UNIVERSITY OF NIGERIA

FINANCIAL GLOBALISATION AND DOMESTIC MONETARY POLICY:
Whither the Economics for the 21st Century?

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By

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I: Introduction

"When a medical doctor makes a mistake, a patient dies. When an economist makes a mistake, a generation or even a society dies" Wisesaying.

"...the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil". John MaynardKeynes, (1954:383-4).

"Economists have probably had more influence on policy in recent decades than at any other time in world history. But the sad reality is that their influence in the developing world has run considerably ahead of their actual achievements "— Rodrik (2007:5)

Permit me, Mr. Vice-Chancellor, to start this lecture with a statement of gratitude and acknowledgments. First, this University, with the vision to 'Restore the Dignity of Man' offered me a head-start in life. As a student, it offered me rich opportunities to acquire knowledge. As an academic staff, the University gave me the latitude to excel. The fact is that I have been away for a greater part of the 20 years of my career as a lecturer, and the University has been magnanimous to tolerate the long period of my absence from duty. Many thanks and, please, keep the tradition alive.

Second, my deepest gratitude goes to my former lecturers, supervisors and colleagues for not only shaping my early career, but also tolerating my long absence from teaching. A special posthumous gratitude goes to my lecturer (Prof. Austine Okore) whose untimely demise still leaves me in a state of shock. May his gentle soul rest in peace! In particular, I remain grateful to Professors A.E. Okorafor. O.E. Obinna, M.N. Ogbonna, C.C. Agu, F.E. Onah, N.I. Ikpeze, A.W. Obi as well as Dr. R. N. Ogbudinkpa, Dr. Ahaghotu, Dr. Micinski, Dr. Sadowska, Dr. Maiti. Dr. Ghosh. Mr. Oleru. and Mr. Onwuachi. I am also grateful to several lecturers from outside of the Department of Economics who taught me various other courses including. Prof. Okwudiba Nnoli, Prof. Ikenna Nzimiro, Dr. Emeka Enejere, and Dr. Ntukogu. I am grateful to Prof. Sam Olofin and fellows of the Centre for Econometric and Allied Research GEAR), University of Ibadan, for providing the infrastructure for my Ph.D thesis. My supervisor and mentor at the Brookings Institution, Washington, DC, Ralph C. Bryant grearly shaped by technical skills, especially in the field of multi-country macroeconometnc modelling and open economy macroeconomics. In my many years as visiting scholar- at the IMF Research Department, University of Oxford, University of Cambridge, at the UN-Economic Commission for Africa in Ethiopia, at the OECD Development Centre. Paris; as a visiting professor at Swarthmore College, USA, as well as consultant to the World Bank and many other institutions and researcher and, later, resource person at the African Economic Research Consortium ^AERC) in Nairobi, I have met and interacted with dozens of world class scholars and they have greatly shaped my career as an academic. My list of indebtedness is very long and I do not intend to bore you with them.

Mr. Vice-Chancellor, distinguished ladies and gentlemen, this inaugural lecture comes at an important time in my career. This month marks the 1Oth Anniversary of my promotion to the rank of professor and this year marks the 20th Anniversary as a lecturer in this University. In 1988, there was no internet, no GSM, laptop computers were few, and access to personal computers was such a great luxury in this country that only very few could afford them. By the time I became Professor of Economics (with effect from October 1998), life without the internet or a laptop was unimaginable. The world had changed remarkably, and so also the ferment of economic ideas and practice.

Today, I am giving my inaugural lecture of this University not just as an academic who has been active in shaping the economic development debate in Africa for over a decade before joining Government, but as a former Economic Adviser to the President of Nigeria and now a practitioner as Governor of the Central Bank of Nigeria. I remain grateful to former President Obasanjo and President Yar'Adua for the privilege and honour to serve my country in these capacities. How then should I frame this lecture? It is a tricky and slippery slope for me.

First, some of you may have come to listen to the Governor of the Central Bank, in which case, you expect me to deal more with my experiences in trying to interface between theory and practice. Let me apologize at the outset that I will disappoint you. You may have to wait for the publication of my memoirs after leaving public office to read about that. Second, if you expected me to try to convince you that I deserved to be promoted Professor by making a tour of my publications and major contributions, or even a tour of the history of economic thought to highlight the missing links in my discipline, again I offer you my apologies. My research and consulting work have covered a wide range of areas in economics including macroeconomics, econometric modelling, monetary economics, international trade, public finance and fiscal policy, and development/institutional economics. Trying to summarize them in one lecture would run the risk of losing focus. Nor have I come to mesmerize you with any one of my important research findings.

I take a rather futuristic view of inaugural lectures. I believe that a Ph.D degree marks the beginning of the first phase of an academic career for its recipient. The attainment of the status of professor should mark the beginning of the second, the 'mature' phase. Most eminent professors have actually published more after they became professors than before, and most of them had their most important publications after they became professors. This is the time to demonstrate research leadership. Therefore, my view of an inaugural lecture is that it should be the time to identify the lecturer's research agenda for the future, while a valedictory lecture should be a time to celebrate past achievements. In other words, the inaugural lecture should be the time when the University is asking the new professor: 'Now that we have rewarded your past effort by offering you a 'chair' to do more research, where do you go from here?'

More fundamentally, for economists at least, this is not the time to celebrate the past. The world economy is in turmoil, which is an indirect indictment of my profession and the global economic governance framework, bearing in mind that the ultimate goal of academic research is to change the society for the better. Economic policy, and even to some extent economic theory, has been subject to changing fads and fashions and, in many cases, has been responsive to the new evidence and challenges of the time. Economic science has largely mirrored the political and social structure of the times. In some cases, theory has 'created' rather than 'evolved with' a new society. In most other cases, however, theory has evolved either to justify an existing socio-political order, or in reaction to the shocks and failures of the existing order. Classical economic theory dominated pre-20th century Economics. With the experience of the Great Depression, Keynes challenged the orthodox views and Keynesianism dominated economic thinking and policy from the 1930s, until the late 1970s **when the neoclassical** staged a strong comeback. Of course, we cannot forget the socialist economics, a product of Marxist-Leninist thinking and which was, ostensibly, a reaction to the perceived failures and internal contradictions of the capitalist or market economics. Although some scholars still find the Marxist-Leninist thinking a powerful tool for social and political analysis, many note that socialism as a framework for organizing an economy emerged and died in the 20th century. Of course, the concept of market economy itself is a spectrum, with different perspectives on how to run such an economy. At the end of the 20th century, three or four mainstream clusters of ideas dominated the policy debate and practice— the new Keynesian economics, the new classical economics, and development economics, or a variant of it called the Heterodox view. On how to organize the global monetary and payments system, the world has evolved from the gold standard, the gold-dollar standard with a fixed exchange rate, and now a floating exchange rate regime with a largely open capital account.

The world has also become more complicated by the forces o "'globalization, and the increasing complexity of economic and financial structure, wrh cross-border capital flows that blur the definition and management of monetary aggregates, as well as the dominant segments of the financial system outside the reguhyntrols of national governments. With these developments have emerged more frequent crises at the management of global and national economies that are largely 'exogenous shocks', with the result that many economies lack the tools for basic stabilization in a world where monetary authorities are increasingly being called upon to pursue multiple objectives.

The current global financial crisis is analogous to several earlier eruptions over the last 100 years: the panic of 1907, the summer market closing of 1914. the August October breakdown of 1929, the OPEC revolution and the stagflation of the 1970s, the short-lived stock market crash of 1987, the Asian currency crisis of 1997, the Russian debt default of August 1998, and the NASDAQ-led stock market swan dive of 2000-2001. Each of these has produced some forms of'new thinking' or 'reforms' in thinking and action. The current crisis has witnessed an unprecedented, coordinated global bailout scheme with the US, Europe and other economies committing more than US$3.3 trillion, in addition to state interventions (nationalisations) and guarantees that have dumbfounded the free marketers, but have brought relief and cheering choruses of'I told you so' by the neo-leftists. Is this the end of free market economy as we know it? Is our knowledge or our tools obsolete and calling for a 'new thinking', a hybrid of existing frameworks, or a choice among competing models? In other words, is economic science lagging behind the pace of the global economy?

In the light of the apparent state of emergency in the global economy and the challenge to the profession of economics, I have decided to be responsive in the choice of a topic for this lecture. In the last one month, I have changed the topic thrice. Initially, I wanted to speak on *"Macroeconomic Modelling Under Uncertainty As Ropes of Sand "*-•- an aspect of my research I pursue with considerable passion. Later, I wanted to focus on whether *Development Monetary policy is passe?* Finally, I decided only two weeks ago to focus on aspects of the challenge of the moment in my profession.

I have, therefore, chosen to speak on *"Financial Globalization and Domestic Monetary Policy: Whither the Economics for the 21st Century?* The current crisis has forced me to reach out for my Ph.D thesis entitled, *"Monetary Policy Simulation Within a Macroeconometric Model of the Nigerian Economy"* which won the Vice-Chancellor's prize. The major framework of the model of my doctoral study was what was called a 'structuralist-developmental' model of monetary policy, which was predicated, essentially, on the existence of weak financial markets, pervasive market failures, and almost a closed economy framework. In today's jargon, the framework would be called the 'heterodox' framework. The model largely validated much of the direct instruments of developmental monetary policy. In less than 20 years since then, the world has become more integrated than could ever have been imagined; the financial structure has become more sophisticated, and the dominant paradigm is now strongly in favour of the Washington-Consensusftype market fundamentalist preeminent focus on 'price stability'. Development monetary policy is now largely regarded as an 'old school', although echoes of it still reverberate within the new heterodox thinking being pushed by Joseph Stiglitz and others. But the dominant theory and practice in the era of financial globalization have left a world economy that is inherently crisis-prone and, some would say, unsustainable. What new research should illuminate the road ahead? This is the focus of my lecture. What I do here is to provoke debate and not to provide answers. I paint a broad canvass of the issues, and challenge us all to think outside of the box, for these are not ordinary times.

Let me clarify here that I am not speaking in my capacity as Governor of the Central Bank of Nigeria, but as Professor of Economics of the University of Nigeria (on leave). My final apology relates to the scanty and incoherent nature of the lecture itself. As you can imagine, I have too many balls in the air and, therefore, have not had the quality time to prepare a well researched lecture as I would have wished to.

The rest of this lecture is organized into four sections. Section II makes a sketchy survey of the history of the contending theories and practice of monetary policy regimes. In Section III, we examine how globalization has altered the environment for domestic monetary policy. Section IV outlines the matters arising and proposes an agenda for research, while Section V concludes the lecture.

II: Theory and Practice of Monetary Policy Regimes

"History", according to Karl Marx "repeats itself, first as a tragedy, then as farce". Arguably, there are not too many other areas of social knowledge where history has cyclically repeated itself, and about which social philosophers and economists (from Aristotle to Adam Smith, David Hume, Marshall, Irving Fisher, Simons, Keynes, Friedman, etc) have repeated themselves, than the knotty issue of money— its role and how it should be controlled for the good of society. If you think we have seen it all with the recent global credit crunch and financial crisis, then listen to what Lord Keynes had to say some *85* years ago:

> *Nowhere do conservative notions consider themselves more in place than in currency; yet nowhere is the need of innovation more urgent. One is often warned that a scientific treatment of currency questions is impossible because the banking world is intellectually incapable of understanding its own problems. If this is true, the order of Society, which they stand for, will decay. But I do not believe it. What we have lacked is a clear analysis of the real facts, rather than ability to understand an analysis already given. If the new ideas, now developing in many quarters, are sound and right, I do not doubt that sooner or later they will prevail. I dedicate this book, humbly and without permission, to*

the Governors and Court of the Bank of England, who now and for the future have a much more difficult and anxious task entrusted to them than in the former days. (John MaynardKeynes, October 1923).

