4. Finance and monetary policy beyond neoliberalism

The way ahead for emerging markets

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Changing contours of received wisdom

Broad consensus had been achieved around dominant neoliberal thinking in relation to financial sector regulation and monetary policy in the two decades leading up to the North Atlantic financial crisis (NAFC) that erupted in 2007-08. Whereas this thinking was essentially developed and applied in the advanced economies (AEs), similar policy prescriptions were advocated for emerging market economies (EMs). The general view was based on two theoretical propositions: the Efficient Markets Hypothesis (EMH) and the Rational Expectations Hypothesis (REH). "The EMH defines an efficient financial market as one in which securities prices fully and rationally reflect all available information…"[1] The REH "proposed that individual agents in the economy—be they individuals or businesses—operate on the basis of rational assessments of how the future economy will develop."[2] Based on the belief that financial markets operate efficiently, it was assumed that free competition in financial markets would result in the efficient allocation of capital across the economy, and hence promote growth. And belief in the REH suggested that both individuals and financial institutions are capable of managing risks. The corollary was that regulation should be light touch only.[3]

Continued development of financial markets should therefore be encouraged; increasing financial depth and intensity is good for promoting economic growth, along with financial inclusion; and continued financial innovation helps price discovery, which promotes efficiency in the allocation of financial resources. "The pre-crisis orthodoxy was built on the idea that even if financial markets were in some ways imperfect, market liberalization and competition would at least bring us closer to perfection."[4] Such a theoretical view saw the economy and financial markets as being inherently self-stabilizing and efficient in allocating resources. A process of financial deregulation and deepening was therefore the order of the day, starting in the 1980s and lasting till the NAFC. Policy advisers to EMs and policymakers in EMs were not immune to this dominant strand of thinking.

Although this period was characterized as the Great Moderation, since the advanced economies experienced relatively consistent growth and low inflation, significant financial instability was experienced in different jurisdictions. Approximately 100 crises occurred during the 30 years before the NAFC, during which financial liberalization policies were dominant.[5] Over this period, the financial sector grew much faster than the real economy in the advanced economies: private sector debt grew from around 50 percent of GDP in 1952 to 170 percent by 2006; trading in foreign exchange markets grew much faster than exports and imports; trading in commodities exceeded growth in commodity production; gross cross border capital

flows grew far in excess of investment; and financial innovation flourished with the introduction of widespread securitization and derivatives.[6] The financial sector began to serve itself much more than the needs of the real economy. This relative explosion in financial sector development across the world was clearly not reflected in the real economy.

The excessive growth in overall debt and leverage in financial institutions, explosive growth in cross border capital flows, along with the development of global macro and financial imbalances, finally led to the outbreak of the NAFC. This shock, the worst financial crisis since the Great Depression, has been instrumental in raising fundamental questions with respect to basic tenets of the neoliberal financial order outlined above. The key lesson from this crisis has to be that financial markets on their own are not necessarily efficient, stable, or self-correcting: "serious economic and financial crises can happen, even in low inflation advanced market economies."[7]

Thus governments, central banks and financial regulators have a crucial role to play in overall economic and financial sector regulation and management. Light financial regulation can no longer be sustained.

The changing role of central banks and monetary policy

Prior to inflation targeting in the 1990s, central banks, over the centuries, aimed to support sustainable economic growth through the pursuit of price and financial stability.[8] In line with efficient financial market theory, monetary policy in the decades prior to the NAFC were exclusively focused on inflation targeting in the pursuit of price stability, along with the use of a single instrument - the short term policy interest rate. The EMH suggested that the short run policy rate would be transmitted seamlessly along the yield curve and across financial markets. Whereas it was always understood that price stability was a necessary condition for the maintenance of growth and financial stability, the inflation targeting approach assumed that price stability was actually *sufficient* for maintaining macro and financial stability. As a consequence, with inflation remaining low in the period before the NAFC, central banks in the advanced economies focused narrowly on low inflation and price stability. They then largely ignored the signals that might have indicated the dangers that emerging imbalances and financial sector excesses could pose. This explains in part why so few predicted the NAFC of 2007-08.

As a consequence of the NAFC, a new consensus is emerging that:

1. The mandate of central banks needs to include both price and financial stability objectives. Consequently, they need to be given adequate authority and policy tools to achieve these objectives. There is also a growing consensus that central banks should have an active role in banking regulation and supervision.

