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FINANCIAL STABILITY: SOME ISSUES

(Y.V. Reddy)

Dear Governor Subbarao, Esteemed Mr. Jaime Caruana, Respected Governors of Central Banks of SAARC region, distinguished central bankers and friends,

I am grateful to my friend and distinguished successor Governor Subbarao and RBI, for giving me this opportunity to be with this august gathering. The subject for the Symposium is very timely, and is of great significance for the central banks.

I want to congratulate the scholars in RBI for outstanding concept papers. They are to the point, comprehensive, updated and, above all, very informative as well as analytical. I am delighted to endorse the papers. All the country papers are of very high standards, and provide deep insights into the relevant issues. I eagerly look forward to the discussions.

In my brief presentation today, I will address some inter-related issues on financial stability. First, what has been the thinking and what have been the actions of RBI in regard to financial stability in recent years? Experience, both good and bad, can provide insights into this issue.

Second, is the global financial crisis behind us or ahead of us? Put differently, are we likely to be out of serious threats to financial stability in the near future, though no one can rule out a financial crisis for ever?

Third, what are the broader issues in regard to financial stability that ought to be addressed now?

Evolution of Policy on Financial Stability in India

India recorded impressive growth in 1980's, though the growth rate has been gradually accelerating since Independence, while simultaneously reducing volatility in output. The higher growth in 1980's was accompanied by a build-up of macro-economic imbalances, especially in regard to fiscal and external position as also, arguably health of financial sector. The balance of payments crisis of 1991 was essentially a liquidity crisis caused by the impact on external trade due to collapse of USSR and Gulf crisis, almost simultaneously. However, the way-out of liquidity crisis which was executed in an exemplary manner despite political uncertainties, warranted attention to a process of reversing the trend in macro-economic imbalances in the economy brought about by the strategy for growth in 80s. The process of reform since 1991 thus addressed, simultaneously, external, fiscal, financial, and real economy.

It must be recognised that throughout 1980's and beginning of 1990's, despite the crisis in balance of payments front, there was virtually no issue of financial stability, due to the public-ownership of banks, financial repression, and closed economy. Incidentally, one lesson from this crisis was that a closed economy, by itself provides no insurance against all instability. Thus, the thrust of reforms in financial sector was not in the context of responding to a crisis or vulnerability in financial sector, but aimed at improving its efficiency. Its aims were to release the rigour of financial repression, improve regulation, promote competition, and increase openness of the economy. All measures taken in this regard, emphasisd gradualism, and a non-disruptive approach. As Reports of Committees on reform of external sector and financial sector indicate, the thrust of reform was on macroeconomic stability, especially in regard to external sector, and improvement in efficiency, while emphasizing prudential regulation in regard to financial sector.

Attention to financial stability was first hinted in August 1997, in a speech [please see Appendix for extracts from speeches between August 1997 and 2008], in response to overvalued exchange rate of rupee and unhedged foreign currency exposures of some corporates.

About this time, the link between fiscal, banking and external sector was highlighted in the report of Tarapore Committee on liberalization of capital account. The pace of reforms in fiscal arena and improvements in regulation of banks was accelerated with a view to promoting overall efficiency, while active intervention in forex markets, both direct and indirect, became the norm in order to avoid excess volatility in financial markets.

The stress on financial stability as one of the objectives of monetary policy was articulated, perhaps for the first time, after Asian crisis and later due to crises in many other emerging market economies. The provocation was the possibility of impact of external developments on Indian economy in general, and in foreign exchange markets, in particular, with consequent impact on banking sector.

In 2001, the developments in equity markets affecting the health of a modern private sector bank as well as cooperative banks, brought to light the importance of liquidity in money markets, banks' dependence on money markets, and banks' exposures to capital markets as well as other intermediaries in capital markets. Consequently, financial stability gained attention of all regulators in financial sector, under the leadership of RBI, and regulatory prescriptions included limits to bank's exposures to money markets and equity markets.