You would be forgiven for thinking that Keynes was responding to today's financial crisis, and I am sure the Governor of the Bank of England, Dr. King, as well as most Governors of central banks around the world, would find Keynes' words insightful in today's world. It seems the world goes in circles, growing but with the same unsolved problems.

After Keynes published his book entitled *"A Tract on Monetary Reform "in* 1924, the Great Depression of the 1930s hit the global economy. In another, much more influential book, (The General Theory of Employment, Interest and Money, published in 1936), Keynes provided a robust critique of the classical theory of Alfred Marshall and others who had posited that a normally functioning market economy leads to full employment. Keynes showed that a market economy, on its own, could lead to less than full employment and that it might actually work against reducing unemployment. He, therefore, strongly advocated active government intervention (through monetary and fiscal policies) for short-run cyclical stabilization, as opposed to the unregulated *laissez-faire* policies of the classical school. The view had been strongly held that there was a sustainable trade-off between inflation and unemployment/growth objectives. Discretionary (active) monetary policy was believed to be capable of effectively combining these two conflicting objectives. The Keynesian view of the world of macroeconomic stabilization prevailed and, arguably, propelled the global economy out of the Great Depression.

It was not until the 1960s, and especially propelled by the works of Milton Friedman, that some aspects of the underlying premise of Keynesian demand management were challenged. Monetary policy was adjudged ineffective in solving the twin problems of unemployment and inflation, and emphasis began to shift to domestic price stability as the major assignment of monetary policy. Macroeconomists have, since Keynes, been broadly divided into two groups: those favouring an active, interventionist approach to macroeconomic policy (Keynesians, neo-Keynesians and the Heterodox group), and those (neo-classicals) favouring a rule-based, largely non-interventionist regime. A central issue of controversy remains the role and usefulness of monetary policy as a counter-cyclical policy tool. Taken to the extreme, the neoclassical employ the 'equilibrium real business-cycle models' (with only 'real disturbances' affecting real output under a competitive economic system and flexible prices) and, hence, conclude that monetary policy cannot be useful in stabilizing the real economy. On the other hand, the neo-Keynesians use their own models of business cycles (especially with assumptions of various market imperfections and frictions— sticky wages and prices, missing markets, asymmetric information, liquidity phenomena, etc) to show that these imperfections provide the impetus for monetary policy being effective in stabilizing the real economy in the face of nominal and real shocks.

However, even when we accept (as most central banks tend to do) that monetary policy can be useful in economic stabilization, there are practical issues to be addressed. If the shocks to the economy are from the supply side, requiring adjustments in prices and quantities, then resorting to monetary policy to correct such a situation might be counter-productive. There is also the problem of the quality of the information set available to enable policymakers know precisely the nature of the shocks and also to respond in a timely manner. An active interventionist regime requires a lot of information and skills on the part of policymakers, an ideal that is often difficult to attain. Monetary policy is more effective if the shocks emanate from the demand side. Moreover, monetary policy affects the real economy with considerable and even unpredictable time lags, thereby raising questions about its effectiveness in stabilization scenarios.

In the world of theory, various extensions of the two competing models have adorned the literature— including the rational (forward-looking) expectations, a renewed interest in micro foundations to macroeconomics, the augmented Philips curve, the time-inconsistency problems, and a dose of literature on policy modelling, including policy rules and reaction functions. The debate is unlikely to end anytime soon.

In reality, however, most central bankers are neither pure neo-classicals nor pure Keynesians— but mostly hybrids. While the Great Depression of the 1930s gave rise to Keynesianism, the Great Inflation of the 1970s in industrial countries (hyper-inflation in Latin America in the 1980s) revived the classical view that attempts to stimulate the economy beyond its productive capacity could lead to an ever rising spiral of inflation. In some countries, stagflationa simultaneous occurrence of high inflation and high unemploymentactually occurred in the 1970s, and is still a feature of many countries. Both schools have elements of reality— Keynesians describe mostly the short-run perspective, while the classicalists take the long-run view. The resulting synthesis— the centre groundis variously claimed by both groups in the name of the 'New Keynesians' or the 'New Neo-classical synthesists.' The sharp divide in analytical works between rules versus discretion in the conduct of monetary policy is, in practice, a mute point. The practical issue is when to apply the rules and when to infuse a considerable dose of discretion. What seems to dominate most of the time is what may be described as *constrained discretion.*

The broad consensus that has emerged over the years has led to the determination of the key principles and operational features of most central banks' actions (see Mishkin, 2007:37-57), as illustrated by the following:

- Price stability should be the overriding, long-run goal of monetary policy, ostensibly because of the belief that price stability provides substantial benefits;
- An explicit *nominal anchor* (a nominal variab le that monetary policymakers use to tie down the price level, such as the inflation rate, an exchange rate, or the money supply) should be adopted:
- A central bank should be goal-dependent. The elected government often legislates to commit the central bank to the objective of price stability as its overriding, long-run goal. This makes it easy to ensure alignment between fiscal and monetary policy, as well as avoid the time inconsistency problem;
- A central bank should be instrument-independent. This insulates the central bank from the myopia of the politicians who usually have a short tenure (an electoral cycle of 4 to 7 years in most countries i and. therefore, could mount considerable pressure to exploit the short-run, trade-offs between employment and inflation. It also allows central banks to be forward-looking and to allow the long lags for monetan policy impacts;
- A central bank should be accountable. An ndependent central bank is subject to oversight by the elected representatives of the people, through mandatory periodic reporting, it must also be held accountable to the goals set for it by legislation;

t A central bank should stress transparency and communication, and;

- A central bank should also have a financial stability goal, because most serious economic contractions occur when there is financial instability. Thus, promoting financial stability or preventing instability should be a critical goal of a central bank. This is done through its supervisory/regulatory actions, as well as acting as the lender of last resort I without necessarily creating a moral hazard problem).

While the above represents a caricature of the emerging 'best practice' or 'mainstream' in the implementation of domestic monetary policy, the debate continues in relation to the specifics— goals, the choice and variability of instruments, transmission mechanism, as well as institutional design. In particular, the debate continues as to the relevance or applicability of the mainstream framework to developing countries. This debate is as old as development economics (the branch of economics dealing with the peculiarities and challenges of development in low income countries).

Since the 1940s and 1950s, development economics has emerged not only as a critique of mainstream economic theory, but as a reminder that developing economies are different and require different tools and instruments. In the area of monetary theory and policy, the literature is long (see for example, Schumpeter, J.A., 1943, Gurley, J.G., and E.S. Shaw, 1955,1967, Mckinnon, R., 1964, Snyder, W.W., 1964, Myint, H., 1965, Goldsmith, R.W., 1969, Handa, J., 1970, Khatkhate, D.R., 1972, Shaw, E.S., 1973; Park, Y.C., 1973, Coats, W.L., 1980, Coats and Khatkhate, 1984, Ghatak, S., 1981, Taylor, L., 1988; Sunkel,O., 1993,AgenorandMontiel, 1999,Agenor,P.,2004,Stiglitz, et al., 2006). The central message of development monetary economics is that the relatively underdeveloped structures and institutions in developing countries make it inappropriate to apply the traditional theory to them and, thus, warrants a different or modified approach.

Specifically, the developing countries, on the average, have relatively undiversified and underdeveloped production structures, dominated mostly by peasant agriculture. The services sector is often dominated by the large informal sector, with a significant proportion of money supply held as currency outside of the banking system. The money market is largely segmented—the formal sector is dominated by banks, with a large informal sector. Most of these countries depend on the export of few primary commodities, with all the volatility associated with such dependence. Supply constraints (limited productive capacity)—generated either by limited availability of capital or foreign exchange— is a more important constraint than aggregate demand. The financial markets are underdeveloped or very thin and dominated by the banking sector. Equity markets are largely in their infancy in most cases, thus limiting the scope for risk-sharing. An important point is that when firms rely mostly on self-finance for investment, and households cannot borrow easily for mortgage/housing and consumption, then changes in interest rates will have significantly lower effects on investment, consumption and aggregate demand than the theory predicts. Developing countries are believed to be susceptible to greater volatility because of their smaller size, less diversified structures and higher exposure to terms of trade and capital account shocks. These economies also face structural rigidities, implying that there could be large changes in relative prices in response to a shock, and in some cases put the burden of adjustment on quantities (income and output)—potentially lowering output and employment.

Owing to the foregoing features of the developing countries, the conduct of developmental monetary policy places considerable emphasis on the 'developmental' role of monetary policy, in terms of boosting the supply side of the economy, rather than on the stabilization function. On the choice of instrument of monetary policy, it was believed that the volume of credit was more important than the price of credit (interest rate). Given the pervasive market failures (or even missing markets and institutions) in such economies, it was believed that the appropriate conduct of monetary policy required government activist intervention to direct credit to the preferred sectors at a price (interest rate) that was 'appropriate' for stimulating supply response. In the period from the 1960s to the early 1980s, most governments in developing countries even owned most of the financial institutions, especially banks.

Agenor (2004: 116-7) has summarized the key elements of the instruments of monetary policy within the framework of a developmental monetary policy as follows:

- *Ceiling on nominal interest rates, which typically lead to negative real rates, with an adverse effect on financial savings and investment decisions. Low interest rates tend to increase the preference of individuals for current consumption as opposed to future consumption, thereby reducing savings and hence growth. Low deposit rates leads to disintermediation by encouraging patronage to informal financial institutions, and thus alter seriously the transmission process of monetary policy:*
- *Quantitative controls and selective credit allocation across production sectors, regions, or activities considered by the government to be a 'priority' with lending often occurring at preferential interest rates;*
- *High minimum reserve requirements on bank deposits, which may vary across financial instruments and financial institutions;*
- *Direct control by the state of part of the banking system, with loan decisions guided more by political factors than by standard efficiency considerations; and*
- *Forced allocation of assets or loans to the public sector by private commercial banks through the use of high statutory liquidity ratios which require banks to hold a certain proportion of their assets in the form of government debt.*

The above framework describes what has been referred to in the literature as *financial repression.* 'According to Agenor (p. 118), such a repression "creates severe inefficiencies, which tend to restrict the development of financial intermediation, increase the spread between deposit and lending rates,.and reduce saving and investment in the economy." In addition to the above, a common feature of development finance in most developing countries was the creation of specialized (development) banks, especially for sectors considered critical for the transformation to modernity, such as agriculture, commerce and industry, export-import, mortgage, etc.