2. Financial markets are inherently unstable and can be inefficient. Hence there is a need for intrusive monitoring and regulation of banks, shadow banks, and other financial market participants to foster economic growth with financial stability. The perimeter of financial regulation has been widened considerably and vigilance must be maintained to avoid financial market excesses.

3. Sustained efficient operation of financial markets requires continuous oversight and management from the government, central banks, and financial regulators. They should not hesitate to intervene as and when necessary.

Whereas there is broad consensus on these basic propositions, debate persists, as might be expected, regarding the various institutions and instruments required for such central bank operations. Likewise, agreement regarding the ways and means by which governments and financial regulators should intervene in banking and financial markets remains elusive.

Nonetheless, regulation and supervision of banks has been tightened considerably. Such oversight has been undertaken through: the provision of much higher capital and liquidity requirements; the return of regulatory and supervision responsibilities under the umbrella of central banks in various jurisdictions; and by the establishment of new oversight institutions. One such example is the Financial Stability Oversight Council (FSOC) in the U.S. set up to extend the regulatory perimeter. Those developments aside, consensus around the extent of regulation of shadow banks continues to elude regulators.

It is therefore clear that the days of freewheeling financial markets and lightly regulated financial institutions are over and the erstwhile theoretical belief in efficient markets and rational expectations has been severely dented. However, as might be expected with the passage of time since the NAFC, there is now considerable push back from the financial sector and, over time, we can expect some loosening of the tighter oversight that has been implemented over the past decade.

What does this portend for emerging market countries?

Financial sector policies in emerging markets: Advice and response

What was the advice being given to emerging market countries during the neoliberal order period?

Otherwise known as the Washington consensus, the advice with respect to financial sector development broadly consisted of:

- Liberalize financial markets.
- Develop competitive private commercial banks
    - Eschew government ownership of commercial banks.
- Make interest rates market-determined.
- Develop bond markets to diversify sources of long-term financing for the corporate sector and for infrastructure.

The approach to the external sector consisted of:

- Open the capital account and allow capital inflows and outflows.
- Make the exchange rate market determined through a free float.

And for monetary policy:

- Make central banks independent.
- Practice inflation targeting monetary policy.

Such advice was of course broadly consistent with the EMH and REH that was the basis of financial sector policy within advanced economies. It is interesting that consideration was seldom given to the specific conditions that characterized financial markets and the stage of economic development in developing countries and emerging markets.

What were the key characteristics of emerging market financial sectors?

First, they were mostly bank dominated with different degrees of government and private ownership in different countries, with a relatively smaller role for direct financing through capital markets[9]; interest rates have been increasingly market determined in EMs; equity markets have been generally more developed than bond markets; most EMs have used development finance institutions (DFIs) to fund longer-term investment needs with varying

degrees of success and failures. On the external side, many emerging markets manage exchange rates while allowing for significant market related flexibility, while maintaining significant monetary policy independence and financial integration through managed capital flows.[10] Monetary policymakers have increasingly practiced flexible inflation targeting in the presence of different degrees of central bank independence.

Second, one of the most important developments in emerging markets since the 1990s has been the dramatic fall in inflation rates in almost all countries barring exceptions like Zimbabwe, Venezuela, and Argentina. This development was most marked in Latin America, which had suffered from very high rates of inflation on a pretty consistent basis until the 1990s. The push toward inflation targeting and central bank independence has certainly been among the key factors that have led to low inflation in Latin America. The acceptance of this framework by most governments meant that they generally accepted the idea that fiscal excesses should not be funded through monetization by their respective central banks and it is therefore desirable to provide relative independence to them. In countries such as Argentina, where this practice was violated, the subsequent increase in inflation was then not a surprise.

That said, most EM central banks have in reality practiced flexible inflation targeting: inflation targets have generally been specified in a range; foreign exchange intervention has been the rule rather than an exception; capital account management has been practiced to reduce the volatility from capital flows; monetary policy instruments have included the use of reserve ratios and other quantitative measures along with use of the short-term interest rate; and financial stability concerns have been kept in view through financial regulation and supervision. In countries where financial markets still have a long way to go for monetary policy transmission to take place, the use of the policy interest rate is naturally limited.

Since inflation was generally low in Asia, it is Latin America that has probably benefited the most from the advocacy and practice of inflation targeting and central bank independence.

