Bandid Nijathaworn: The pursuit of monetary and financial stability in emerging market economies[1]

Speech by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at a Public Lecture at the Centre for Banking Studies of the Central Bank of Sri Lanka, Colombo, 23 July 2008.

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Ladies and Gentlemen,

I am delighted to be here today in Colombo, and am honoured by the invitation that has been extended to me by the Centre for Banking Studies of the Central Bank of Sri Lanka to give this evening's public lecture. The Bank of Thailand and the Central Bank of Sri Lanka has a long history of mutual friendship and cooperation. So, I am deeply touched by the invitation, and am privileged to join the long list of eminent speakers and scholars who have previously participated in this prestigious lecture series.

The topic of my lecture this evening is the Pursuit of Monetary and Financial Stability in Emerging Market Economies. The lecture is drawn from the research done at the Bank of Thailand on the same topic. The research paper was first presented last year at a seminar at the Bank of England, and the lecture today is an updated version of that paper. What the research attempts to do is to examine the challenge faced by emerging market economies in the pursuit of monetary and financial stability. The key hypothesis of the research is that the context in which monetary and financial stability is pursued in emerging market economies is different to that of developed economies, and so the challenge and the implications for policy are different.

My lecture this evening is organized into two parts. In the first part, I will talk about the unique context of emerging market economies compared to developed economies in the attainment of monetary and financial stability, and discuss the underlying cause of the difference. In the second part, I will highlight the key implications of these differences for the pursuance of monetary and financial stability in emerging market economies, both in the context of short-term stabilization challenge and the longer-term structural challenge in implementing structural reforms. The lecture will be brief, so that we will have time for a Q and A session afterward.

1. First, the unique context of emerging market economies.

As a general statement, one can begin with the notion that the attainment of monetary and financial stability is something that policymakers everywhere place at the forefront of their agendas. And, monetary and financial stability are desirable because they are prerequisites for welfare-enhancing macroeconomic outcomes. Along this line, the context in which monetary and financial stability is pursued in emerging market economies is quite distinct from that in developed economies. For emerging markets, there are two stylized facts that are unique to its policy setting. The first is the greater income and consumption volatility that have been observed in emerging markets, both in terms of the level and in terms of growth relative to developed economies. And the second is the fact that economic agents in

[1] The views expressed in this paper are those of the authors and do not necessarily represent those of the Bank of Thailand or Bank of Thailand policy. I would like to thank Piti Disyatat, Ashvin Ahuja, Sarawan Angklomkliew, Jaturong Jantarangs, Nawaporn Maharagkaga, Don Nakornthab, Kobsak Pootrakool, Mathinee Subhaswadikul and Supradit Tangprasert of the Bank of Thailand for their substantial contribution to the drafting the original paper.

emerging markets face greater limitations in the ability to smooth consumption in response to shocks.

The empirical evidence from two recent studies are summarized in Table 1.

Table 1: Output and Consumption Moments

Aguiar and Gopinath (2007): Quarterly data up to 2003Q2		
	Emerging Markets	Developed Markets
$\sigma(y)$	2.74	1.34
$\sigma(c)$	3.97	1.26
$\sigma(\Delta y)$	1.87	0.95
$\sigma(c)/\sigma(y)$	1.45	0.94
Kose, Prasad, and Terrones (2005): Annual data 1961-2000		
	Emerging Markets	Developed Markets
Median ΔY	2.61	2.80
Median ΔC	1.89	2.71
$\sigma(\Delta y)$	4.07	2.59
$\sigma(\Delta c)$	5.63	3.32
$\sigma(\Delta c)/\sigma(\Delta y)$	1.38	1.28