The experience of the late 1970s and early 1980s with hyperinflation in Latin America, combined with a huge and unsustainable debt burden and a balance of payments crisis in most developing countries, characterized growing default in debt service payments, led a drastic review of the 'developmental model' and the foisting of standard IMF/World Bank driven stabilization and structural adjustment programmes (SAPs) in most highly indebted developing countries. Besides the aggressive curtailment of aggregate demand through restrictive fiscal and monetary policies, SAPs entailed detailed programmes to "unleash the market" by getting governments out of the way. The programmes included the broad policies commonly referred to as the Washington-Consensus, including the privatization of public enterprises, liberalization of the trade and the financial sector (including the foreign exchange market and a transition to the market-determined exchange rate,' the transition from direct instruments of monetary policy to indirect instruments, as in mature economies), and the elimination of quantitative controls and subsidies, etc.

Table 1: Broad Summary of the Washington-Consensus policies

Original Washington Consensus	*"Augmented" Washington Consensus (Additions to the original 10 items)*
1. Fiscal discipline	11. Corporate governance
2. Reorientation of public expenditures	12. Anticorruption
3. Tax Reform	13. Flexible labour markets
4. Interest rate liberalization	14. Adherence to WTO disciplines
5. Unified and competitive exchange rates	15. Adherence to international financial codes and standards
6. Trade liberalization	16. "Prudent" capital-account opening
7. Openness to direct foreign investment	17. Nonintermediate exchange rate regimes
8. Privatization	18. Independent central banks/inflation targeting
9. Deregulation	19. Social safety nets
10. Secure property rights	20. Targeted poverty reduction

Capital account liberalization was one of the central elements of SAPs, although the IMF has recently softened its stance on that aspect. Coincidentally, the period of the 1980s until now has witnessed an unprecedented integration of capital and financial markets around the world. This has also heightened the vulnerability of developing countries to external shocks emanating from the financial sector (recall the 1997-8 East Asian financial crisis and impacts on Latin America and other developing regions). The current global financial turmoil, originating from the US, is a case in point.

Incidentally, many developing countries have eliminated the speed bumps which had hitherto insulated them from much of this kind of crisis, and yet their structures and institutions remain underdeveloped, thereby amplifying rather than dampening the consequences of the shocks. Was the liberalization of the 1980s and the migration to market instruments and stabilization a mistake? In other words, should we return to the old school— developmental monetary policy with the controls and emphasis on the supply side, or is that phase over? Stiglitz *et al.*, (2006) believe that we should return to capital controls and monetary policy focussed on the supply side (equitable growth) rather than the current aggregate demand management and price stability. Can we realistically return to the old school in today's world of financial globalization?

Ill: Globalization and the Challenge of Monetary Policy

The world economy has changed in many fundamental ways since the birth of development economics, especially since liberalization cum-market fundamentalism had dominated economic practice in developing countries. The collapse of the former Soviet Union and the practical death of socialism as a model of economic management have fundamentally redefined the global rules of the game, with capitalism (market economy) as the only game in town. The sharp contrasts between the 'capitalist parts of China'Taiwan, Hong-Kong and Shanghai, compared to the socialist mainland, the chasm between East and West Germany, and between North and South Korea, the decay of the Soviet Union before the implementation of perestroika and glasnost— all were practical evidence that the market economy framework is the superior model. In industrial countries, the hitherto leftist parties quickly moved to the 'centre'; the US embraced the 'New Democrats,' led by Clinton, and Britain elected Tony Blair's 'New Labour' party. At the present time, the former socialist economies of Eastern Europe are struggling to join the European single currency block, with all the requirements for 'convergence' to 'best practices.' China has joined the World Trade Organization (WTO) and is fast 'reforming' to comply with the 'global best practices' of a market economy. In a sense, the first major feature of the global economy today i s the broad consensus that a market economy framework is the most superior model of economic management.

The second feature is globalization - the interconnectedness of national economies through technology, trade, capital and labour flows, as well as the increasing convergence of processes and rules all of which have significantly altered the way monetary policy is designed and implemented. Globalization is not new. Indeed, before the First World War, labour mobility (especially among Europeans). as well as the ratio of trade to GDP were very high.

The global economy has become more complex in recent times, with cross-border financial flows, and the increasing integration of financial systems. Global exports to GDP ratios have reached about 20 percent; almost all countries have eliminated exchange controls affecting imports of goods and services; capital account has been liberalized (to varying degrees) in most countries and hundreds of billions of dollars move across national boundaries on daily basis; technology is being transferred at unprecedented rates, and governments are increasingly bound by multilateral agreements.

Given the increasing interconnectedness of the global economy, the world has, for about 200 years, been in search of an appropriate global monetary arrangement to facilitate orderly payments in a reliable exchange system. The foremost, organized international system was the rule-based, gold standard which ended with the First World War. Since then, the history of the global monetary system has been synonymous with a search for a code of conduct that would optimally incorporate the benefits of a rule--based system, while also allowing national governments sufficient discretion to conduct their monetary policies. A gold-exchange system, envisaged in the 1920s at the Genoa conference, did not see the light of the day nor did the London conference of 1933 produce an acceptable result on the issue. The Bretton Woods Agreement of 1944 laid the institutional and legal framework for the conduct of international monetary affairs and gave birth to the U.S dollar-exchange standard, with the delicate balance between a rule-based system and the use of national discretion. With the abandonment of the dollar standard' by the United States in the early 1970s, the discretion-dominated regime as laid out in the IMF Articles of Agreement took centre stage. The prevailing global system today is one based upon a flexible exchange rate arrangement which, given the so-called trilemma problem, theoretically gives national governments the full discretion over their monetary policies (except for countries involved in regional monetary unions).

But to what extent do national authorities have full discretion over their monetary policies? One major feature of financial globalization is the (discretionary or forced) deregulation and liberalization of financial sectors and capital accounts in most countries, thereby integrating them into the global capital markets. Such globalization of financial markets and cross-border flows of assets opens up different kinds of dynamics in an open macroeconomic context, exposes the country to higher external shocks and risks and complicates the design and implementation of stabilization policies, as the following amply illustrate:

- With cross-border capital flows, there is the challenge of identifying appropriate national monetary targets as guides to monetary policy. Furthermore, with deregulation, the boundaries between banking and other financial activities have become blurred, and this complicates the difficulty in identifying a monetary variable which is stable enough to act as a nominal anchor. Deregulation generally affects the stability of the demand for money function, and hence makes reliance on targeting monetary aggregates for monetary policy largely useless. There is the fundamental issue of the stability and predictability of national and international monetary aggregates. With the increasing substitutability between the banking system liabilities and those of other financial intermediaries, the definition of what constitutes 'money' in a way to encompass the entire financial system becomes more challenging:
- The openness of financial boundaries also means that there is increasing substitutability between national and foreign currencies. Monetary policy in a context where residents easily substitute from local to foreign currencies can complicate the conduct of monetary policy (e.g., the dollarization of national economies);
- New financial innovations — derivathc transactions (e.g., forward contracts, swaps and options) that result in off-balance-sheet exposures, rather than changes in recorded balance sheet positions are now commonplace. These developments have greatly complicated the task of exercising prudential supervision over the major players in international capital markets (Isard, 2005:65);

Financial globalization leaves national authorities with very little margin for error or inconsistency in the conduct of monetary policy, as capital flows operate to effect adjustments and punish policies that are believed to be out of sync. Policies that otherwise could have been effective (whether expansionary or restrictive) in a relatively closed economy framework or without capital mobility, are no longer as effective as they once were. Such policies stimulate net capital inflows or outflows. This is worsened by the sometimes idiosyncratic, herd behaviour of market participants. These 'animal spirits' as Keynes put it, or Greenspan's 'irrational exuberance' by investors can cause heavy financial crisis as we have witnessed in recent years. Market expectations can sometimes be irrational, but they surely become self-fulfilling. If the market expects a bank to fail, it surely will irrespective of whether or not it is sound. AsGuitian(1994:35) puts it,

> *"The fundamental implication is that a powerful constraint has been placed on the scope for monetary policy implementation—that is, on the room for discretionary maneuvering*—as *well as on the operation of*

policy rules. This constraint is, of course, market forces, which subject monetary management to market discipline either under rules or under discretion "; and

Furthermore, the new global financial architecture, although in theory designed as a loose form of coordination, contains a web of integrated institutions and processes that impose constraints on national economic behaviour. The banking sector is being globalized to such an extent that the top 50 banks would soon dominate the global banking infrastructure; the Bretton Woods institutions— the World Bank and the IMF— have implemented relatively standardized reform programmes in the developing (especially highly indebted) countries while, under the leadership of the Bank for International Settlement in Basel, a code of principles and standards for financial system regulation and supervision is being spewed periodically as 'global best practices.' In the meantime, the emergence of thousands of unregulated financial institutions— private equity funds, hedge funds, sovereign wealth funds, etc., are complicating the global financial landscape. The written rules, and even more so the unwritten ones, are changing rapidly. There are several 'informal' but powerful global influences that continually put pressure on national authorities to conform to some benchmarks of market-conforming 'best practices.' For example, bilateral donors demand the IMF-endorsed reform programmes as a precondition for debt relief to developing countries (cross-conditionalities). Several 'international' credit risk rating agencies are increasingly relied upon by countries and financial markets to price sovereign risks and, hence,

determine access to international finance. There are anti-money laundering rules. Indeed, there is a template of best practices' that countries are judged upon, the closer the policy regime is to the template the more 'modern' and respectable it is, and the more likely it is to benefit from the globalizing finance.

Financial globalization, with increased cross-border spillover effects, makes the global financial system prone to crises and the highly vulnerable developing countries have little instruments to manage such crises. This presents several paradoxes. Vulnerability to macroeconomic shocks raises the need for developing countries to be adept at stabilization, and yet what emerges from this section of the lecture so far, is that financial globalization has fundamentally altered and constrained the landscape for the conduct of monetary policy/stabilization in individual countries. Contagion has become a key feature of crisis-prone financial globalization and yet there is no supranational agency for enforcing the coordination of national policies. In the absence of the leverage exercised by the Bretton Woods institutions, through their lending operations (or cross-conditionalities imposed through the bilaterals), their surveillance role is nothing but an 'advisory[1] one. Beggar-thy-neighbour policies by individual countries pervade the global system, with all the obvious dire consequences for everyone. This is precisely why the global economy is experiencing macro imbalances (with the U.S running huge deficits while China and other emerging markets are accumulating equally huge surpluses).

In the light of the foregoing, the conduct of monetary policy in developing countries can only become more, not less, complex. While the Washington-Consensus, based upon market fundamentalism and globalization paradigms, appears to be the mainstream framework for action, there are several counter-attacks. Stiglitz et al. (2006) and Serra and Stiglitz (2008) in particular have tried to amplify the heterodox framework as opposed to either the new Keynesian or the new classical perspectives.

In relation to stabilization policies, the authors *"reached a broad consensus that the Washington consensus has too narrow goals (focused on price stability), too few instruments (emphasizing monetary and fiscal policy), and an excessive focus on markets. The new framework focuses on real stability and long-term sustainable, equitable growth, and stresses the importance of separating intermediate goals (such as inflation) and final objectives (long-term, equitable growth) "* (see Stiglitz *et al*, 2006:ix).