Overall the special focus on inflation has certainly been beneficial for macroeconomic management in emerging markets, but policymakers have had to adapt their policy tools in line with circumstances.

Third, there is naturally a large variance in financial sector policies among emerging markets. It is perhaps correct to say that Latin American countries attempted to follow the Washington consensus in the 1980s and 1990s, particularly with respect to the external account, which led to recurring banking and debt crises over those two decades. Asian countries were generally more conservative over the period but they did suffer the Asian financial crisis in 1996-97.[11]

So, whereas there was general understanding of the tenets of the neoliberal order and its benefits among emerging markets, by the late 1990s there was a better appreciation of the constraints that their own particular circumstances and stages of development posed in terms of achieving the policy frameworks that were the order of the day. While being guided by the desirability of using market processes in the financial sector, they were perhaps more cognizant of the need for policy and process guidance by public authorities.

After the Asian crisis, for example, financial authorities in Asia strengthened capital requirements for their banks, tightened other financial regulations, improved systems for managing capital flows while increasing market flexibility and exchange rates, and strengthened both micro prudential and macro prudential regulations. Such prudence helped most of the Asian banking systems withstand the shocks emanating from the NAFC.[12] Thus, actual practice in EMs was somewhat different from a strict application of both EMH and REH, or from a narrow application of inflation targeting monetary policy. Whereas EMs

demonstrated much more respect and understanding of the benefits of market-oriented policy than they had in previous decades, their experience of crises made them more conscious of the need for active financial policy and regulation.

Consequently, one of the miracles of the 2007-08 NAFC was that no financial institution went into crisis in any emerging market or developing economy, despite a flood of capital flows during the great moderation period, especially in the 2000s.

What did those EM economies do to avoid full contagion?

Managing the impossible trinity

Having had the experience of financial crises in different forms over the 1980s and 1990s, emerging markets had perhaps learned their lessons well and were not hesitant in going against the then conventional wisdom arising from the tenets of the EMH. They practiced relatively intrusive financial regulation; pursued heterogeneous monetary policy while nominally observing the basics of inflation targeting; and managed the impossible trinity, particularly as it related to capital account policies and exchange-rate management. They understood that there was no need to be at any of the policy corners of the so-called impossible trinity.[13]

First, with regard to exchange rate management, the experiences of the 1980s and 1990s had already demonstrated the virtues of flexible exchange rates: pegging was clearly a bad idea. There was a clear understanding that exchange rates needed to be essentially market determined reflecting fundamentals, but the effect of volatile capital flows had to be tempered through managed floats. Completely free floating exchange rates were not seen as the best option. So there has been an increase in intermediate regimes reflecting different kinds of managed floats.

Second, high growth demonstrated in many Asian countries, including China and India, and in spurts in Latin America, along with increasing global trade openness, demonstrated the need for a relatively open capital account. Once again, an essentially open capital account did not mean a completely open one with no management with regard to different kinds of flows. This can be done by managing the capital account through a vector of measures. There is a quality hierarchy in the nature of different types of capital flows, with some more stable and others less so: foreign direct investment is clearly seen as the most beneficial to recipient economies and also the most stable; followed in turn by portfolio equity flows, long-term debt, followed by short-term debt portfolio flows. Different kinds of measures can be taken to temper these flows to reflect this hierarchy. So, as may be seen from the balance of payments accounts of emerging market countries—which are seen to have relatively managed capital accounts—the actual magnitude of flows in both directions has been quite large and has generally been increasing over time. In fact, there is often little difference in the magnitude of gross capital flows relative to GDP between managed capital accounts and fully open ones. This suggests that the capital accounts of EMs have indeed been quite open, but of course not fully open. They are able to reap the benefits of cross border capital flows, while avoiding the costs of their volatility.

Third, in view of both the large magnitude and volatility of capital flows in the 1990s and 2000s, most EMEs intervened actively in forex markets to build up precautionary reserves in line with a managed floating exchange rate policy.

Fourth, volatility in advanced economy monetary policies in the 1990s and 2000s, perhaps reflecting global financial cycles, also suggested that emerging markets and developing economies need to adapt to practice independent monetary policies. If advanced economies

have to resort to unconventional monetary policies to preserve their growth and financial stability, so do emerging markets, from their viewpoint.