At a personal level, there was exposure to the operations of IMF in Turkey, Argentina and Brazil during 2002-03 which showed clearly that IMF's level of comfort in regard to financial sector and macro-management in EMEs was not a dependable measure of signs of macro or financial stability. The limits to the support available from global financial architecture were all too evident, and hence a higher weight for avoiding serious instability, it was felt, was warranted.

Since 2004-05, there were signs of excess global liquidity being transmitted to India. In India, the "lazy-banking" was moving towards "crazy banking" with pick-up in credit and money supply. Pre-emptive actions on monetary policy-front at this stage were justified partly due to reasons of financial stability. Further, the increase in oil prices was not totally ignored by RBI as a mere supply shock. There was also a reference to early signs of overheating, indicating a preference for countercyclical monetary policy.

The activities of financial conglomerates were expanding in India warranting formal mechanisms for identification and coordination among regulators. The rapidly expanding activities of non-bank finance companies and off balance sheet exposures of banks domestically became a cause for concern in 2005-06. However, process of gradual liberalization and deregulation continued but in a carefully calibrated fashion.

The preoccupation of overall policy at this stage was global economic imbalances and risks arising out of very lax monetary policies, including rise in asset prices. In 2005-06, it was clear that global economy was in a state of "stable disequilibrium" with dissonance between perceptions of markets and policy. The importance of analysis of balance sheets of households, corporates, banks, government and central banks to monitor threats to financial stability was recognized at the sign of early symptoms of excess leverage in global financial markets.

During 2005-06 and in particular during 2006-07, there were signs of exuberance in real estate and consumer credit, in addition to boom in equity markets in India. At the same time, there were simultaneous pressures on exchange rate, interest rates and liquidity due to massive capital flows, despite efforts by RBI to contain it through management of capital account. Hence, regulations in regard to banks, non-bank finance companies, money markets, derivatives, etc were tightened and supervisory review of select overstretched banks and non-banks undertaken. The annual policy of 2006 was a turning point when the quality of credit gained attention.

During the year 2006-07, it was clear that there were excessively leveraged operations in global markets along with issues of setting of trades, and ignorance on where risks lie, etc. There were fears about uncertainties in trades in credit derivatives, structured products and their settlement.

Thus, in the years leading to the global financial crisis, the focus of measures to counter threats to financial stability were no longer confined to global factors, but included domestically induced factors. Provisioning for standard assets and risk weights increased sensitive sectors. The “excesses” of domestic financial sector in a way reflecting the excesses of global factors, warranted several monetary tightening, regulatory, and supervisory measures which were resented by market participants. They were supported by preference of political economy to growth and short term gains.

Since the beginning of 2007-08, the anticipation of threats to financial stability, due to both domestic and external factors was unambiguous. Further, determination to counter threats to financial stability through what had been described as “unconventional measures” was demonstrated in speeches and in monetary policy statements. In addition, contingency plans in the event of sudden and significant reversal of capital flows were prepared and hinted at in first week of January 2008, indicating a set of detailed precautionary measures.

What were the challenges faced by policy-making in the process of promoting growth, containing inflation and taking precautionary measures against instability?

It is difficult to consider macro-stability and financial stability as distinct and different. Often, weaknesses in macro situation may warrant greater stress on stability in financial sector, and vice-versa. The sources of instability cannot be easily predicted, but continuous vigilance helps the process of identification.

A major challenge in administering the regulatory restrictions on 'exuberance' and 'excesses' in financial markets was to make a distinction between 'growth enhancing' credit and finance, and 'speculation enhancing' ones. The distinction required discrimination based on end-use and products, virtually amounting to selective credit-controls; and often judgments were required on instruments and magnitudes of interventions. In brief, operationally, pursuit of financial stability could not be divorced from promoting of development, both for short-term and over medium-term.

Yet another challenge was the calibration of pace and extent of reform in financial sector on the basis of evolving global uncertainties and domestic vulnerabilities such as slow progress in fiscal consolidation and in removing structural rigidities in real economy. When it was felt that domestic vulnerabilities coincide with global uncertainties, precautionary measures and recalibrating pace of reform financial sector were resorted to more vigorously.