This quote sounds familiar and, for me, is reminiscent of the underlying analytical framework for my Ph.D thesis—the structuralist-developmental framework for monetary policy. Although the book contains several contradictions in terms of what should constitute the goals as well as how to conduct a monetary/stabilization policy and, in particular, almost falls guilty of its own critique by prescribing a one-size- shoe-fits-all policy, it nevertheless provokes an important debate. It is a reminder that although the Washington orthodoxy dominates monetary policy in most countries and globalization has tightly circumscribed the room for wide discretion, the debate is far from over and, indeed, given the spate of crises in the national and global economies, many are even calling for a 'new' economics or a return to the old school. Which kind of economics will illuminate the complexities of the 21st century?

IV: Where Do We Go from Here? Matters Arising and an Agenda for Research

> *"There is probably no field of economics in which the writings of economists are so strongly influenced by both current fashions in opinion and current problems of economic policy as the fit Id of monetary economics "* (Johnson, 1969: 51).

So, what new thinking or writing should emerge out of the current financial crisis? I would like to seize the opportunity of this inaugural lecture to present my views.

(a) A Global Economy in search of a new Economic theory or new institutions

(i) The global economy has changed in fundamental ways, but it is doubtful that the tools for understanding and managing it have kept pace with the change. The current financial crisis presents an opportunity for deep reflection. In modern economic history, no crisis has been of such magnitude and elicited such massive global response as the current financial crisis. The Great Depression saw the birth of Keynesian economics. Other financial crises have been either contained to countries or regions of the world, but none has been as global in scope and devastating in effect as the current one. A similar crisis which has elicited much debate, in terms of 'reforming the global financial architecture' was the 1997/8 Asian financial crisis. However, the crisis was believed to be a 'developing country problem'. The reforms were timid and largely limited to what 'each country' should do to be more transparent and competitive. The current crisis, originating from the world's largest economy, and wiping out hundreds of billions and trillions of dollars of wealth of citizens of developing and rich countries and with no immediate solution in sight, poses a challenge to the science of economics. The major economies of the world have thrown at it everything the cookbook says should be in the menu, but the patient's condition seems to be getting worsen or, at best, not yet, in the recovery mode. The policy responses, so far, have been the classic Keynesian pump-priming at a global scale, although the neoclassical view is that governments should have allowed the markets to work themselves out and should not have 'wasted' over $3.3 trillion of taxpayers' money in a rescue programme that is doomed to failure. Meanwhile, much of the developing world watches helplessly as their economies, with 'sound fundamentals', have, all of a sudden been plunged into a crisis whose effects on growth and poverty can be long-lasting, due to the hysteresis effect of such shocks. The bad news is that the current international monetary system is prone to periodic crises, with each succeeding one potentially more devastating than the previous one.

As in previous crises, the debate rages as to what consists an appropriate response by national economies. What kind of macroeconomic and structural policy responses are appropriate? What exchange rate and interest rate policies, as well as fiscal adjustments are required? Following the East Asian currency and financial crisis, a menu of what constitutes 'reasonable domestic policies' (especially on the part of developing countries) can be summarized as follows: devise a sensible strategy for liberalizing domestic financial markets and international capital flows; strengthen institutions, information and the financial and corporate sectors; adopt sustainable exchange rate arrangements; maintain debt discipline, sound macroeconomic policies, and market confidence; open the economy to trade and FDI in a manner that results in growth-enhancing activities (Isard, 2005: 243-275). Needless to say that many emerging markets have diligently followed these prescriptions, but still suffered massive devastations of their financial markets due to the contagion effects of the current financial crisis.

Is there a case for a deeper re-examination of the theory and practice of international monetary and financial system? The overarching framework for analysing the policy options is the Fleming-Mundel framework of open economy macroeconomics, namely, the *impossibility theorem* or *trilemma problem.* This posits that a country cannot simultaneously maintain a fixed exchange rate and retain the autonomy to direct its monetary policy at domestic stabilization objectives in the presence of large stocks of internationally mobile financial capital (perfect capital mobility). Thus, in the presence of a currency crisis (which some developing countries, such as South Africa, are also having), resort to a fixed exchange rate regime is constraining. Only a globally coordinated exchange rate system can systematically solve the problem. But even that is a far cry now, for as Isard (2005:15) argues:

> *... changes in the global environment have essentially precluded two of the three theoretically possible ways of resolving the basic policy trilemma. In particular, an attempt to return to an international monetary regime in which the key-currency countries gave exchange rate stability priority over domestic economic stability (such as the international gold standard) or a system that essentially relied on controlling international capital flows (such as the Bretton Woods regime) would have little chance of succeeding today.*

Eichengreen (1999:2) more strongly concludes that ...*international financial liberalization and growing international capital flows arc largely inevitable and irreversible...... capital mobility is the wave of the future. This does not mean that capital-account liberalization must be embraced before banks have upgraded their risk-management practices, supervisors have strengthened their oversight of financial institutions, and governments have corrected their macroeconomic policies; to the contrary, there are compelling arguments against precipitous liberalization. But greater capital mobility is coming, like it or not.*

It is generally believed that, given the revolution in Information and Communications Technology (ICT), any controls of capital movements will easily be evaded by sophisticated market participants, especially in the more advanced financial markets. Given that all countries will ultimately have more matured markets, capital controls will inevitably become more difficult. Is the global economy, therefore, helpless? How should countries react to the dangers of an open capital account, especially with a banking system where risk management is inadequate, supervision and regulation are less than effective, and there is a culture of explicit guarantees? Should countries consider adopting the Chilean-type, capital-inflow taxes system as an effective solution for the vast majority of developing countries?

The second and perhaps more fundamental issue on the international monetary system agenda is the appropriate governance regime. The Bretton Woods system is dead, but the institutions created by the conference (that is International Monetary Fund, and the World Bank) still exist albeit largely ineffective in the face of the modern-day and, perhaps, even future financial crises. Without an effective governance system, the recurring financial crises can be long-lasting and may eventually ruin the global exchange and payments system. Most people agree on the need for institutional mechanisms to overcome the information asymmetries and collective action problems that prevent crises from being rapidly resolved, but the question pertains to the nature of such an institution.

Fundamentally, the debate is between the *ideal* and the *practicable.* The global system is probably operating as a *de facto* optimum currency area, but without the requisite institutions— a common currency, a central bank, a financial system regulator, etc. Eichengreen (1999: 3) agrees that —*in a world of global financial markets, there is an argument by analogy for an international lender of last resort, although there are questions as to whether the IMF or any other candidate for this role has either the capacity to carry it out or the ability to contain the moral hazard that results. And if there are good political reasons why there will be no international lender of last resort, then countries need to take measures to protect themselves from the consequences of its absence.* In essence, the keyword here is the political feasibility of crafting a new economic order. In 1999, Eichengreen described as 'pie-in-the-sky' the call for a world currency, a world central bank, a world financial regulator and a world bankruptcy court. So far, no one has seriously challenged the theory or logic of the proposal for global coordinating institutions in the face of global factor mobility. The only obstacle is that the world does not have the political will to undertake such a required change. In the absence of the required political feasibility, each country will essentially be left to its own devices of'protecting itself from others, with all the beggar-thy-neighbour policies that are guaranteed to perennially plunge the global system into crisis.

The current financial crisis was essentially caused by some laxity in the United States but the collateral damages have become global. Countries that have done everything prudently to keep their fundamentals sound are being imperilled and with no compensation mechanism from the US. The US and European Union have amassed over $3.3 trillion in less than two weeks to bail out their institutions and economies. What about the developing countries, especially the least developed ones that are suffering a serious currency and balance of payments crisis and are in the crunch international trade finance, due to the current crisis? Many aid-dependent, poor countries will see their own financial institutions collapse, and their commodity prices plummet in a certain fiscal crisis that will stifle growth and worsen poverty, but without the financial capacity to put together a 'bail-out package'. And many of such crises can be expected in the future.

Our view is that the current order cannot endure. The patchwork of reforms in existence is akin to papering over a cracked wall. There is a disjunctive between theory and practice. With a *de facto* global optimum currency area and rapid factor mobility in the face of weak coordination, the global monetary system is in search of a new economic theory and new institutions.

Some analysts argue that amid all the complexities and uncertainties that the existing international monetary system presents, the Bretton Woods institutions seem to evoke a more orderly and cohesive world, raising the question of whether the international community should now strive towards a "new" Bretton Woods financial arrangement. The devil is in the details: what should this 'new' Bretton Woods arrangement be all about?

Furthermore, in response to the current financial crisis, the world has witnessed an unprecedented coordination of monetary policy by major central banks (USA, Japan, China, European Union, Brazil, India, etc). This *ad-hoc* and loose coordination needs to be formalized into a more systematic framework. If the Bretton Woods conference of • 1944 could hammer out a new system, and the meeting of six countries at Chateau de Rambouillet in France in November 1975 (involving France, Germany, Italy, Japan, the United Kingdom, and the USA) could do the 'impossible' by reaching a compromise amendment of the IMF *Articles*, including Article IV, then the so-called political infeasibility of a new financial regime is a farce. Over and over again, the global system has risen up to fundamental challenges to craft a new financial regime. Serious research is required in thinking through the economics and institutional and implementation settings of the required regime to reshape the chaotic global financial system.

Another issue that calls to question the durability of the current financial system is the growing macro imbalances, especially as typified by the USA with huge twin deficits (fiscal and current account) and the surge of alternative economic centres and the likelihood of alternative reserve currencies. The US occupies an asymmetric position at the centre of the international monetary system, running balance of payments deficits, providing international reserves to other countries, and acting as the export market of last resort for the rest of the world. Other countries have kept their currencies pegged to, or floated against, the US dollar. Many are reluctant to revalue their currencies even in the face of chronic US BoP deficits and even where they enjoyed rapid productivity growth for fear of harming their export-led growth and suffering losses on their foreign reserves. Today, we have largely undervalued Asian currencies and Asian surpluses with an overvalued dollar and the US deficits (Eichengreen, (2007). In the current order, there is no mechanism to correct the imbalances except by talking about it, or advising the deficit countries to live within their means and the surplus countries to revalue their currencies. These have not happened. Imagine a world tomorrow with multiple reserve currencies other than the US dollar or the Euro. Imagine common currency schemes in the mould of the Eurozone— with a Chinese currency zone; a Yen Area around Japan; and Latin America around Brazil. For now, imagine that the five currencies become reserve currencies. With the growing economic power of the developing countries (now accounting for about 50 percent of world GDP), a financial crisis would, in such a scenario, easily become a currency crisis, with many countries migrating from one reserve currency to the other. How would the world economy under such a system adjust to promote orderly growth and prosperity?

ii) Asymmetries of Globalization and the Search for an Appropriate Analytical Framework

A fundamental disjuncture in the globalization process pertains to asymmetry, in terms of the movement of productive factors across boundaries. Barriers to trade, financial services (capital flows) and investment have been significantly reduced under the prevailing system. Yet, the factor which is most abundant in developing countries—labour—is not allowed to be mobile. A segment of the labour force, mainly the top one percent of the most skilled labour force around the world is relatively mobile. With capital and a highly skilled labour force freely moving across national borders to locations where they receive the highest reward, globalization produces two dynasties in the global economy— a dynasty of poverty and a dynasty of prosperity (or a vicious circle and a virtuous circle). Highly productive factors (capital and skilled labour) flow to the advanced world, leaving the developing world (especially the least developed countries) highly depleted. Many of the least developed countries experience under-investment and divestment (with negative net capital flows) as economic agents move their savings abroad. Paul Collier has estimated that the African private sector held about 40 percent of its non-land assets abroad. In terms of labour, many of these countries experience a net brain drain as much of their investment in training high-level human resources is being lost. It is, for example, estimated that there are more than 10,000 Nigerian medical doctors in the United States. With productive assets concentrated in the rich countries and the assets continuing to flow there from developing countries, the capacities (capital and high-level skills) required to transform the developing countries are continuously being depleted. thereby creating development traps or dynasties of poverty. As most analysts have observed, a growing feature of globalization is rising inequalities between the rich and the poor across, and within, countries.