As a consequence of these intermediate exchange-rate and capital account regimes, they could also practice independent monetary policy despite managed floats and capital accounts: the proof of the pudding is that, during the great moderation period, many emerging markets exhibited high growth and price stability along with financial stability.

Looking to the future:

1. *Persistent need for capital account management: should no longer be called unconventional.*

Capital flows to emerging markets are caused by both push and pull factors. To the extent that emerging markets grow faster economically than advanced economies, and are expected do so for an extended period while maintaining price and financial stability, capital will continue to flow to these countries as investors search for higher yield. Second, experience shows a persistent inflation differential exists between emerging markets and advanced economies, leading to higher nominal interest rates, even if real interest rates get equilibrated. Thus there is a constant incentive for global capital to flow to emerging markets for arbitrage purposes. With real interest rates being zero or negative in advanced economies today—a trend likely to persist through the medium-term— we can expect capital flows to emerging markets to continue in a search for better yields.

If such capital flows are not managed in some form, they lead to appreciation of exchange rates, consequent widening of the current account deficit, and loss of competitiveness, ending in the typical sudden stop, disorderly adjustment, financial instability, and eventual onset of crisis. This was amply demonstrated by the experience of the so called fragile five[14] at the time of the taper tantrum in 2013. These countries had undertaken minimal intervention in the forex market in previous years to the applause of the International Monetary Fund (IMF) and other policy observers. The real exchange rates had appreciated significantly; the current account deficits had widened relative to GDP so the mere announcement of a potential tightening in U.S. monetary policy suddenly resulted in capital outflows which had to be then countered by a range of emergency measures.

The “Unconventional” should be seen as part of the conventional toolkit just as unconventional monetary policy and practice today in advanced economies is rapidly becoming conventional.

2. *Forex intervention and reserve accumulation*

The experience of the Asian crisis and capital flow volatility in the 2000s had necessitated accumulation of forex reserves for precautionary reasons; such reserves came in useful during the turbulence of 2008 and 2009. This is well understood and much discussed.

There is, however, another reason for accumulating foreign exchange reserves that has received much less attention and discussion.

Recent experience suggests that emerging markets can grow at sustained annual growth rates in the region of 10 to 15 percent in nominal terms, reflecting real growth rates in the range of 5 to 10 percent. That suggests that, other things being equal, central bank balance sheets also have to expand by similar magnitudes to enable a commensurate degree of financial deepening and growth. Assuming that these countries do practice prudent fiscal policy, and also need to develop deep financial markets for government securities, the availability of such domestic securities could be limited for central bank balance sheet purposes. Thus, emerging market central banks need to accumulate forex reserves just for

the purpose of normal expansion of their balance sheets. Note that forex reserve accumulation to this extent would not need any sterilization.

This was not an issue in terms of the availability of reserve currency securities, as long as emerging market economies did not form a significant weight relative to advanced economies. Even then, the inflow of emerging market forex reserves into advanced economy safe assets was mistakenly seen as a sign of a global savings glut. As the magnitude of emerging markets' collective GDP is now approaching that of reserve currency economies, and it will exceed their GDP in the near future, I believe that this issue will start assuming even greater importance in the discussion on international financial architecture. Will we have a shortage of safe assets for central bank balance sheets and what solutions will we find?

This kind of intermediate approach in external sector management went against the advice emanating from the neoliberal order and multilateral institutions. Now, however, in the light of developments in macroeconomic thinking and recognition of relatively successful practice in emerging markets, both before and after the NAFC, such approaches are receiving increasing acceptance and are beginning to be seen as constituting elements of conventional macro toolkits. The adoption of the new institutional view with respect to capital flow measures by the IMF in 2012 has helped to make such practices "respectable" in the eyes of international observers.[15] However, they are still not seen as intrinsic components of a standard macroeconomic management toolkit, as they should.

Financial sector development: The (new) middle path

Whereas there has been considerable discussion with regard to new directions for monetary policy and external management in the wake of the NAFC, the path ahead for policies to foster financial sector development in the interest of achieving economic growth and financial inclusion, with consistent financial stability has received little attention. Here also, in the light of lessons from the excessive financial expansion in advanced economies in the 1990s and 2000s, the way ahead can essentially be characterized as the middle (market oriented) path.

