Peter J. Montiel, Pierre-Richer Agenor, and Nadeem ul Haque. *Informal Financial Markets in Developing Countries: A Macroeconomic Analysis.* Published in the "Advances in Theoretical and Applied Economics" series edited by Homa Motamen-Scobie. Oxford: Blackwell. 1992. i–xi + 212 pp., including appendices. Hardbound. £40.00.

This volume reviews the nature and scope of informal financial markets in developing countries and elaborates on the theoretical and conceptual models which analyse 'financial repression' and other aspects of government intervention in financial markets. It also focuses on the consequences which the prevalence of informal financial markets in developing countries may have for monetary and exchange rate policy. In particular, it attempts to capture the functioning of informal, unregulated markets into macroeconomic models, working towards a general equilibrium model with informal financial markets.

Two types of informal markets are analysed. The first are for informal lending at terms and conditions which differ greatly from those prevailing in the official banking system. The second are the 'parallel' markets for foreign exchange which tend to emerge in response to quantity restrictions on trade and administered allocation of foreign exchange to certain users at official rates, which are well below those on the parellel markets. The key question is whether these informal markets change the efficacy of monetary and credit policy–and, if they do, to what extent and in what direction? Two supporting appendices present econometric analyses of the efficiency of parallel currency markets and the degree of capital mobility in developing countries.

Financial repression refers to a situation of inadequacy of financial intermediation. Partly in response to government regulation and supervision, banks and other formal financial institutions concentrate on safe, low-yielding lending, like short-term trade finance, rather than on high-risk, high-yielding projects. Self-financing becomes an important, perhaps even dominant, method of realising private investment. However, the equalisation of expected returns on investment across the economy fails to take place. Potentially, high-yielding projects may never be undertaken, typically because the investment is lumpy and indivisible and too large to be generated internally by a firm or a household. The original theories of financial repression by McKinnon and Shaw, formulated in the early 1970s, largely ignored the functioning of informal financial markets, perceiving them as inefficient and limited responses to the deficiencies of financial intermediation. But evidence has proved their persistence and importance, especially for countries with public and current account deficits and, hence, high inflation, low real interest rates, and continued pressure on the official exchange rate.

One of the authors' central contentions is about the nature and behaviour of agents operating in informal financial markets. It states that "agents in these markets are relatively effective and well-functioning financial intermediaries" (p. 25). To find that economists of the International Monetary Fund (IMF), the doyen of formal financial policies in developing countries, regard the exotic, innovative and, above all, unrecorded ways or informal finance to be an effective system of financial intermediation, may leave some readers sceptical, perhaps surprised. The authors seem to make light of the evidence of high and extremely high rates of interest as well as the inefficient allocation of resources resulting from the interlocking of markets of credit, trade, and production. It is particularly surprising as the assumption of the efficiency of informal markets does not appear to be necessary for most of the results obtained in the subsequent analysis.

Informal Financial Markets in Developing Countries offers a lucid and clear survey of the existing models of financial markets, including an analytically attractive presentation of (i) financial repression and its neo-structuralist critique and (ii) the functioning of parallel foreign-exchange markets with under/overinvoicing of traded goods and unrecorded capital flows. The pivotal third chapter presents the partial and general equilibrium analytical forms of a macro-model incorporating both types of informal markets. The chapter examines " the actions of the monetary authorities and the state of aggregate demand in such an environment" (p. 85). The main limitation of the analysis appears to be the representation of the 'real' side of the economy–compressed into a single clearing market for homogeneous goods. Nevertheless, the results of the analytical model are quite fascinating and diverge from the orthodoxy at H-Street, Washington, D. C. Interest-rate liberalisation (read: raising administered interest rates) "will tend to have contractionary macroeconomic effects on impact ... policy-makers need to be alerted to the possible need to adopt compensating measures to maintain internal balance..." (p. 109). Unification of foreign-exchange markets (read: devaluation by selling foreign exchange in the free market) "will be contractionary on impact... [and] require additional measures, as in the case of financial liberalisation" (p. 112). Hence, the two main ingredients of financial policy, habitually advocated by the IMF as part of the adjustment programmes across developing countries, are shown to work unambiguously in a direction many mortals would fear to tread.

The next two chapters present a numerical application of the general equilibrium model with informal financial markets. Chapter Four presents the base-scenario parameters, whereas Chapter Five reports on the simulation results under various policy shocks. The results do not principally differ from those obtained with the analytical model, even though the real side of the economy has now graduated to a static Cobb-Douglas world with a constant stock of capital and an exogenous

level of labour supply. Aggregate demand is fully specified and includes income earned from underinvoiced exports and foreign exchange bought from government at the official rate against a fake bill of imports.

I am the least persuaded with *Informal Financial Markets* when it comes to the numerical simulations themselves: explanations are scanty, the values of most of the variables are not provided, and the no-change baseline scenario–against which we are evaluating the various policy shocks–is not spelled out. Moreover, some of the parameter values, used to initialise the simulations seem implausible, even though the authors have relied on a stylised data-set from 31 developing countries. Is not an effective income tax rate of 30 percent of real disposable income far too high for developing countries? Which developing countries import merely 20 percent of the private sector demand for consumer imports at the official exchange rate? These and other questions are not addressed and make it virtually impossible for the reader to evaluate the quantitative results. A detailed appendix explaining the simulation experiments is lacking. Committing the folly of numerical simulation with a general equilibrium system obliges one to stay for dance and dinner.

Although well-presented, this monograph contains some further omissions and errors. It draws on a valuable list of references on the subject, but it does not discuss one of the godfathers of finance and money in general equilibrium: Frank Hahn. The country coverage is good, with examples from Latin America, Africa, and Asia–with perhaps a specific emphasis on South Asia as Pakistan and Bangladesh feature quite a few times. Yet one might have wished to learn more about informal finance in China, the country which defies so many standard beliefs of economists regarding development finance. The information about non-institutional informal market terms and conditions is positively outdated–nothing measured after 1980! The empirical basis for estimating the parallel market premium for foreign currencies (pp. 30–32 and 169) is not explained, which is particularly problematic as the source of the estimates (*World Currency Yearbook*, formerly *Pick's Currency Yearbook*) is not in the references. Too many typographical errors slipped through the proofing: the market-clearing wage equation lost an important subscript (p. 134); 'net creditors' inadvertently became 'n*o*t creditors' (p. 89); and I am still wondering about the 'Case of India' (p. 196). More seriously, the gamma parameter in the simulation Table 4.2 remains unexplained: is it a zero substitution elasticity in the real sector of the model with important implications for growth projections?

Informal Financial Markets comes at UK Sterling 40. This creates considerable incentive for some parallel market activity, infringing copyrights. Can one seriously expect a developing country's policy-maker or academic to spend half a month's salary for the book? The first-best solution for this important analytical

work would be an affordable student edition, with additional appendices, distributed widely throughout the developing world.

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