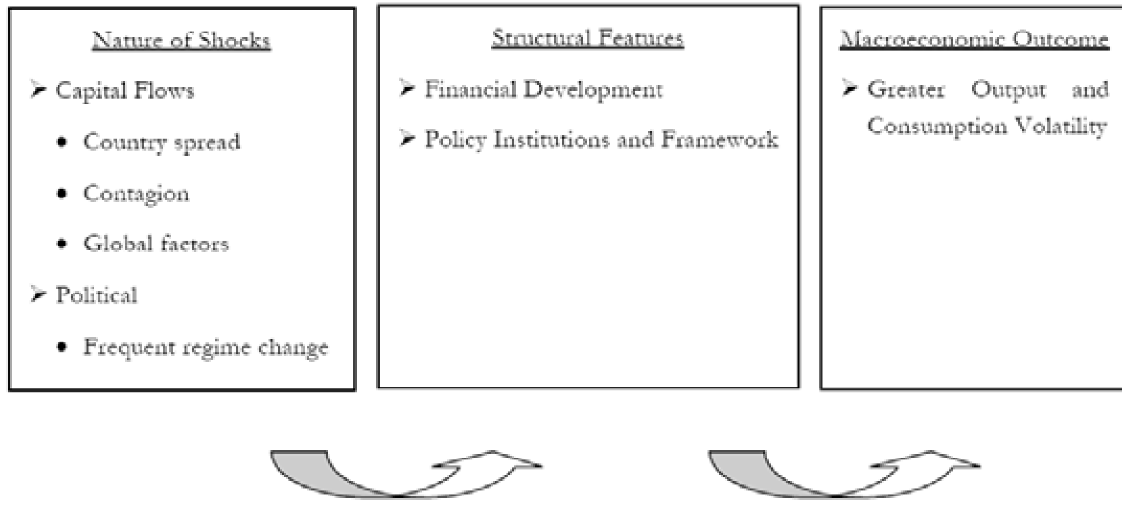
Note: Aguiar and Gopinath (2007)'s sample contains at least 40 quarters of data. Reported figures are average values for the group of 13 emerging and 13 developed economies following the classification of Standard & Poor's (2000). Level data are log HP filtered while the differences are unfiltered log differences. Kose, Prasad, and Terrones (2005)'s emerging markets sample consists of 23 more financially integrated developing economies, while developed economies' sample consists of 21 OECD countries. Data are unfiltered.

As documented by Aguiar and Gopinath in 2007, consumption is around 40 percent more volatile than income at business cycle frequencies for emerging markets, while the ratio is less than one for developed economies. The same is true when comparing relative volatility in growth rates of consumption and income. A study by Kose, Prasad, and Terrones in 2005 also shows greater income and consumption volatility in emerging markets relative to developed economies. Such heightened volatility in macroeconomic outcomes undoubtedly has adverse implications for welfare. And the fact that consumption is so volatile – in itself as well as in relation to income – suggests the existence of serious limitations in the ability of economic agents in emerging markets to smooth consumption in response to shocks.

A central proposition of our studies is that a large part of the explanation for higher macroeconomic volatility in emerging markets rests with key differences in the nature of shocks hitting emerging market economies, as well as the way in which the economic system of emerging markets propagate the shocks.

Figure 1 captures our basic arguments, and depicts how observed macroeconomic outcomes are the result of the interaction between the nature of shocks and the structural features of the economic system.

Figure 1: Determinants of Macroeconomic Outcome



Firstly, the nature of shocks that emerging market economies experience is quite different from that of developed economies. A particularly pertinent example in this context is capital flow shocks. By virtue of their limited access to capital relative to their growth potential, emerging market economies are natural recipients of capital inflows from capital-rich economies. These inflows are attracted by prospects of higher return and provide the necessary funding of investments that facilitate economic development, especially when the inflows are of the type that bring technological transfers and managerial expertise.

But as shown in Table 2, capital flow shocks, especially debt and equity, are more volatile in emerging markets relative to developed economies, as well as relative to other developing economies.

Table 2: Capital Inflow Volatility

	FDI/GDP	Equity/GDP	Debt/GDP
Coefficient of Variation			
All Countries	0.85	0.98	0.76
Advanced Economies	0.92	0.99	0.64
Emerging Markets	0.75	1.07	0.85
Other Developing Economies	0.9	0.7	0.8

Source: Table 3 of Kose, Prasad, Rogoff and Wei (2006). The coefficient of variation is the standard deviation divided by the mean. Data shown in this table are the cross-country means for each group of countries of the different categories of gross capital inflows over the period 1985-2004. The sample comprises 21 industrial, 20 emerging market and 30 other developing countries.