First, it is important to recognize the importance of commercial banks in the financial sectors of emerging markets. The share of banks in financial sector assets in emerging markets is usually in the range of 60 to 80 percent, with the share generally decreasing as countries grow towards upper middle income or advanced economy status. Even in Korea, which has achieved advanced economy status, the share of banks is around 60 percent of total financial sector assets. It was almost 75 percent as late as 2006.[16] Thus, in the large majority of emerging markets, which are in the middle-income range, commercial banks will continue to be the most important factors in the financial sector. Indirect financing through commercial banks will remain the order of the day in these countries for quite some time to come. Direct financing through bond markets has been a dominant feature of debt financing only in the United States and the UK: much of Europe remains bank-dominated.

It is therefore of the utmost importance that the banking sector is induced to be efficient and competitive while also being restrained from excesses. Most emerging markets have experienced periods during which much of the commercial banking sector has been government-owned or dominated, giving rise to a whole host of governance issues. Similarly, issues of governance often arise when such banks are privatized. During periods of external or internal shocks, government ownership or guarantees have been important in preventing bank runs and thereby provide stability within the banking sector. Thus, it may be worth considering what would be an appropriate mix between public and private ownership of banks in emerging markets. Complete private ownership of commercial banks may not be the panacea as has often been advocated.

Bank ownership and governance have posed significant problems in AEs and EMs alike. Ownership by business groups and private entrepreneurs raises obvious conflict of interest issues. A bank license empowers the licensee to access public savings, which can then be diverted to the owner's own firms or connected ones. For this reason, dispersed ownership is normally the preferred form of bank ownership. In the U.S., for example, nonfinancial companies are not permitted to own banks. In advanced economies it is usually institutional investors who own such shares in a dispersed manner. Even in relatively advanced emerging markets, there is a scarcity of institutional investors. It is therefore not uncommon for dominant business groups to end up owning banks in EMs. It is for the same reason that it is not unusual to see significant government ownership of commercial banks in EMs. It is also observed that when private bank ownership is preferred, or when bank privatization takes place, such banks are often owned by foreign investors. In India, for example, where dispersed ownership has been enforced in private-sector Indian banks, ownership of these banks has ended up in the hands of foreign institutional investors. Thus, the largest Indian private banks have foreign ownership of over 70 percent, but such ownership is dispersed.

The main solution to this conundrum lies in some combination of state and private ownership of banks, along with certain degrees of foreign ownership and presence of some foreign banks, which would then provide a certain degree of competitive discipline in the banking system. Such competition will not be enough, so robust banking regulation and supervision is a necessity for both state-owned and private sector banks. There would then be a possibility of conflicts of interest to be regulated and supervised. Regulatory capture certainly poses problems in such circumstances, thereby placing a premium on the appointment and maintenance of competent technocratic banking regulators and supervisors.

There are no magic solutions: once again a middle path is the only way out, along with constant oversight by the government, the central bank, and other financial regulators as the case may be.

Second, the conventional wisdom that had emerged was that commercial banks would essentially do short-term lending whereas bond markets need to be developed to provide direct financing for long-term financing needs. There has therefore been a constant refrain from financial sector advisors and international financial institutions (IFIs) urging the development of bond markets in EMs.

Consequently, the development of local currency bond markets became a policy priority for many Asian economies after the Asian financial crisis. Even after more than a decade and a half of such efforts, bond market financing of the corporate sector in Asia has barely reached 10 percent of the total needs: around 50 percent continues to be from bank lending whereas about 40 percent comes from equity financing. Moreover, the majority of corporate bond issuance is originated from government-owned corporations, banks, shadow banks, energy and transport utilities.[17] Furthermore, an average of about 60 percent of corporate bonds in Asia have maturities of less than five years, thus belying the expectation of long-term financing from bond markets. The issue, perhaps, is that even in mature bond markets most of the investment is sourced from institutional investors, which take considerable time to develop. The expectation that EMs will rapidly become a source of long-term financing for industry and infrastructure will therefore remain a mirage until there is intensive development of contractual savings through pension and insurance institutions. Once again, a middle path is called for: keep developing bond markets but keep realistic expectations on the efficacy in the short to medium-term.

