Preface

The study of monetary economics in developing economies typically involves applying well-established theories and models meant for advanced capitalist systems. These theories are often tested by using a relevant econometric method and inputting data from developing countries. Sometimes the models of the advanced world are calibrated to fit data from the developing world. Several peculiar features pertaining to the said economies are often not included in the received models; therefore, econometric models are likely to suffer from omitted variable bias. Building on my PhD dissertation, this work integrates some of the institutional and structural characteristics of the developing world into the microeconomics of banking, in particular focusing on oligopolistic banking. The oligopolistic mark-up interest rate is embedded into a macroeconomic model that allows for solving for aggregate prices, output and the exchange rate. The exchange rate is fundamental to macroeconomic stability in developing economies, particularly the small open economies. Therefore both the commercial banks and the central bank must hoard ample foreign exchange reserves. Moreover, devaluations and depreciations of the past have played a significant role in driving many citizens into penury. This was a reality in the small open economies of the Caribbean, Latin America and Africa. It is for this reason this work devotes substantial space towards the issue of foreign exchange management that is done through the compensation mechanism.

Financial intermediation occurs mainly via oligopolistic commercial banks, although there are some exceptions with fairly substantial flexible price capital markets. Nevertheless, commercial banks with significant market power still form the core of intermediation. These banks hoard large quantities of non-remunerated excess reserves in local currency. The hoarding of excess reserves is also a structural feature as it manifests the compensation system maintained by the central bank. Compensation, instead of open market operations, therefore, is central to monetary management linking the domestic money market with the foreign exchange market. Excess reserves also result from the fact that the commercial banks mark-up their lending rate over some benchmark interest rate. Thus the excess liquidity phenomenon is rooted in the practice of monetary policy

and the motivation behind the interest rate mark-up. The persistent spread between lending and deposit interest rates suggest there is a bifurcation in the market for financial or bank loanable funds. There is no single interest rate that clears the market for financial bank loanable funds; hence there is no natural flexible interest rate. It will be argued later in this work that bank liquidity preference, asymptotic at the mark-up interest rate, is the fundamental force behind the formation of interest at which consumers and investors borrow. These features imply that monetary policy implementation and the monetary transmission mechanism are fundamentally different in developing economies.

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Tarron Khemraj
New College of Florida
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