Even when the returns on investment are not necessarily the highest in some rich countries, the design of the international financial architecture (with some currencies acting as 'reserve' currencies, such as the US dollar) almost automatically ensures that net resource flows to them would be positive. Today, the United States as the richest country in the world receives the greatest inflow of resources (with most countries holding their national foreign reserves in US instruments). In effect, the rest of the world is subsidizing America's profligate budget and consumption (e\ en as returns on US assets are some of the lowest). China still holds much of its US$ 1.5 trillion reserves as investment in the US as do the oil-rich Middle East countries, India, and Russia among others. About 80 percent of Nigeria's US$64 billion foreign reserves is invested in the United States.

The unskilled and mid-level skilled labour-force which account for more than 98 percent of the workforce of developing countries are not freely mobile. Trade and capital liberalization are promoted and national governments left to manage the rest of the population (which is confined) with depleting capacities. Rodrik (2007: 241) estimates that if the rich countries were to give temporary work permits of 3 to 5 years to skilled and unskilled workers from developing countries, amounting to just 3 percent of the rich countries' labour force, such a scheme would easily yield $200 billion in annual income to developing countries. This potential benefit is vastly higher than what the present WTO trade arrangement can yield for the same countries. One can only imagine the effect of freeing up to 10 percent of such labour force to become mobile!

Important research questions arise. First, can the globalization of finance and trade endure without the globalization of labour? Should the current system, with dominant reserve currencies for international exchange, endure with its inequities? Alternatively, how should a new system be designed that does not automatically confer advantages to certain currencies? Furthermore, if labour remains immobile, is there a case for a form of globalization tax to generate a fund to either compensate countries that are trapped into a dynasty of poverty or lift such societies up in a manner that ensures that every country attains a minimum threshold for productive factors to be attracted and retained?

(b) **Conduct of Domestic Monetary Policy in a World of Globalization and Uncertainty about the Underlying Economic Structure?**

(i) Do we need a different Economic theory for developing countries?

This is an old question, but with a long answer, and .resurrects the debate about 'development economics.' In a general sense, economics as a science has universal applicability. The neoclassical framework, firmly rooted in micro foundations, is still the dominant mode of economic analysis. "At the core of neoclassical economics lies the following methodological predisposition: social phenomena can best be understood by considering them to be an aggregation of purposeful behaviour by individuals— in their roles as consumer, producer, investor, politician, and so on— interacting with each other and acting under the constraints that their environment imposes" (Rodrik 2007:3). In my view, this coherent framework is the only sensible way of thinking through economic issues. Coherent macroeconomics must be firmly rooted in solid micro foundations. Economic agents in developing and industrial countries respond to incentives and sanctions, and no one has shown that the demand curve slopes upwards and the supply curve slopes downwards for normal goods in developing countries.

However, the developing countries can often be treated as 'special cases'— where market failures and imperfect or asymmetric information are more pervasive— thereby often requiring greater intervention by a 'developmental state' (whatever that means) not only to allocate resources, but also to orchestrate the development of markets and institutions.

At the outset of my lecture, I stated that I do not believe that we should devote time to developing a different economics for developing countries. Development is a spectrum and all economies are conceptually 'developing' in the sense that no country ever reaches the end of development. Thus, the extent of market failures and information asymmetries is a matter of degrees. For example, every country has a dose of the informal sector and institutional development remains as work-in-progress everywhere. Government intervenes everywhere, but the contexts differ from country to country. The earlier chasm between the Keynesians and the Monetarists has narrowed to a so-called 'Consensus'. Even Stiglitz *etal* (2006:62) agree that, "the laws of economics may be universal, but economies function in markedly different ways. Moreover, there are systematic differences between developed and developing countries, and large differences among developing countries." I believe that policymakers and analysts should spend time understanding these differences as well as the special cases, and design interventions to address the special cases (at least in the short run). In practice, I also believe that the market economy framework— private ownership of the means of production, property rights and the enforcement of contracts, stable money, competitive prices (where possible) and freer trade— is the best arrangement for organizing an economy. Howeverj I agree with Aslund and Dabrowsk (2008: 12) that the main "issues are limited to how large public redistribution should be, how much regulation of various markets is optimal, and how the difficult public functions can be organized."

The problem of economics is not so much the science itself, but its practice. Often, the problem lies in the different readings of the evidence and the overzealous attempts by some practitioners and advisers to insist on some textbook prescriptions, without taking a proper account of the contexts or environments that shape the behaviour of the economic agents. Institutions matter and differ, and no two economies are the same.

Even within a country, say, Nigeria, there are bound to be regional .differences. The policies that work in Lagos state may fail in Jigawa state and vice-versa.

Attempts by the so-called Heterodox view (a hybrid of neoclassical, Keynesian and development economics, and its application to developing countries) does not provide an internally consistent framework. The main strength of the Heterodox view is to continually draw attention to the fact that policy prescriptions should not be driven by dogma or ideology, but by a careful reading of the evidence as well as the peculiarities of society. While it has its own logic and triumphs as a critique of the neoclassical 'one-Size-fits-air market fundamentalist policies, it offers a cocktail of policies that cannot work in all places at all times. A statement of the main thrusts of the Heterodox view as the'formulation of a new and better system of policies—policies that offer more flexible approaches to development' is summarized in Serra and Stiglitz (2008). The new view is emerging under the Barcelona Development Agenda as a 'post-Washington Consensus Consensus' and, according to the authors (seep.12):

> *The new consensus is different from the Washington Consensus in important ways. It emphasises broader goals for macroeconomic policy (including long-term sustainable growth and equity), a wider range of economic policy instruments (including prudential regulations and other microeconomic tools — though the details of these tools is still being debated), and a balanced role for markets and government (as opposed to minimizing the role of the state).... But this framework is only a starting point. Many questions remain to be answered, and many issues are still being debated.*

Relying on carefully selected pieces of evidence, the Heterodox view ends up with the general endorsement of the role of the state (the govemment-has-a-role-to- play argument). Fundamentally, there is not much that is 'new' about this view, except to emphasize that there is not one cookbook of policies that always maximizes welfare in all societies under the market economy framework. As the authors also admit, once you go beyond this general proposition to prescribing 'an agenda' of policies, then the debate begins. Conceptually, no one seriously disputes that government has a role to play in economic management. The size of government has, indeed, grown rapidly under some neo-conservative governments. The question is to define when, what, how, and whether such roles always (in all circumstances and societies) lead to socially optimum outcomes. The view does not account for the different environments in which the state can act or even the capacity to do so. Empirically, for every case that the Heterodox view cites to ' prove' the success of micro interventions, one can cite two similar cases that have failed. Often, also, the view falls into the same temptation of prescribing a 'one-size-shoe-fits-all policy menu for developing countries. As we shall show later, such views are, at best, special cases and not generalizeable ones.

It is important also to note that a market economy is a spectrum, and different countries are at different points on the spectrum. France, with dominant state participation, as well as the welfare states of the Scandinavians, are market economies. China is experimenting with gradual liberalization and a state-led market economy. These are markedly different from the UK or the US. Hong-Kong is a province of China and is even a more classical market economy than the USA. The fundamental point is that while these economies are different, the basic economic laws operate everywhere.

Thus, when people ask whether developmental monetary policy is still relevant, or point to the recent massive bail-out programmes by governments as a signal that market economics has failed and, by implication, advocate a return to state controls or command planning, my reaction is: it depends. Clearly, the features of the developing countries that have warranted special and interventionist monetary policies directed at the supply side have not disappeared. The issue is not whether 'developmental monetary policy' is still relevant— but how and whether, in any specific case, it can be designed and operated in such a way that it does not lead to system underperformance and inefficiencies to the extent that society is worse off on the aggregate. A major and enduring research agenda will pertain to the appropriate extension, modification, or adaptation of the mainstream analytical framework to provide a unified theory for monetary policy in a country such as Nigeria. Such a theory must be dynamic enough to reflect the dynamic evolution of society because in all practical purposes, most developing countries can be described as experiencing constant regime shifts. Can there, therefore, be a static theory of such a society?

(II) What should be the goals and How should Monetary policy be conducted?

This question has dominated the debate in monetary policy. Whether monetary poficy shoufd focus primarily on *price stability or pursue other 'devefopmeataP* objectives to ensure 'equitable growth,' or a combination of both is an old debate. The need for 'stability' is specifically required in the IMF Article IV, which requires each member state to:

> *Collaborate with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates. In particular, each member shall: (i) endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth and reasonable price stability.... (ii) seek to promote stability by fostering orderly underlying economic and financial conditions....; (in)*

avoid manipulating exchange rates or the international monetary system in order to prevent effective balance a/payments adjustment or to gain an unfair competitive advantage over other members.

Here, the key foci of stabilization are: a 'stable system of exchange rate'; an 'orderly economic growth and reasonable price stability[1], and the 'stability... underlying economic and financial system'. For stabilization purposes, these are, indeed, nebulous, albeit conflicting, requirements. It is not exactly clear what is the operational meaning of these requirements. The need for stabilization, especially in developing countries, is not in doubt. As Stiglitz *et al* (2006: 6) note, "developing countries experience more economic volatility than developed countries (in part, because developing countries often have less diversified economies), so attention to stabilization is particularly relevant." However, the authors also argue that the focus should be on "real stability and long-term sustainable growth, and ... the importance of separating intermediate goals (such as inflation) and final objectives (long-term, equitable growth)". The authors thus complicate the requirements under Article IV by treating inflation as an 'intermediate' objective, rather than adopting the conventional wisdom of macroeconomists who see inflation as one of the key objectives of economic management. Under Article IV, the issue is that of multiple objectives which, given the Tinbergen rule (which requires that you must have at least as many instruments as there are objectives), you need some other instruments other than monetary policy to simultaneously achieve them. For policy, targeting exchange rate stability obviously requires domestic output/employment to be the variable to adjust to shocks. In the limit, having a fixed exchange rate eliminates the power for independent monetary policy.

Although most central bank charters/laws mandate price stability as the primary objective of monetary policy, in practice, most central banks pursue multiple objectives, including output growth/employment and financial system stability. Not having enough instruments to simultaneously pursue all the objectives, the emphasis on each objective depends on the weights assigned to each of them in the central bank's policy reaction function. Instrument choice, parameter setting, time horizon and variation over time are, therefore, guided by the weights. The fundamental issue that arises in the context of financial globalization is that, given the increasing volatility of key macro variables, the difficulty of measuring and targeting monetary aggregates, and the increasing importance of financial system stability, what new instruments of stabilization policy and institutional coordination mechanisms should be in place to simultaneously attain the objectives?