Such volatility, which sometimes manifest itself in "sudden stop", is linked to a variety of factors including the pro-cyclical nature of the flows. For example, the pro-cyclical nature with respect to sovereign bond ratings. On the other hand, information asymmetries in emerging market economies may also make the flows more susceptible to contagion effect, resulting in large swings in capital flows unrelated to changes in fundamentals. Macroeconomic conditions in developed countries is another factor that can make emerging market economies more susceptible to a wide array of global shocks.

And lastly, domestic political shock in the form of policy uncertainty can also be more pronounced in emerging markets, as evidenced by more frequent regime switches, that is from fixed to floating exchange rates, as well as reversals in policies. Such shocks can exacerbate capital flow volatility and manifest themselves in terms of greater macroeconomic volatility.

The second key difference between emerging market economies and developed economies has to do with structural features of the economic system that influences how various shocks are propagated through the economy. While there are many key differences in this regard, two features are especially important in the context of monetary and financial stability. The first is the financial development and the second is the institutional framework of monetary and financial supervision policy.

On financial development, one of the most vital foundations of modern economies is the process of channeling resources to their most productive uses. Whether an economy functions smoothly and efficiently or not depends much on the manner in which the financial system performs this task. A strong banking sector with highly disciplined risk management helps to mitigate the risks of financial imbalances while the existence of a deep and liquid financial market that offers a breadth of financial instruments helps improve the ability of the economy to absorb shocks. More generally, the level of development of an economy's financial sector has a fundamental bearing on social welfare insofar as it determines the ability of agents to smooth out their consumption profile in the face of fluctuations in income. As such, a substantial part of the observed differences in macroeconomic outcomes between emerging market economies and developed economies can be attributable to the disparate levels of financial sector development in these two groups of countries. Indeed, a number of empirical studies indicate that financial development, especially greater financial access, is associated with lower macroeconomic volatility.[2]

Next, the institutional framework of monetary and financial supervision policy also has an important influence on the extent to which various shocks make their way through the economy. Importantly, in a setting where the central bank lacks independence, its performance is likely to be more easily influenced for short-term political ends with adverse macroeconomic consequences. At the same time, a weak financial supervision framework increases the risk of financial imbalances building up, especially in situations where substantial capital flows drive up asset prices and generate favorable conditions for credit expansion, which may ultimately lead to severe economic dislocations. In contrast, a credible policy framework and enshrined central bank independence provide the necessary preconditions for alleviating the impact of shocks on the economy. For example, by anchoring the public's long run inflation expectations to the target level, a credible inflation-targeting framework helps to mitigate the impact of temporary supply shocks on inflation and

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[2] Cecchetti, Flores-Lagunes, and S. Krause (2006) provide empirical evidence for OECD countries that increased access to credit enables households to smooth their consumption, which in turn reduces the volatility of consumption and output growth. See also Larrain (2004) and Raddatz (2003). Similarly, the evidence regarding international financial integration suggests that moving towards the latter ultimately will bring benefits of enhanced risk-sharing that leads to reduced consumption volatility (Kose, Prasad, Rogoff, and Wei (2006)).

allows the central bank more leeway to adjust its policy instrument to cushion any negative impact on output.

Overall, our observation is that the unique combination of shocks and structural features of the economic system in emerging market economies give rise to a macroeconomic backdrop that is characterized by significantly higher output and consumption volatility than in developed economies. The period leading up to and immediately following the Asian financial crisis is a prime example of this interaction. In that case, rapid movements of capital flows into and out of emerging markets interacted with financial system underdevelopment, deficient bank supervision, and balance sheet weaknesses, resulting in a boom-bust cycle. In contrast, the experience of developed economies is more generally characterized by one where large shocks typically result in substantial asset price volatility and substantial financial losses that are not accompanied by significant disruption to either short run or long run economic growth. A rigorous assessment of the challenges of monetary and financial stability in emerging market economies therefore must explicitly recognize this underlying difference in the economic backdrop.

Let me now turn to the second part of my lecture and discuss the implications of these differences on the pursuance of monetary policy and financial stability.