There is, however, a corollary to the development of bond markets. Whereas it will take considerable time for corporate bond markets to develop, it is essential that EMs pay special attention to the development of government securities markets. The efficient price discovery

of market interest rates and benchmarks for overall functioning of financial markets needs the operation of relatively efficient government securities markets. They are also necessary for central bank operations with respect to monetary policy implementation. Given the safety that government securities imply, it is much easier to develop government securities markets. As they become more liquid and efficient, they also help in the eventual development of corporate bond markets

Third, it may therefore be desirable to reinitiate discussion on the need for development finance institutions (DFIs) once again in EMs. Most emerging market countries initiated development finance institutions (DFIs) in the 1950s to the 1970s. These DFIs were largely government owned or dominated, including frequent participation by multilateral financial institutions. They were established in recognition of various market failures that inhibited long-term financing by commercial banks: industrialization required long-term financing.

In the absence of well-functioning bond markets, DFIs were seen as the solution. Because of increasing governance issues, usually due to excessive government interference in these institutions, they went out of fashion by the 1990s, and were increasingly frowned upon by denizens of the neoliberal order. Such DFIs were promoted heavily by IFIs in a host of developing countries in the 1950s to 1970s. They did indeed experience a great deal of political interference, often suffered from low-quality management and staff, and lacked the capacity to adequately evaluate projects, among other shortcomings. Hence, many ended up with significant nonperforming assets and erosion of their capital.[18]

However, most emerging markets still have active DFIs and the remaining ones appear to be profitable.[19] There is little difference in their profitability in comparison with commercial banks. As infrastructure investment is increasingly being done through private participation, a new need has arisen for DFIs in EMs. In view of the limited success in setting up corporate debt markets, there is a revival of interest in scaling up development finance through such institutions, both those that already exist and by creating new ones.[20] "DFIs across the world hold roughly $6 trillion in total assets, with G-20 members as shareholders of $4.3 trillion of that total. The largest amount of DFI capital is held in national development banks, which are $4.8 trillion of the total, and MDBs at $1.8 trillion."[21] It is certainly the case that the most successful fast-growing EMs such as Japan and Brazil in the 1950s-1970s, Korea, China and others, have indeed used DFIs to fund their industrial and infrastructure investment needs, even though they certainly have their own share of financing failures.

The new challenge therefore is to develop new thinking on how such institutions can be resuscitated or newly established to serve the emerging needs for long-term finance. Perhaps some lessons can be taken from the running of institutions such as the European Investment Bank in Europe or the Nordic Investment Bank, along with other similar successful institutions. Whereas AEs and IFIs generally frown on the setting up of DFIs, the existence of these institutions in the most developed parts of the world suggests that there is indeed a significant role for such institutions in financing long-term industrial and infrastructure development. The establishment of the Asian Infrastructure Investment Bank (AIIB) by China and the New Development Bank (NDB) by the BRICS countries are prime examples.

How to ensure that DFIs avoid meeting the same fate as many of those that are now defunct is an important issue. Yet, there is now greater availability of financial sector and banking expertise in EMs to staff such institutions with adequate experience and competence. Additionally, just as MDBs have been structured in such a way that they have technocratic management subject to political oversight, similar ways can be found to structure both multilateral and national DFIs. As has been done in certain cases, national DFIs can invite partial but significant ownership by multinational DFIs and private-sector institutional investors that have long-term horizons like insurance and pension funds, in addition to

national governments themselves. Such structuring could help in curbing harmful government interference that had been the bane of former DFIs. Finally, there does need to be some understanding that such institutions do take higher-risk than commercial banks and hence some degree of loss provision should be anticipated.

Fourth, in view of the importance of commercial banks there must be recognition that governments, central banks and financial regulators need to understand their responsibilities with respect to adequate regulation covering the whole financial sector. Commercial banks are usually subject to greater regulation than other financial institutions in view deposit taking role and stewardship over public money. This can lead to regulatory arbitrage and increasing expansion of nonbanks or shadow banks, creating greater risk in the financial sector. At a minimum, all institutions permitted to take public deposits should be subject to similar regulations. These issues assume somewhat greater importance in EMs, given their typically higher growth and continuing need for financial expansion.

Fifth, countries experiencing high growth also naturally experience a high rate of credit growth, which is often helped along by desirable large capital flows. There is equal need to temper the transmission of external capital flow volatility into the internal credit and financial markets, along with possible domestic excesses in terms of over-leveraging. Otherwise, we know the consequences: excessive credit growth, low risk perceptions, irresponsible borrowing and lending, along with asset market booms followed by busts, as happened in the NAFC. To the extent that domestic financial markets are open to portfolio flows there is an even greater likelihood of the transmission of external volatility to domestic financial markets.

