



CREDIT POLICY OF THE ECONOMY

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ABSTRACT

The credit machine is so designed as to serve the improvement of the productive apparatus and to punish any other use. However, this turn of phrase must not be interpreted to mean that that design cannot be altered. Of course, it can... the existing machine can be made to work in any one of many different ways.

Keywords: monetary policy, Technologies, Companies, Expenses, Profits.

Since the days of Keynes and the Great Depression, economists and policymakers have generally accepted the view that, unless prices are perfectly flexible and productive resources are fully employed, money and credit can exert a strong influence on economic activity and growth in the short run. In addition to persuasive evidence from econometric models for industrialized countries; economic developments in the United Kingdom and the United States in the early 1980s were especially revealing in this regard. The imposition of monetary restraint (or merely the threat of restraint, depending on the interpretation of the statistics in the case of the United Kingdom), accompanied by record high real interest rates and exchange rates, contributed significantly to a major downturn in economic activity.

Over the 'years, the authorities of many member countries of the Fund have hesitated to make the macroeconomic adjustments necessary to correct fundamental balance-of-payments disequilibria and reduce inflation. There is little doubt that their reluctance has frequently reflected concern about the potentially adverse effects of adjustment on the rate of growth of output and employment in the short run, as well as on the distribution of income. These concerns have also been the source of old and new criticism of the widely accepted policy prescription that monetary and fiscal restraint—and sometimes also devaluation—are normally necessary for lasting success in the battle against balance-of-payments deficits and inflation.

To set the stage, it may be worthwhile to review briefly the major channels through which credit policy can affect output and employment in the short run. There is general consensus about the adjustment mechanism on the demand side of the economy. A reduction in the supply of domestic credit, or in its rate of expansion, reduces expenditure by the private sector, the public sector, or both. By thus reducing aggregate demand for goods and services, credit restraint exerts downward pressure





on prices or the rate of inflation and on the demand for imports, improving the current account of the balance of payments. Less is known with a reasonable degree of certainty about the response of the supply side of the economy to a contraction of domestic credit. The aggregate supply of domestically produced goods and services may be unaffected in the short run. This might be the case, for example, in some primary-producing countries where output is determined principally by production conditions in the primary sector (e.g., mining), producers have limited flexibility in the use of factor inputs, and the production technology is to a large extent fixed in the short run. In most agricultural countries and especially in semi-industrialized countries, however, complete rigidity of supply must be considered unlikely except perhaps in the very short run. In manufacturing, for example, salaried labor and imported intermediate goods and raw materials are important variable factors of production, and so is financial working capital.

It is difficult at present to judge the empirical importance of these supply-side effects; very little direct or indirect evidence pertaining to them is available for developing countries. If these effects are important, restrictive credit policies may have a greater adverse effect on output growth and less of the intended depressing effect on price inflation than is commonly assumed. In the extreme case, the supply-reducing effects of credit restraint on prices may dominate the demand effects, causing stagflation, and the same applies to interest-rate and exchange-rate policy. This is the case contemplated by many critics of orthodox stabilization programs that emphasize monetary and fiscal restraint sometimes combined with devaluation (see the quotation from Taylor, 1981, at the beginning of this chapter, as well as Bruno, 1979, and van Wijnbergen, 1982). At the other end of the spectrum is the assumption frequently made in monetary analyses of inflation and balance-of-payments problems that output is predetermined in the short run independently of credit conditions, because factor markets clear continuously and price expectations adjust rapidly. Neither of these extreme views is likely to have much applicability to most developing countries. On the one hand, price expectations do not appear to adjust very rapidly to new circumstances, nor do factor markets normally clear instantaneously, as demonstrated, for example, by persistent urban unemployment in many less-developed countries. On the other hand, there is no evidence to support the contention that the supply effects of monetary and fiscal restraint on price developments, with or without devaluation, tend to dominate the demand effects and thus cause stagflation. To be sure, many non-oil-producing developing countries have been afflicted by slower growth, higher rates of inflation, larger payments deficits, and heavier debt burdens than before, despite attempts by some of them to





restrain domestic demand. But that observation is irrelevant in this respect: the supply shocks responsible for these developments during the mid-1970s and early 1980s can be traced more directly to events in the industrialized and oil-producing countries than to unintended side effects of domestic monetary, fiscal, and exchange-rate policies.

Certain limitations of the statistical methods should be pointed out before proceeding. First, because the "patients" are countries, it is impossible to select a reference group identical to the program group in all respects except the treatment. A comparison of the program group with itself in earlier years, when it suffered from the same disease without receiving the same treatment, is subject to the difficulty that the world economic environment may have changed substantially in the meantime.

hanged substantially in the meantime. With comparisons between matched pairs thus ruled out, an independent reference group must be selected.' One possibility would be to use all non— oil-producing developing countries (as was done by Donovan, 1982, and, casually, in section B above), but such comparisons can be misleading, because many of those countries did not have the disease defined here. Furthermore, the patient population is small, so that random selection of samples is impractical, nor can treatment be randomly assigned to patients.

By and large, the standby arrangements under review were successful with respect to the balance of payments. The evidence shows that credit expansion was reduced markedly and the overall balance of payments improved substantially. Subject to the qualifications noted, both these outcomes were statistically significant compared with events in a reference group of countries. At the same time, the inflation rate, although increasing on average, was generally kept below the rates prevailing in other non— oil-producing developing countries.

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