In light of the unique agglomeration of factors in emerging market economies outlined above, the pursuit of monetary and financial stability in emerging markets has two key facets. The first is to address the immediate short run concerns emanating from the various shocks; and the second is to implement structural reforms to ensure that financial stability becomes embedded in the underlying economic structure of emerging markets in the long run. The former essentially concerns the challenge of maintaining economic stability through appropriate policy settings and actions to offset the various shocks hitting the economy at any given point in time. The latter, on the other hand, focuses on strengthening the institutional framework for monetary policy and financial supervision as well as fostering financial sector development that improves the ability of the system to absorb shocks by itself, in a way that minimizes the impact on the real economy without the need for policy intervention. Given the significant gap that emerging market economies have in this respect relative to developed economies, it becomes more crucial that the pursuit of monetary and financial stability in emerging markets be accompanied by a vigilant focus on making progress on structural reforms. In what follows, I will discuss some specific challenges to monetary and financial stability in emerging markets from both the short and the longer run perspectives.

Let's begin first with the short run stabilization challenge.

As we have seen in past years, the search for yield among international investors has resulted in a resurgence of capital inflow into emerging markets, leading to a pick-up in asset price volatility.[3] Given the high degree of dependence on foreign trade, and the inadequate experience with modern financial risk-management tools particularly at the firm level, these asset price fluctuations have become an important policy issue in emerging markets. Typically, when large capital flows into financially shallow markets, it puts pressure on emerging market central banks to lower interest rates or to increase sterilized intervention in

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[3] This global liquidity glut may have stemmed from various factors, both structural and cyclical. A few examples of structural factors include a demographic shift from working-age to older population, which swells up the volume of pension funds that need to fulfill their obligation to retirees; the rise of sovereign wealth funds in the era of high international reserves under rigid exchange rate arrangements; technological innovation and the decline in telecommunication, transport and other financial transaction costs from credit risk transfer mechanisms; and, capital account liberalization that have over the years eliminated a significant degree of cross-border financial friction. At the same time, the liquidity glut is also due in no small part to accommodative monetary policy in advanced economies, whether one looks from the angle of low interest rates or high money growth.

the foreign exchange market. Both of these actions are accommodative from a monetary policy sense and tend to sow the seeds for inflation down the road. And in the case where capital inflows are persistent, the flows may even induce authorities to make use of prudential measures, which can range from credit policy to capital account restriction on short-term inflows. The core issue facing emerging market central banks in the short run, therefore, is how best to contain financial vulnerabilities that accompany the volatility of short-term capital.

On this issue, when the challenge is on the side of managing capital inflows, there are three key decisions that emerging market policymakers must face in the short term. The first is how to deal with the cost and the constraint of coping with capital inflows. The second is the challenge in finding a set of tools that can help assess the potential build-up of financial vulnerabilities. And the third is how best to complement monetary policy with prudential measures to help prevent potential financial instability.

On the first decision, for those under a managed float regime, lowering interest rates to reduce the relative attractiveness of the country to capital inflows may be an appropriate way to ensure price stability. But concerns of fast appreciation may not subside as exchange rates tend to behave more like asset prices than relative goods prices in practice. That means the nominal effective exchange rate can appreciate for a while in the short run, even after central banks repeatedly cut interest rates. This is an element of the well-known exchange rate disconnect puzzle. The risk is that a central bank may cut interest rate by too much, and at the same time sowing the seeds for inflation and an asset price boom down the road. An obvious important technical challenge to emerging market central banks, then, is to improve its ability to forecast inflation and output and be more precise about the range of possible natural rates of interest, which vary through time.

Resisting the appreciating momentum of the exchange rate through interest rates alone may not be sufficient. A widely adopted practice that is assumed to be effective in the short run is through sterilized intervention. Sterilized intervention, however, entails quasi-fiscal costs from swaps or bond issuance, which adds to the liability side of the consolidated public sector balance sheet. Since the debt is in local currency, there is an inflation risk attached to it should there be future fiscal stress. There is also a potential for the market to raise doubts about monetary policy independence and therefore increase the risk of policy uncertainty. In the same vein, accumulating international reserves can also lead to a possible damage to central bank credibility in some countries, as they incur balance sheet losses when assets and liabilities are marked to market in local currencies.