It may be observed that most of the actions taken were on the basis of close observation of evolving developments in macro economy, multiple indicators of such developments and also practices of market participants. Anything out of the ordinary was not necessarily a good innovation or a positive development but needed to be continuously evaluated in terms of impact on efficiency and stability, and in that, judgements were inevitable.

It is worth noting that the design of instruments, whether Market Stabilisation scheme or provisioning risk weights had to explicitly provide their use to counter threat to stability from both excesses and deficiencies. It was considered wise to keep all the tools of intervention on the table and insist on option to use them always and at any time. Keeping options by itself does not curb efficiency of markets, but its exercise had to be based on continuous vigilance.

A wide range of tools to a central bank to intervene in the functioning of the financial markets, institutions, and instruments seems to have made the task of ensuring growth with stability.

Financial Instability: behind or still with us?

There was indeed a threat of depression when serious instability in financial sector in 2008 occurred. This event was followed by recession in most countries leading to the current stage of uneven or multi-speed recovery.

There are debates about the firmness or fragility of current phase of recovery. There are also some academics and a few analysts who hold that there could be a recurrence of a financial crisis, not necessarily as part of such episodes that seem to recur periodically but simply as a consequence of the manner in which the global financial crisis was managed so far and its proximate causes addressed. When an important market participant adds his voice to such sentiments, there is merit in analyzing the prospects of another crisis, as an extension or a fall out of the recent crisis in global finance.

A report in Economic Times last week, partly sourced from Bloomberg reads as follows:

> Mark Mobius, executive chairman of Templeton Asset Management's emerging markets group, said another financial crisis is inevitable because the causes of the previous one haven't been resolved.

> “There is definitely going to be another financial crisis around the corner because we haven’t solved any of the things that caused the previous crisis,” Mobius said at the Foreign Correspondents’ Club of Japan in Tokyo in response to a question about price swings.

It is useful to briefly review whether the causes have been addressed, assuming that the main causes relate to macro-economic imbalances; regulation of financial sector and global financial architecture.

Macro-economic imbalances

There has been considerable discussion on macro-economic imbalances this in policy circles, and G20 has arrived at an agreement on indicators of macro-economic imbalances. These include public debt, fiscal deficits, private savings and debt, and external imbalances composed of several factors including fiscal, monetary and other related policies. Both structural and statistical approaches are proposed to be adopted. The G20 has also identified countries or economies which have spillover effects on global economy. It is useful to speculate how some of the major countries stand with reference to these criteria.

In U.S.A., structurally, there are disturbing signs of fiscal deficit but current policy debate is on desirability of permitting fiscal deficit to spur growth. There is also a view that any effort to contain fiscal deficit would warrant further monetary easing over and above QE2 with spillover concerns. It is not clear as to how the stated policy of strong dollar would be consistent with its stand on current account deficit / surplus. The outlook for U.S.A. at this stage is still mixed. Contrary to the position of U.S. on fiscal stimulus, U.K. has opted for fiscal austerity. Euro zone, as a whole, does not contribute to economic imbalance in relation to the rest of the world in terms of current account deficits. However, the surpluses of Germany and deficits of the southern European countries warrant greater economic integration within the zone over the medium-term but there is still lack of clarity about managing the fiscal and debt sustainability issues of several countries. If the route of debt restructuring of some countries, in some form or other is resorted to, the spillover effects on global financing markets are likely to be severe. Japan has huge public debt and it can legitimately claim that its holders and currency are such that it has little spillover effect on the rest of the World. China has committed to shift in policy towards increased domestic consumption, but the role of exchange rate in the process of correction of imbalance is still contentious. In any case, such a shift cannot occur in the very short-term. India has a large public debt and fiscal deficit, but it will be difficult to establish that it has contributed or is likely to contribute to global economic imbalances on this account. Current account deficit is on all accounts reasonable. Briefly stated, there is no evidence of agreement on corrective policy actions and hence there could be an undesirable sense of unease on way forward in systemically important countries.