In real time it is difficult to know what is excess and what is normal and desirable. So a good deal of judgment has to be used by the regulatory authorities and central banks in how they address these issues. There are many instruments that are potentially available: use of cash reserve ratios, calibration of risk weights by sector or instrument or overall, margin requirements, loan to value ratios, and the like. In addition, a close watch should be kept on external borrowing by banks: it is indeed possible to design macro prudential regulations that are market related and self-administering.

Much of what has been said here suggests a greater role for central banks and financial regulators. Should such unelected technocrats be given such policy powers and freedom? Why should we have confidence that they will operate in the public interest? Paul Tucker has addressed this question in some detail in his recent book in the context of AE central bank independence.[22] What is important is that governments attempt to provide relatively clear policy mandates to these institutions along with reasonably high degrees of autonomy and legal powers to perform their functions efficiently. This is helped by increasing acceptance of the need for transparency and accountability in their functioning.

Once again, there are no magic solutions. Typically, senior officials in central banks and financial regulatory authorities in EMs, as in AEs, have longer and more stable tenures than those in government. They are no doubt subject to rules and pushes from political and government authorities on a relatively continuous basis. It is probably correct to say that the technocratic quality of these officials has improved over time significantly. There is now a great deal of communication between central bankers and financial regulators across the world, among EMs and between EMs and AEs. This is facilitated by a range of regional groupings that have emerged along with the IMF, the Bank for International Settlements (BIS), the Financial Stability Board (FSB), the G-20 and others. This kind of exposure and discussion has helped in the functioning of these institutions. However, there is also a downside since such continuous communication also leads to a certain degree of group-think, particularly the advocacy of policies that that are more suited to conditions in AEs. EM officials need to guard against this tendency and continuously adapt so-called best practices to their own conditions.

That the EMs did not suffer from their own financial crises as a consequence of the NAFC suggests that they were indeed relatively successful in starting their own monetary policy and regulatory paths.

Conclusion

Central banks and financial regulators in emerging market economies have to keep their basic aims in mind: achievement of growth with price and financial stability, and *do whatever it takes* to achieve them. In a world of relatively open capital accounts and globalized finance, they do need to expand their arsenal of macroeconomic, monetary, exchange-rate, and financial policies that encompass some of the policy and institutional instruments that have been discussed.

As we adapt to a post neoliberal order the approach to financial sector development for EM economies must essentially be seen as a middle path between free market imperatives tempered by appropriate and necessary public policy intervention by governments, financial regulators, and central banks alike. Their focus must be to incentivize and manage their financial sectors so that they serve the financing needs of the real economy rather than themselves.

The lessons derived from crises observed in the past three to four decades in both emerging markets and advanced economies suggest that financial markets are inherently unstable and hence need different kinds of public policy controls in the quest for maintaining high growth with financial stability in emerging markets.

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[1] Adair Turner (2016). p. 37.
[2] Ibid.p.38
[3] Group of Thirty (2015). p.9.
[4] Adair Turner (2016). p.37
[5] Stiglitz (2014). p. 335. (In his comments Homi Kharas quoted a figure of 412 financial, banking and sovereign debt crises in the last 40 years, derived from IMF documents.)
[6] Adair Turner (2016). p. 1.
[7] Group of Thirty (2015). p. xii.
[8] Ibid. p. xi.
[9] Ilhyock Shim (2019), with regard to Asia.
[10] Joshua Aizenmann (2019).
[11] Ilhyock Shim (2019).
[12] Ilhyock Shim (2019).
[13] The 'Impossible Trinity' contends that countries cannot simultaneously have a fixed exchange rate, capital mobility, and monetary policy autonomy.
[14] Brazil, India, Indonesia, South Africa and Turkey.

[15] IMF (2012).
[16] Kiseok Hong and Jong-Wha Lee (2019).
[17] Cyn Young Park (2019).
[18] Comments by Shahid Yusuf in the workshop, reflecting on long experience in the World Bank.
[19] 63 in Asia in 2016, down from 121 in 1998. Vikram Nehru (2018).
[20] See Kevin P. Gallagher and others (2018) for an excellent review of the current literature on this issue.
[21] Ibid p. 4
[22] Tucker (2018)