In sum, the challenge of containing the effects of capital inflows on asset prices may pose risks to future inflation and financial stability in emerging markets. This challenge seems to suggest a potential for complementing monetary policy with prudential measures. The extent of the challenge here depends crucially on the ability of the economy to cope with asset price fluctuations. Also, it depends critically on the ability of the real sector to adjust to the pace of the appreciation as capital inflows continue.

Next, the second challenge in the near term concerns the ability of emerging market central banks or financial supervision authorities to identify and quantify risks of potential financial instability in advance. In this context, stress-testing is one of the most powerful tools to assess financial stability ex-ante. If implemented effectively across the financial industry, stress-testing can help curb destabilizing activities and help prepare financial institutions to deal with macroeconomic or financial shocks. Unfortunately, financial institutions and regulators in emerging economies have lagged behind their counterparts in advanced economies on this issue, especially on the credit and liquidity risk stress-testing.

A priority for regulators in emerging economies, therefore, is to move faster on stress-testing. To accomplish this, they should push financial institutions to invest in human resource and technology, with the aim of conducting macro stress-testing at least on an annual basis. As regard implementation, regulators and monetary policy makers must increase coordination

so that macroeconomic and financial stability assessment can be done in an integrated fashion, so as to arrive at a more relevant and convincing macro stress-testing scenario.

Finally, the third challenge or decision is the use of prudential measures. While it is unclear how effective domestic monetary policy can be in checking excessive asset price volatility, the threat of financial instability has given rise to a more prominent role for macro-prudential measures to reduce the procyclicality of the credit market. As we see it, the primary challenge in this respect is how best to move forward. Combining the use of prudential measures with monetary policy is a useful policy option, but it is still an unsettling issue because of the concern for efficiency. In practice, discretionary prudential measures pose difficulty in the form of potential regulatory forbearance, market distortion, timing effectiveness, and the difficulty in modeling early warning system. Rule-based prudential measures, on the other hand, pose difficulty in policy calibration. That is to say, calibrating this type of policy tools has so far proven difficult for emerging markets where data availability is limited and large structural breaks are usually present.

Let us now turn to the longer-term challenge in the pursuance of monetary and financial stability in emerging markets, that is, the issue of structural reform and its implementation.

From a longer-term perspective, the attainment of monetary and financial stability is determined predominantly by the embedded structural features of the economy. These matter not only with regard to how shocks are propagated through the system but they also influence the effectiveness that policy stabilization efforts can cushion the economy from such shocks. In what follows, I will discuss two key aspects of the structural features that are important for the pursuance of monetary and financial stability. These are the financial development and the policy institutions and framework.

First, financial development.

One important requirement to ensure that the risk management capacity of the economy evolves with the changing nature of risk is to enhance the risk management ability of economic agents. The key to this would be to strengthen the efficiency and the robustness of the financial system. To achieve this, the strategy to enhance economic and financial resiliency must pay attention to the following considerations:

The first is to recognize the benefit of having a well-balanced financial structure.

Efficient and well-balanced financial system will allow the system to better manage and absorb shocks as the market would be less prone to one-way market conditions and would posses greater liquidity. A well-balanced financial structure contributes positively to information processing, price discovery, and risk management. The experience of the Asian crisis, for example, points to the critical importance of the development of a long-term local currency debt market, to increase the depth and the breadth of the financial market. In relation to this, the Bank for International Settlements, in their studies, have identified that the lack of diversified structure and market may lead to increased risk from concentration of credit and maturity risks in the banking system as the lack of markets may lead to the mispricing of risk, excessive delay in correcting large exposures, as well as increased vulnerabilities from capital inflows.

The second important consideration is the importance of strong financial market infrastructure.

One of the key issues for emerging markets is the structural weaknesses which can create disincentive and moral hazard. The presence of such distortions contribute to a build-up of financial vulnerability, hinder growth of market solution for tackling risk, and complicate policy actions in events of crisis management. Progress in correcting these weaknesses in emerging markets, however, may have been somewhat slowed.