The second issue pertains to the role of inflation in economic development and the appropriate level of inflation that policymakers should target in specific circumstances and over what time horizon. The definition of'low' or 'high' inflation, and more so, the benefits of low inflation vis-a-vis the perceived costs of pursuing such a regime, is a subject of intense debate in many developing countries.

In theory, the optimal inflation rate should be greater than zero, but there is no guidance as to what it should be. In theory also, 'high' inflation is bad for growth and development, but the empirical definition of 'high' or 'low' is debatable. Consider the following two quotations from Mishkin (2007) and Stiglitz *et al* (2 006).

According to Mishkin (p.38):

> *In recent years a growing consensus has emerged that price stability— low and stable inflation rate— provides substantial benefits to the economy. Price stability prevents overinvestment in the financial sector, which in a high-inflation environment expands to profitably act as a middleman to help individuals and businesses escape some of the costs of inflation. Price stability lowers the uncertainty about relative prices and the future price level, making it easier for firms and individuals to make appropriate decisions, thereby increasing economic efficiency. Price stability also lowers the distortions from the interaction of the tax system and inflation. All of these benefits of price stability suggest that low and stable inflation can increase the level of resources productively employed in the economy, and might even help increase the rate of economic growth. While time-series studies of individual countries and cross-sectional comparisons of growth rates are not in total agreement, there is a consensus that inflation is detrimental to economic growth, particularly when inflation is at high levels. Therefore, both theory and evidence suggest that monetary policy should focus on promoting price stability.*

On the other hand, Stiglitz *et al* (2006:18-20) argue that:

> *There is a general agreement that hyperinflation has large economic costs, and that defeating it should be a top priority. Hyperinflation, and even high and uncertain inflation, creates huge uncertainty about changes in relative prices, which can be devastating for the information quality of prices and for the efficiency with which resources (including individuals' energies) are used. Behaviour gets distorted as firms and individuals work to spend money quickly, before it diminishes in value. In some countries, huge amounts have been spent on institutional arrangements to protect individuals from the effects of inflation. Under more moderate inflation levels (let's say 15 30percent), these costs will be much lower.... These cross-country regressions, although imperfect, suggest that inflation is not closely related to growth, so long as inflation is not too high— below a threshold of some 20 to 30 percent.*

The authors agree that in theory and practice, 'high' inflation is bad for growth. The impact of inflation on growth in cross-country regressions is mixed and sensitive to alternative specifications. Put differently, inflation is not a fundamental determinant of growth.

The fundamental issue here is what constitutes a 'high' or 'low' inflation rate. To underscore the potential subjectivity in choosing a benchmark, Stigtliz *et al* arbitrarily indicated two benchmarks as 'moderate' (15- 30%; and 20- 30%) and one wonders which range is the correct one. More seriously, the authors attempt to be prescriptive about what constitutes a range of optimal inflation rates for all countries and for all times. This is probably overstretching the argument. I believe the point Stiglitz *et al* wanted to make was that what constitutes 'high[1] or 'low' inflation is environment-specific, and what matters, really, is the nature of relative prices which determine resource allocation. For example, in an economy with 20 to 30 percent inflation range, what would be the deposit and lending interest rates in the banking system? How would you convince anyone to keep deposits for a longer time in a bank at rates much lower than the inflation rate, and how can the banking/financial system deepen and develop if such a regime is sustained for a long period? Will lending rates be pegged below the inflation rate also? Wouldn't this be the classic case of financial repression which, over time, would stunt the financial system, lower the overall credit availability for the real economy and, hence, hurt growth and increase poverty? Alternatively, if interest rates were to be positive in real terms, how many investments will be profitable at such interest rates?

Also, many empirical studies have found that real exchange rate (RER) misalignment, overvaluation, and volatility are unambiguously harmful to competitiveness and growth. What Stiglitz *et al* miss is the point that the effect of inflation on growth is more powerful through the real exchange rate effect, as well as the distortions in the financial system. Thus, the relative prices (inflation differentials between the country and its major trading partners or between the tradable and nontradable goods sectors of the economy) as well as the structure of the economy matter greatly. While some countries can, for a period of time, grow with the moderate inflation rates, depending on their economic structure, they cannot permanently ignore relative prices in today's globalization of finance. For sustainable long-term growth and poverty reduction, a deep and sound banking/financial system, with long-term loanable funds, is key; a competitive RER is imperative; and a stable nominal exchange rate is necessary. One is not sure how an inflation range of 20 to 30 percent can provide such an environment for all countries at all times.

In addition to the above, and in the absence of wage-price indexation, it is difficult to see how the vast majority of the poor, whose wages are fixed in nominal terms, can survive with annual inflation rates of 20 to 30 percent. Such an inflation regime can, indeed, plunge more people into poverty, depending on the initial levels and distribution of income.

Thus, researchers have their work cut out for them in light of the ongoing controversy, and given the complications of open economy macroeconomics and the globalization of finance. What constitutes an optimal inflation rate for a country, that is consistent with long-run sustainable growth given the underlying economic structure, sources of inflation, size and composition of its tradable goods sector, and extent of its integration with the global economy? Which definition of inflation should monetary authorities target (headline versus core inflation), especially in a context where food prices dominate the basket for the consumer price index and agricultural production is dominated by peasant agriculture and is largely rain-fed? What sacrifice-ratio (in terms of output loss due to deflationary policies below a certain threshold of inflation rate) is the society willing to tolerate? For specific countries, an empirical question remains the extent to which inflation is a demand-pull versus cost-push phenomenon, and hence the relative effectiveness of aggregate demand management in inflation control. When Milton Friedman asserted that inflation is everywhere and always a monetary phenomenon, was he also speaking about many developing countries?

The next major issue is how to conduct monetary policy. The new kid on the bloc on how to conduct monetary policy is the inflation-targeting framework, while short-term interest rate is the operating target. Because of the instability of the money demand function, many central banks are abandoning targeting monetary aggregates. However, in less developed financial systems (with a dominance of the banking sector and the near absence of consumer credit and mortgage finance) as well as a dominance of the informal sector with currency in circulation outside the banking system as the larger proportion of money supply, monetary policy of the 'traditional form' can be challenging. Where financing of most transactions— investment and consumption— does not depend on credit from the financial system, there is the fundamental issue of the appropriate transmission mechanism for policy and, hence, the choice of instrument. Furthermore, where the structure of the economy is such that inflation is largely a supply, rather than a demand, issue (e.g, food shortages due to drought, energy costs, etc) and the second round effects into wages and demand side are weak, monetary policy targeted at curtailing aggregate demand could actually plunge the economy into a stagflation. The narrower sectors of the economy that are in the formal sector might bear the brunt of adjustment since.

For the developing countries (especially the least developed ones), the questions are many and the research agenda long. Should monetary policy swing back to the old school of directed credit at controlled interest rates simply because the money, credit and capital markets still remain underdeveloped? Should monetary policy also target the supply side by attempting to alter the composition of output? In other words, is there a supply-side approach to price stability? How can such policies be designed and implemented without necessarily inundating the central bank with detailed micro-level interventions, with all the. inefficiencies and distortions that go with it? What is the effective transmission mechanism for monetary policy in such markets?

Furthermore, how should inflation-targeting be designed in countries with fiscal dominance? This is because, as Mishkin (2007: 15) argues, "an inflation target is not capable of establishing a strong nominal anchor if the government pursues irresponsible fiscal policy or inadequate prudential supervision of the financial system, which might then be prone to financial blow-ups." Given the unreliabil ity of monetary targeting, what then should be nominal anchor in such economies?

An important feature of the regulatory framework for banks under both Basle I and Basel II is that the standards are pro-cyclical. Banks are required to provision capital against bad loans or short-term expectations against future loan losses. Expectations of losses or actual losses are lower during economic booms and hence banks have an incentive to take excessive risks during booms. On the other hand, during economic downturns, loan losses, or expectations of losses are higher, requiring them to make higher provisions for those losses thereby reducing their capital and capacity to extend credit. This pro-cyclical prudential framework can cause a credit squeeze during the time credit is required the most in the economy. A major research question is how to design a prudential regulation that is counter-cyclical. Should developing countries adapt the Spanish system of forward-looking provisions (introduced in 1999) whereby provisions are made when loans are disbursed, based on the expected (or latent) losses which are assessed on the basis of a full business cycle?.

(Hi) Selection of a nominal anchor and a credible commitment of monetary policy?

How do you conduct monetary policy of the 'best practice' type in a developing country context where financial globalization precludes commitment to a single nominal anchor? These are small, open economies and cannot credibly commit to a fixed exchange rate regime, because of their vulnerability to speculative attacks. On the other hand, they cannot commit to a full-fledged inflation targeting regime because of their relatively weak fiscal position and a relatively underdeveloped financial system. Thus, they resort to a form of discretionary monetary policy, which varies in degrees of public commitment to announced inflation targets. According to Aninat (2003: vii),

> *This type of monetary policy framework, which does not fit into the standard classifications, deserves to be analyzed and understood. The challenge for the central bank facing these realities is how to conduct an effective monetary policy without a single anchor and with limited options for monetary targets and instruments. To what extent should the central bank be transparent in its objectives and operations?*

This is a major research agenda for monetary policy practitioners in developing countries, such as Nigeria.

(iv) How should monetary policy be conducted under uncertainty?

Macroeconomic management generally, and monetary policy in particular, is conducted in a highly uncertain environment. There are uncertainties about the underlying structure of the economy; uncertainty about the current state of the economy as official data (even if robust) at best represent incomplete snapshots of various aspects of the economy; uncertainty about the sources of variation in. the data; uncertainty about the underlying analytical model of the economy and its predictive power and uncertainty about the transmission mechanism, time lags, and quantitative impacts of particular policies. Indeed, that monetary policymakers try to stabilize, especially in the context of a globalizing finance, is in a state of flux.

To provide an internally coherent framework for thinking through the complex relationships, policymakers have used (as part of their toolkit) some quantitative models as useful approximations of the economy's dynamics. The truth is that while these models are useful in shedding light on some pathways in the forest of the economy, the structural models (with constant parameters and linearities) do not illuminate a large part of the continuously changing economy, often buffeted by idiosyncratic shocks.

