies be useful. Unfortunately the restricted set excludes mot of the policy experiments that are of interest to governments. Most

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policy interventions change the way individuals form expectations about the future. Yet the proxies failed to take account of this change in expectations formations.

Adaptive expectations hypothesis is also objected on the grounds.

(1) It may underestimate in case of acceleration e.g. inflation

(2) It is based on limited information such as size

(3) of current wage settlement, government policy etc. are ignored. He point out that in RE only monetary surprises effect output and not monetary policy.

Rational Expectations

H. Haseem\textsuperscript{26} (1988) believe that it is possible to modify the adaptive expectations hypothesis by augmenting it with information on changes in other variables. Next and most widely experimented is the hypothesis of Rational Expectations.

Rational expectations takes one step further the basic assertion of econometrics that individuals in the aggregate act in the regular manner as it each was a typical individual following a systematic decision process. The stepisto assert that in this decision process the individual utilizes efficiently the information available to him in the forming expectations about future outcomes, by efficient utilization is meant that the typical individual's perception of the probability distribution of future outcomes is conditioned on the available probability distribution conditional on the information.

\textsuperscript{26} H Haseem (1988) The limits to rational expectations basil black well- 1988
The REH also ceases to yield optimal forecasts whenever agents know the true model but are uncertain of the values of some of the parametric in the policy rules or other processes operating non-policy exogenous variables". However the agents may not be aware of the true model”. The optimality of the REH fundamentally depends on whether agents know the correct model of the economy in reality the 'true' model is rarely known and in the presence of behavioral uncertainty if may not even be unique or stable.

Effects of Money on Prices

Lucas and Prescott27 (1971) interest in REH was quickly developed and much research in the area followed. Walters (1981) and Lucas (1972) used REH Walters showed that the effect of money on prices would be substantially quickened by REH. Lucas argued that under REH (unlike adaptive expectations) monetary expansion could not raise output above the natural rate on average (the natural rate hypothesis) although the responses of money to logged output & prices (feed back responses) could affect the time path of output in response to shocks.

Lucas28 (1927 to 1973) established classical results, such as neutrality of money and 'ineffectiveness of government policy Lucas made a comprehensive attack on the consensus view which implied the stability of the coexistence of lower level of unemployment and higher level of inflation.

He argued that consumption etc depends upon expectorations of the future course of the economy. He wanted that the econometric models based on adaptive

27 A note on price system in infinite dimensional space” International Economics Review, June. 13. 1971, pg 416-422
28 Lucas
expectations hypothesis should not be used to evaluate the policy the consensus broke down.

LUCAS rejected the Keynesian model and stressed that expectations about future policy will influence current decisions and thus after the behavioral relations. This was not considered by Keynesians analysis. Lucas argued that expectations could not be formulated in arbitrary mannoo and must be consistent with individual maximization and should be rational in the sense of Muth (1961) on the ground that policy interventions change the expectations.

**Rational Expectations**

Muth\(^{29}\) (1961) postulated that economic agents form their expectations on the basis of the true structural model of the economy. "Expectations, since they are informed predictions of future events, are essentially the same as the production of the relevant economic theory", in the words of

Bagg (1982) "The hypothesis of rational expectations asserts that the unobservable subjective expectations of individuals are exactly the true mathematical conditional expectations implied by the model itself.

**Economics of Information**

Boland\(^{30}\) (1982) puts it: "Economists might argue that even if indication were logically possible it might not be economical" Further the decision to collect costly information, and hence the possibility of learning can be adversely affected by agents a priori held subjective beliefs. By wrongly believing that it is not worth collecting

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\(^{29}\) Rational expectations and the theory of price movements". *Econometrica* 1961. 19 pg 315-335

\(^{30}\) "The foundation of economic methods" George Allen and Unwin London. "On the impossibility of informational efficient market" AER, to Pg. 394-408

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and processing information, agents may never learn about their mistakes. They can find themselves trapped in the vicious circle of ignorance.

Grossman and Stiglitz\(^3\) (1980) when information acquisition is costly, and the expected benefit of information is uncertain economic agents may make systematic mistakes. But according to REH systematic errors of expectations give rise to opportunities for profitable trading and hence errors will be eliminated in costless information world. But this may not happen.

Efficient market theorists seem to be aware that costless information is sufficient condition for prices to fully reflect all available information (Fama) they are not aware that it is a necessary condition. But this is a deduction and absorption since price systems and competitive makers are important only when information on is costly.

**Studies on Individuals**

Mankind\(^2\) (1989) studies of individual's labour supply over time find that expected changes in the real wage lead to only small changes in hours worked. It is also hard to believe that labour supply depends on the real interest rate.

The above discussion is with respect to one sector but many real business cycle theories also consider multiple sectors. It will be sufficient if a few sectors experience large technological disturbances which will cause fluctuations but these models also suffer from the same weaknesses the absence of evidence for large technological disturbances and implausibility of strong international substitutability leisure.

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\(^3\) Grossman and Stiglitz (1980)

\(^2\) Mankind (1989)

According to these models, when workers move from one job to another there is unemployment. Recessions are periods of this type of move sectors shockers and thus greater intersectional adjustment. But the evidence does not support this story.

**Business Cycle**

Robert King and Charles (1984) show that money supply responds endogenously to fluctuations in output standard measures of money supply such as M, are inside money, that is created by banking system according to them. They view services of the banking sector as transaction services and are simply 'output' of the banking sector as other sectors develop there is greater demand for these services and hence money supply increases. Therefore money supply is inside money. Hence the procyclical behaviour of money cannot be interested as evidence that changes in outside money caused by monetary authorities have real effects.

King and plosser can explain the procyclical behaviour of money it cannot explain the procyclical behaviour of prices. It is affect that inflation tends to rise in borrow and fall in recession. The model of king and plosser generates procyclical money through the demands for balance and not with fluctuations in prices. The short only Philips has thus been left without an explanation by real business cycle theorists.

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33 LILJEN (1982)
Cost Push - Inflation

Lurence Ball and David Rumer (1990) have shown that nominal rigidities caused by menu costs are enhanced by real rigidities such as efficiency wages. Menu costs prevent prices from falling in response to a reduction in aggregate demand, Rigidity in real wages to fall keeps firms costs high and thus ensure that they have little incentive to cut prices.

Hence although real wage rigidity alone is of little help in understanding economic fluctuations because it leads only to classical unemployment and gives no role to aggregate demand. Real wage rigidity to gather with many costs provides a new and powerful explanation for Keynesian disequilibrium.

35 DAVID RUMER "Real rigidity and the non-neutrality of money" Review Economic study April 1990, 57(2) pg. 183-204