Market-driven financial market developments need the support of critical infrastructure, namely: (1) *Information that allows efficient decision making and pricing* on various asset markets, financial as well as related markets such as real estate market, which are still very lacking in many emerging markets, and may be an area of public support. (2) *Legal reforms to ensure an enabling environment for innovation in products and business models for the financial system.* And (3) *Human resource with proper competency in modern financial and risk management* are scarce and is becoming a bottleneck for development. The authority may need to step in to facilitate training and accredition of professional standards, if it has external benefits.

Notwithstanding these challenges, however, notable progress has been made by emerging markets in the past decade, much of which is catalysed by comprehensive economic reform in which market-oriented economic and financial liberalization have been the main features. For East Asia, despite the progress made, significant gap still exists in diversification, efficiency and robustness when compared to the role played by financial markets in developed economies. Looking ahead, in addition to the pressure from globalization, the shift in demographic structure will also be an additional pressure. This is to say some smaller emerging markets will face an aging population and the increase in demand for wealth management, while the supply of local products are limited for diversification. This will pose challenges for inter-temporal allocation of resource and risk. Thus, it is imperative that emerging markets devise a proper strategy and process to expedite reforms and develop the financial system.

The second longer-term reform I want to bring up is policy institution and framework. On this, two policy institutions are of utmost important for attaining monetary and financial stability. The first is a credible monetary framework that effectively anchors the public's expectation of inflation. The key issue here is the importance of independence and transparency of the monetary policy process. The usual case is that the lack of independence can come at a great cost in terms of lower central bank credibility and a less favorable trade-off between inflation and output volatility. Likewise, weaknesses in monetary policy transparency can contribute to policy uncertainty and exacerbate the impact of shocks on macroeconomic volatility.

The second important policy institution is an effective supervisory policy and domestic financial institution's capacity for sound risk management. The logic for this is clear. With less effective supervision and limited capacity to manage risk, the ability of the economic system to absorb volatility from global markets is significantly compromised.

Reflecting this, emerging markets have put enormous emphasis on building up the necessary institutions with regard to effective supervision. But the challenges are many. For example, at this time, many emerging markets are facing the challenges in implementing Basel II.

The objective of Basel II is to strengthen the soundness and stability of the banking system through more risk-sensitive capital requirements and rigorous internal risk assessment process. This has a direct bearing on ensuring financial stability. But because Basel II is developed from the current practice among banks in developed countries, some banks in emerging markets may have a large gap to fill. For example, in moving away from collateral-based to credit-based loan approval, banks must focus more on the ability to pay of customers and to make loan decisions in a forward looking manner. This requires a different set of expertise that focuses on risk assessment in the environment of changing economic cycle and asset quality.

Next is the information system which is the most important foundation for achieving financial stability through capital adequacy. Whereas developed countries generally already have in place the necessary infrastructure in this regard, financial institutions in emerging countries have to build the system from the ground up, involving areas such as data collection, storage, analysis, and ways to effectively embed the information in the decision-making

process. This step may take more time and effort because it involves building a knowledge base for quantitative analytical skills and ability to apply international best practices to the unique local settings of emerging markets.

Another difficulty in Basel II implementation is that other players in the wider financial industry will be playing more active roles in the banking sector's risk assessment. For instance, the simple approach of Basel II ties the amount of required capital to ratings by External Credit Assessment Institutions (ECAIs) because they have the strength in both the wealth of data and expertise in credit risk assessment. Unfortunately, only a few large companies in emerging countries are rated. Therefore, the challenge for regulators lies in the process of ECAI recognitions and risk-weight mapping processes as they must ensure the stability of the banking system while at the same time, foster the development of local ECAIs and the bond market. These efforts will undoubtedly take considerable time and patience, but it is a road that has to be taken.

Financial development and the strengthening of policy institutions and framework, therefore, are the two most important structural features of emerging markets that need to be promoted, developed, and strengthened in the pursuance of monetary and financial stability. In my view, this is the most important reform issue that need to be effectively carried out.

For the remaining part of my lecture, let me now turn to my last topic, that is the challenge of implementing structural reforms.