On how to react under these circumstances, Alan Greenspan (2003) and Ben Bernanke (2007) offer interesting insights. According to Greenspan (2003:2-3),

> *Given our inevitably incomplete knowledge about key structural aspects of our ever-changing economy and the sometimes asymmetric costs or benefits of particular outcomes, a central bank seeking to maximize its probability of achieving its goals is driven, I believe, to a risk-management approach to policy. By this I mean that policymakers need to consider not only the most likely future path for the economy but also the distribution of possible outcomes about that path. They then need to reach a judgement about the probabilities, costs, and benefits of the various possible outcomes under alternative choices for policy.... Some critics have argued that such an approach to policy is too undisciplined---judgmental, seemingly discretionary, and difficult to explain. The Federal Reserve should, some conclude, attempt to he more formal in its operations by tying its actions solely to the prescriptions of a formal policy rule. That any approach along these lines would lead to an improvement in economic performance, however, is highly doubtful. Our problem is not the complexity of our models but the far greater complexity of a world economy whose underlying linkages appear to be in a continual state of flux.*

On his part, Bernanke (2007: 4) largely agrees with Greenspan but highlights the importance of predictability and transparency. According to him:

> *Uncertainty—about the state of the economy, the economy's structure, and the inferences that the public will draw from policy actions or economic developments—is a pervasive feature of monetary policy making....The fact that the public is uncertain and must learn about the economy and policy provides a reason for the central bank to strive for predictability and transparency, avoid overreacting to current economic information, and recognise the challenges of making real-time assessments of the sustainable level of real economic activity and employment. Most fundamentally, our discussions of the pervasive uncertainty that we face as policymakers is a powerful reminder of the need for humility about our ability to forecast and manage the future course of the economy.*

If the central bankers in more developed market economies face this kind of challenge, the challenge faced by developing countries is even more humongous. In addition to the list of uncertainties provided above, central bankers particularly face the uncertainty related to the continually changing institutions and severe vulnerabilities to external shocks. Some aid-dependent economies face uncertainties about aid disbursement by donors as well as fiscal dominance. Official data about the economy are limited and sometimes unreliable. In the face of uncertainty about data, literally everyone becomes a mobile databank, and objective measurements of performance are often impaired. Early warning signals are blurred, and expectations formation is in a state of flux. Besides adaptations of innovations in the global financial system, the financial institutions (banks, insurance, stock exchanges, and other financial institutions) are themselves being 'created' or 'reformed' continuously. In other words, the parameters of the system are highly variable; credible formal models of the economies hardly exist.

In such a context, the policymakers' set if skills as well as the institutional arrangements that shield them from undue political pressures are critical. Generally, in many developing countries, there is ignorance about what central banks or monetary policy can do. In these environments, it is often challenging to remain narrowly focused on a single objective. More than in the industrial countries, active coordination between the monetary and fiscal authorities is critical to effectiveness. Statistical agencies require important attention and funding, too.

In the contexts of uncertainties, central bankers become policy entrepreneurs: they become focused on measurable objectives and eclectic or pragmatic in their choice and design of instruments. None of the mainstream theoretical models completely describes reality in developing countries. But a central banker in a developing country should strive to be deeper in analytical rigour than his counterpart in more developed countries because, given the structural and institutional distortions and pervasive market failures that he faces, he has to typically deploy all available models to understand his environment, and sometimes experiment with the unorthodox to achieve his goals. Typically, the central banker in a developing country has many balls in the air, and continually has to balance between macro stability (price stability) and output growth in a world where the binding constraints are supply constraints, and more so a combination of both the institutional development of the financial system and its stability.

With the financial system still evolving, its stability is a continuous concern, and thus not a case of an occasional diversion to 'rescue' or 'stabilize' an otherwise well functioning financial system. Conducting monetary policy under such circumstances of multiple objectives requires more than a casual acquaintance with basic models of the economy.

For instance, in Nigeria, we have managed to keep nominal exchange rate 'stable' in the face of huge capital inflows and, with a low inflation rate, we have also avoided a real exchange rate (RER) overvaluation, as we had experienced in the 1970s and 1980s. We have managed to avoid populism in the conduct of monetary and exchange rate policies. If we had allowed the nominal rates to appreciate as it should, we probably would have been below N100 to the US dollar as at today, with consequences for RER appreciation and production of tradeables/exports, rising imports against the nascent industrial sector with consequences for employment, lower fiscal revenues in the face of fixed and rising recurrent expenditure, de-cumulation of foreign reserves, etc. Of course, consumers and importers would have applauded us at the time. This *v*> as what happened in the 1970s, and when the 'oil boom' burst in the early 1980s, the currency had to be depreciated with a vengeance. The point, however, is that this success has required out-of-the-box actions, including the supply side approach to monetary policy. Unfortunately, there is no textbook on monetary policy that provides a complete menu of what policymakers do in practice.

(v) How Should Policymakers respond to a Financial Crisis?

This is a big question, and there are no answers in the textbook. I guess a general answer to this question is that a response would depend on the source of the crisis, its magnitude, and the instruments available to the policymakers. Many would prefer that policymakers have early warning signals of a crisis and therefore prevent it from happening rather than attempting a rescue operation, with all the collateral damages and their lingering hysteresis effects.

Every major crisis seems to have caught policymakers unawares, and they usually threw in everything in their cookbook. During the Great Depression, the classical economists believed the economy would automatically return to equilibrium (self-correct), until Keynes advised otherwise. The debate still goes on as to whether the IMF policies in response to the East Asian crisis aggravated or mitigated the crisis. In the current global crisis, the response has been a patchwork of learning by doing'. At first, it was considered an American problem. When the Northern Rock bank crisis broke out in the UK, the authorities hesitated in intervening on the excuse of the well known classic argument of a potential moral hazard. That is, it was believed that bailing out the bank or giving a blanket guarantee of all deposits would reward irresponsible behaviour and give incentives for future mismanagement of banks in the expectation of a bail out by government. Finally, the UK government bowed to public pressure and intervened. In the case of the US, it literally took ages for the mortgage giants— Freddie Mac and Fannie Mae— to be considered for government intervention. The government of the US watched Lehman Brothers and other banks declaring huge losses and wiping out their capital due to the mortgage crisis and hoped that the market would self-correct. For almost 9 months, policymakers and practitioners around the world bemoaned the 'global credit crunch', but somehow hoped that the market would self-correct.

When finally the roof began to come down in the US and the contagion spread quickly to many other countries, the major central banks coordinated an unprecedented liquidity injection as well as cutting of interest rates to ease the 'liquidity and credit crunch'. Financial system stability became the primary goal of central banks and price stability took a temporary backstage in the central banks' lexicon. The governments of major industrial countries threw the moral hazard argument out of the window and began announcing massive bailouts for their banks (recapitalization of banks with public funds which is akin to a nationalisation programme). Blanket guarantees were being given for deposits in the commercial banks. In what sounded like an extreme act of desperation, the US Federal Reserve set out to lend directly to businesses by repurchasing their commercial papers. As if from the lessons from the Great Depression and the East Asian crisis, major economies were determined to move in a counter-cyclical fashion with regards to the stance of fiscal policy by embarking on fiscal expansion. The French President was reported to have called for a European Fund to buy cheap stocks from the depressed capital markets. Suddenly, global policymakers have all become Keynesians, albeit sometimes to ridiculous extents that would have shocked even Lord Keynes himself. The world has literally thrown everything at this crisis, and policymakers seemed to be surprised at every stage that what they believed was 'the solution' was greeted with even greater pessimism by the markets.

Indeed, before and even in spite of, the massive interventions by the governments, the damage has been and continues to be done to this day. Economic agents around the world feel less wealthy by trillions of dollars 'loss'' in the capital markets, credit has frozen, aggregate demand is down and businesses are closing with soaring unemployment and poverty around the world. Primary commodity (especially oil) prices are tumbling. Emerging markets that experienced significant resource outflows due to the crisis have also witnessed a currency crisis of sort as their exchange rates depreciated heavily, and many countries have run out of their reserves and hence having severe balance of payments difficulties. In many countries, local banks are experiencing difficulty with trade financing.

One hypothesis is that these effects could have been prevented if the governments acted in a 'timely' and in a 'proactive' manner. Some suggest that if the UK government had prevented Northern Rock from hitting the rock, and the US government had pre-emptively saved Freddie Mac and Fannie Mae as well as Lehman Brothers, the panic and loss of confidence that engulfed the world economy could have been prevented. That is the problem with hindsight: it is always too late. Perhaps, if the governments had intervened before it became obvious that there was a full-blown crisis, it would have been difficult to muster the political support for the bailout as the case of the US demonstrated. Indeed, here in Nigeria, the banking sector revolution in 2004- 2005 was greeted with a massive resistance by politicians and vested interests ostensibly because it was difficult for them to see the imminent (but at the time still 'probable') crisis or to fully anticipate the counterfactual of what would have happened if the reforms were not carried out. Thus, even if the policymakers saw the crisis coming, how would they have built the political support for the kind of action required when the people could not as yet 'feel' the need for action?

One lesson of the current crisis is that policymakers can indeed deepen the crisis by the way they react to it. My hypothesis is that much of the global crisis was aggravated by the panicky reactions of policymakers. Politics and grandstanding often takes over from sober and sure-footed response. Politicians under pressure to be seen to be 'sensitive to the suffering masses' sometimes behave like a panicky doctor in an emergency room who literally decides to administer all the drugs available to a convulsing patient in the hope that, with the cocktail, there is a chance that one of the medicines could get to the ailment. Unfortunately, the market watches every body language of the policymakers, and the last thing it wants to observe is any sign of panic. The ad-hoc, piecemeal manner of the responses gave the signal to the markets that the policymakers had lost control. At this point, the herd instinct took over, and the market became overtly irrational. One would expect that investors would enter the market to buy stocks when the prices are depressed but that is precisely when they exit, and re-enter when prices start rising.

A major policy question emerging from the crisis is how policymakers should respond when credit markets freeze and there is a general confidence trap in the sense that there is a generalized belief that things will get worse such that even when the fundamentals are sound, the markets still behave in a way that might seem irrational. The US and European central banks have tried to liquefy the markets and yet, the credit freeze is yet to 'thaw'. Currently, most central banks are employing moral suasion to get the banks back on the lending window. Even interbank activities dried up in many countries. As economic activities slow down and banks view lending to each other and to the private sector as risky, the banks behave in a pro-cyclical manner: they extend more credit during economic booms and severely curtail credit precisely when it is required most by the economy. What should policymakers do? Stiglitz, et al (2006: 83) believe that there are varieties of ways that governments and monetary authorities can nudge banks to lend in such circumstances:

> *They can, for instance tax excess reserves, or impose taxes on capital gains from currency changes to discourage banks from, in effect, engaging in foreign exchange speculation. They can take more explicit regulatory actions, such as not allowing banks to hold net foreign exchange assets (either loans or bonds). They can go so far as to actively discourage banks from purchasing government bonds (e.g. by limiting the amount of excess reserves that can be held in the form of government bonds, or by increasing the risk rating of such bonds).*

I believe that it is time to begin important debate on this issue. What if the banks still f'refuse to lend after all these taxes? Are there other kinds of direct interventions in the credit market the government could quickly implement in the face of such a credit freeze by the private banks? What about massive injection of funds into the Development banks and having quick disbursing credit desks in such banks? Does the government have the capacity to implement such a programme without running the risk of simply throwing away tax payers' money in a credit jamboree, most of which will never be repaid? What about the kind of intervention being undertaken by the US Federal Reserve in the commercial paper market? The point here is that we must learn from the current crisis in terms of a counter-cyclical response mechanism.

The other issue in terms of appropriate response framework is the nature of communication. How much and what kind of information should policymakers divulge to the public in times of crisis? Who should be communicating with the public and in what frequency? Important insights on this question will help illuminate the resolution of future crisis.

Finally, an important empirical issue is the time lags of market responses to rescue packages once an economy has gone into a confidence crisis. In recent months, governments have thrown everything at the problem, and each new initiative elicited even further negative responses by the market. The new mantra by policymakers is to ask the public to be patient, and many people are asking, 'for ho\\ long?' Researchers may need to study previous and current crisis to estimate the time lags in policy initiatives and response patterns by the private agents. How long does it take the economy to return to the 'normal' path once it is hit by sustained idiosyncratic shocks? This will inform policymakers' response to future similar crises.