While the two facets of monetary and financial stability discussed above are present in all economies, the interaction between them and the tensions that arise in terms of where the policy emphasis is placed are arguably more varied and more complex with greater welfare implications in the emerging market context, not least because the gains to be had from structural reforms are much higher in these countries. It is therefore important to focus on the *process* of implementing structural reforms and how to ensure that they remain on track. In what follows, I will discuss some of the complexities that arise on this issue and highlight some of the lessons learned from many previous reform efforts.

The most prominent conclusion obtained from the literature on structural reforms is that they are difficult to implement. The first problem is that the gains from reform are hard to quantify because they are often indirect and thus rarely fully appreciated by the wider public. The enshrinement of central bank independence, for example, helps to insulate monetary policy from short-term political consideration and paves the way for monetary stability in the long run, but making a case for this in a non-technical manner to a wide audience, with conflicting interest, often proves a communication challenge for central banks.

Next, the fact that many structural reforms entail short-run costs compounds the problem. The opening up of the domestic banking sector to foreign competition, for example, brings long-run benefits in terms of improved banking services but may adversely impact domestic banks' profitability in the short-run. This time mismatch between the costs and benefits of reforms is a prime reason why they are hard to sell. And where the costs and benefits accrue to different segments of the economy, as in this example, the difficulty of instilling reforms is exacerbated since it is hard to create satisfactory compensation schemes while those who lose out tend to be concentrated and thus more effective in organizing political opposition to the reforms.

There are, however, general empirical regularities on the conditions that make reforms more likely.[4] First, is the period of economic downturn or crisis that focuses the public's mind on the need for reform. Second, there must be sufficient fiscal room to compensate the losers. Third, the success of previous reforms that may help create competitive pressure for reforms in other areas. Fourth, the longer the length of time remaining in office for the Government,

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[4] See OECD (2007), IMF (2004) and Rajan (2004) for a detailed discussion.

the more likely that reforms will be undertaken. And fifth, external pressure either in the form of foreign reform efforts that increase competitive pressure domestically or membership in an international economic organization that requires reform as part of the admission criteria.

Next, even if the obstacles to the reforms have been overcome, the practical aspects of implementing them pose further challenge. One of the most important issue in this respect concerns the proper pace and sequencing of structural reforms. In the context of financial sector reforms, for example, the underlying challenge is the proper mitigation of the additional risks that are injected into the financial system as markets develop and become more sophisticated. These risks consist of both financial risks borne by market participants as well as macroeconomic risks that may be associated with greater financial market volatility. Indeed, the inappropriate setting of priorities among the reform measures or an overly rapid pace of change can result in financial instability in the short run. More generally, initiatives in the areas of financial sector development, monetary policy regime, and capital account liberalization are all closely related and designing appropriate reforms in one area requires a careful consideration of how to proceed with the others.

On this issue, suffice it to say that the consensus on the importance of structural reform efforts does not carry over with the same strength to the issue of the appropriate pace and sequencing of policy changes. Nonetheless, it should be stressed that a frequent outcome of the debate on this issue is excessive inertia in reaching an agreement and actually starting the process of change. The more protracted the transition period, the greater the eventual costs to the economy in terms of deferred benefits of stronger fundamentals.

Finally, a recurrent theme that has been underlying much of the discussion in this lecture this evening is the intricacy of achieving monetary and financial stability while at the same time maintaining the delicate balance of short-run stabilization efforts and long-run structural reforms. This is perhaps the toughest challenge for emerging markets in this regard. In particular, a heavy focus on maintaining immediate financial and economic stability can often hinder efforts to deliver these very same goals in the long run. Thus, ensuring that the outcome of such trade-offs turn out favorable to the attainment of monetary and financial stability in the long term is perhaps the toughest challenge for emerging markets in the present context.

Ladies and Gentlemen,

To conclude, despite the challenges presented above, the overall direction of change in emerging market countries in the past decade is fundamentally reassuring. Much has been achieved in terms of strengthening the monetary framework and financial system development, reducing vulnerability to external shocks through the establishment of sizable foreign reserves cushion as well as significant restructuring of external debt currency denomination and maturity profile. These changes make it more likely that the process towards further global financial integration will bring substantial benefits in terms of growth and fewer risks, in terms of financial distress, and ultimately contribute towards a more stable macroeconomic outcome.

And with that note, let me now end my lecture this evening. Thank you.

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