(vi) Do policymakers in the least developed countries have the policy space to conduct policy?

In a world of globalizing finance, no policymaker anywhere has complete control of its policy parameters because of the cross-border interactions. However, some countries are much worse-off than others. In spite of the talk about policy ownership among poor countries, it is doubtful that a heavily indebted, aid-dependent country, especially with an IMF programme, can have the policy space to pursue the 'best policies' that it deems fit (even if there were to be such). Donor cross-conditionality that requires the endorsement of the IMF before debt relief or rescheduling can be granted implies that such economies either have to explicitly adopt programmes and policies designed by the IMF for them or through a self-censorship, implicitly adopt policies that they know are 'approvable' by the Fund. For this group of countries, changes in their policy orientation depend on changes in the orientation of the Fund and the World Bank. In any case, the dominance of the Washington Consensus was essentially because the Bretton Woods institutions had the power to leverage them in developing countries. A research agenda is whether changes in the governance of these institutions can change the policy agenda? Alternatively, is a new Bretton Woods institution likely to alter this narrow policy space?

(vii) Should we create financial market institutions or allow them to evolve?

The effectiveness of a market economy and the transmission mechanism for monetary policy depends on the strength of the institutions. How do we build such institutions? This is not a trivial question; it is at the heart of the debate as to when and how a state should intervene. If care is not taken, you create a vicious circle that is difficult to break from: because there are no efficient markets, the state might be tempted to substitute for the market, and with its coercive power might again prevent the market from developing. The fundamental question is whether you build institutions to fit where you are, or where you need to be. Researchers need to illuminate this question. This reminds me of the central issue in Patrick (1966), namely, whether finance is demand-following or supply-leading. Put simply, he asked whether a financial system evolves in response to demand to its services, or a financial system creates the demand for its services. Practically, it comes down to an organic evolution versus a revolutionary or an engineered approach.

With many developing countries lagging so far behind the industrialized ones, the question is the appropriate way to leapfrog the process of development. A shock therapy of the type experienced under the structural adjustment programme (SAP), whereby economies embraced privatization and liberalization of markets, irrespective of the extent of their readiness was roundly criticised by many analysts then, but I am not sure if any of such countries would rather wish to return to pre-structural adjustment programme days of state-administered prices and a control of the so-called commanding heights of their economies. Similarly, in Nigeria, the banking sector revolution was underpinned by our conviction that to leapfrog the process of development, we needed to supply a new system ahead of demand for it. Researchers need to seriously consider what lessons can be learnt from alternative institution- building strategies and what they mean for the theory and practice of the economics science. Should we engineer the environment to fit theory or should theory be modified or developed to fit the environment? In the case of the latter, is the environment static to warrant a static theory of how it functions?

(viii)Does ownership of financial institutions matter?

The impact of government and foreign ownership of domestic financial institutions on the performance of such institutions is a subject of debate. As part of the rapid responses to the current crisis, governments have mobilized trillions of dollars to recapitalize their banks and bail out the financial system. Implicitly, governments are back as major shareholders of banks (with the promise to divest once the institutions are stabilized). In the light of the recent experiences, is there a basis to suggest that government ownership makes a difference in terms of the transmission of contagion following a financial crisis?

Furthermore, there is a debate as to whether foreign ownership of financial institutions is beneficial or harmful. While some evidence point to the fostering of efficiency, competition and skills transfer as benefits of foreign banks, others note that foreign owned banks have little country risk appetites, crowd-out domestic banks in the market for funds while concentrating credit to the so-called international businesses. Furthermore, it is argued that foreign banks are often a ke> channel for transmission of contagion from one country to another. In practice, many countries consider their financial system as part of the national security infrastructure. The jury is still out on this matter. Empirical analysis is required to illuminate the role of ownership and financial system performance, especially in the context of globalizing finance.

ix) How can regionalism by way of regional *common currency* ***help in the world of globalizing finance?***

In a world of many small open economies with tremendous transaction costs, countries are increasingly resorting to regional integration as a means of risk pooling and sharing and exploiting economies of scale. The financial systems of developing countries are fragmented and small. As Hanson, et al (2003: 4-5) indicate, only about six developing countries (China, India, Brazil, Thailand and Mexico) featured in the top 25 banking systems in the world in 2000, with aggregate deposit share of about 6%. Of about 108 developing countries studied, 80 had total bank deposits of less than $10 billion, of which 42 had less than $1 billion. The tiny sizes of their financial systems reflect the size of their GDP. In 2000, it was found that the Bank-Fund Staff Federal Credit Union (a bank for the staff of the IMF and the World Bank) had a balance sheet size larger than those of banks in 60 poor countries put together. Only very few countries have organized stock exchanges. Size is seen as a binding constraint for many of these countries, and only regionalism and globalization offer them a chance of sustained growth. In Asia, Latin America, and Africa, regionalism is top of the agenda albeit with varying speeds and successes.

A new development in the wave of regionalism is the push to fast-track the process by moving straight on to a common currency irrespective of whether or not the conditions for an optimum currency area are fulfilled. Paradoxically, proponents of this view ignore the imperative of political integration for the success of such a forced currency area. A key research question is whether a monetary union in a context where the structural and macroeconomic convergence criteria are not met on a sustained basis and shocks are symmetric can endure. A central bank should be goal-dependent, and instrument-independent. Which political authority should set the targets for inflation and other goals for the regional central bank if economic structures and macro fundamentals are widely different? How should regulation and supervision of financial institutions be organized in such a regional framework without a centralized governance structure? More broadly, given the crisis-prone nature of the globalizing finance, would individual countries be better-off with a more flexible regime to adjust to shocks or be tied to the basic rules implicit in the operations of a regional monetary authority?

V: Conclusion

Mr. Vice-Chancellor, distinguished ladies and gentlemen, permit me to now conclude.The global market economy is at a threshold of history, and there are more questions than answers. The neo-leftist scholars and politicians are sounding triumphant, almost in an 'I-told-you-so' mood. Newspaper and magazine headlines are wondering whether this is the end of capitalism and globalization. Even The Economist magazine of October 24. 2008 screamed the headline "Capitalism at Bay"! But beyond the outbursts, the world has very little choice. Zedillo (2008:19) underscores the present dilemma when he notes that:

> *"Capitalism s hour of greatest triumph is its hour of crisis. The fall of the Berlin Wall ended more than a century of political*

competition between capitalism and communism. Capitalism virtually stands alone as the only feasible way to rationally organize a modern economy. At this moment in history, no responsible nation has a choice. As a result, with varying degrees of enthusiasm, third world and former Soviet nations have balanced their budgets, cut subsidies, welcomed foreign investment, and dropped their tariff barriers. Unfortunately, however, their efforts have been repaid with bitter disappointment. From Russia to Venezuela, the past half-decade has been a time of economic suffering, tumbling incomes, anxiety, and resentment"

The French president, Mr. Sarkozy, was one of the first set of leaders to vent their tirades against what he called 'financial capitalism[1], but in the same speech, he grudgingly still accepted that: "Capitalism is the system that has enabled the extraordinary development of western civilization.... Anti-capitalism offers no solution to the current crisis" *(The Economist*, October 4-10,2008:46).

Several analysts confuse the extreme forms of market fundamentalism as being cotaminous with capitalism or the defining form of a market economy. What is wrong is not the system of capitalism or market economy or even the globalization of finance, but some tendencies towards *laissez-faire* in their operations. There is no one model of a market economy.

For sure, capitalism as a system in its purest form, with the Smithian *invisible hand* as the sole mechanism for allocation of resources leaves mankind in the Hobbesian state of nature (with everyman to himself and God for us all) and is so inherently full of contradictions and crisis-prone that the Marxian expectation of a proletarian revolution becomes inevitable. Luckily, at every stage that the contradictions became perilous, there has not been a dearth of intellectual and political response to rescue and preserve the system. The Great Depression saw the birth of Keynesian economics which provided the basis for active state intervention especially to implement counter-cyclical policies. President F.D Roosevelt of the United States designed the 'New Deal' for America which, together with the welfare states in most of Europe (minimum wage, unemployment compensation, public health and housing, minimum free education, affirmative actions, etc) helped to give capitalism a 'human face' and hence continuing endurance.

The current global crisis has once again raised the urgency for new thinking. That one country could cause a crisis of this magnitude and many countries with sound fundamentals also plunged into a crisis because of the contagion effect, and then the rich ones bail themselves out because they have the resources to do so while the least developed countries suffer the long-lasting effects ofthe crisis, is a market-cum-system failure of global proportions. Aside from the cost of direct government interventions around the world, the other indirect costs of the current crisis could run into several trillions of dollars in income loss and tens of millions of people plunged into poverty for a generation, especially in developing countries. The global economic system cannot survive many more of this kind of crisis. The current crisis offers a chance to create the beginning of an inclusive and responsive globalized capitalism.

Unfortunately, the economics science is once again, like during the Great Depression, caught unprepared. The analytical tools for understanding and managing the current system are somewhat inadequate. The national and global governance infrastructure for resolving or even preventing future crisis is at best obsolete. The pace of financial and economic globalization appears to have outstripped the pace of the theory and institutions that underlie it. No patchwork will do: a new economic thinking and a New Deal by way of fundamental institutional and governance architecture are urgently needed. Following the end of the Second World War and collapse of the old order of global financial and monetary system, the Bretton Woods conference of 1944 was convened and it gave birth to the International Monetary Fund and the World Bank. In today's world, it seems the two institutions are for the times we no longer live in. It is perhaps time for the second Bretton Woods conference!

At the domestic policy level, we have shown that financial globalization has complicated and severely constrained the latitude for monetary policy. None of the existing theoretical frameworks provides a complete guide for domestic policy actions. While the laws of the economics science have universal application, analysts and practitioners in every country need a deeper understanding of how the features and operations of their economy as a 'special case' modify or extend the general economic theory, taking into account the dynamics of the evolution of society. No two economies are the same, and every economy is, in a sense developing, to the extent that no economy ever reaches the end of development. We have argued that the attempt by the so-called new Heterodox view ('post-Washington-Consensus-Consensus') to craft a unified, static economic theory for the largely disparate group of developing countries is at best tenuous. On the other hand, the orthodox Washington-Consensus is not the Book of Revelation: it needs rigorous adaptation or modification in specific circumstances.

Mr. Vice-Chancellor, distinguished ladies and gentlemen, the point of this lecture has been to draw attention to the crisis of appropriate analytical and governance framework for the global economic and financial order in the 21 st century. We have tried to provoke debate and research by raising many questions. A crisis of the current nature is neither an inherent feature of a market economy nor is it inevitable. It is the result of the failure of the system design and operations. A new world is not only possible, but inevitable if humanity sets its mind to make it happen. The University of Nigeria was set up in 1960 to 'Restore the Dignity of Man'. If the ideas and questions raised in this lecture provoke sufficient outside-of-the-box thinking and research that possibly contribute to a new order, then the University of Nigeria must have contributed its own quota to the building of a new world in which the dignity of man will be restored on a sustainable basis.

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