No doubt, there are positive of these initiatives. First, spillover effects of national policy have been recognized. Second, the principle of unlevel playing field for conduct of surveillance and implicitly imperatives for corrective actions at national level has been accepted. Third, whether the peers are willing to honour peer pressure or not, is not yet clear, but the domestic opinions or forces that support responsible policies consistent with interests of global economy, do get strengthened through such multilateral exercises.

There are several question marks on the thinking and prospects for unwinding of imbalances. First, prima facie, as is evident from earlier narrative, indicators provide partial truths, and solutions are not self evident. Second, the IMF framework, including indicators, is based on economic theories and models that were proved inadequate so far. The recent seminar on macro-economic policies by IMF recognizes the limitations of current models, but the search for alternate model is still in progress. Some of the areas where empirical evidence seems to contradict IMF framework is, openness of capital account and role of volatile flows; role of domestic savings in financing public debt; possible benefits of financial repression in promoting growth or managing public debt; structural shifts in tolerable inflation; and possible benefits of public sector in financial sector since financial crisis seems to be ownership. Third, the dominant role of global financial markets, especially large financial conglomerates as also that of credit rating agencies with their infirmities continues. Fourth, the most fundamental issue of international monetary system, and in particular reserve currency, remains unresolved. There is, as yet, no market discipline and no rules of issue, on the issuer of dominant global reserve currency.

There are some scholars who refer to several fundamental causes of global economic imbalances, and these have been in some form or other recognized as relevant in policy debates. These relate to growing inequality and its impact on savings / investment balances, excessive financialisation with incentives to multiply financial transaction for the benefit of participants with no social value added, and lack of distinction between massive gross financial flows and net flows, which impart volatility. These have not been addressed but one should recognize that their link to the causes of the crisis, are not fully established.

Financial Sector Regulation

There have been several positive developments in regard to regulation of financial sector. These include reforms in bank capital and liquidity standards, special dispensation for systemically important financial institutions, attempt to regulate shadow banking and possibly differentiating traditional banks from others; and reform in derivatives markets. Efforts have been made to reform regulatory structures, particularly in U.S.A., U.K. and Europe, which were centres of crisis.

However, several concerns remain, and in some cases, new issues have arisen. First, the new capital standards are sought to be introduced with a large time gap, and in some cases till 2019. The risks to global economy will persist in the meantime. Second, there are incipient tendencies to dilute the rigour of the standards in the operational detail of standards. Third, while 'too big to fail' is a concern, larger financial conglomerates have become even larger. Further, by recognising them as too large to fail, they have little incentive for strict compliance with regulatory discipline. Fourth, the race to the bottom in financial regulation, especially between U.S.A. and U.K. has resurfaced. Many large financial institutions are successfully threatening the policy-makers and regulators that they would move out of the jurisdictions unless the ongoing proposals for strict regulation are diluted. They are also threatening that the economic recovery will be stalled due to cumulative burden being imposed on them by new regulatory prescriptions. Fifth, the magnitude and complexity of derivatives do not seem to have abated. For example, exemptions for forex derivatives from being traded on exchanges, is being accorded in some jurisdictions. Sixth, it is not clear whether restrictions on the pay and other incentives to assume risk on the part of senior managers are really effective, if one were to assess the current level of payment of bonuses, etc. despite mixed signals on employment and output. Legislations for severe limitations on such payments have been facing resistance. Seventh, proposals for taxes that would hamper or penalize financial sector for causing a burden on tax payer have also been stalled. Finally, major contributors to global crisis have been the financial intermediaries that were most active in cross border activities and there is little that is in the nature of restraining them or specially focused regulation on them.

Global Financial Architecture

The global financial architecture was found to be somewhat inadequate to prevent the global financial crisis. Immediate response to manage the crisis and improve the situation was in terms of revitalizing two institutions, which were created in the context of the Asian crisis. These are G20 and the Financial Stability Board. It is hoped that these institutions in the revitalized form (the G20 and FSF in previous Avatar were not very successful in their mission relating to financial stability) would be in a position to meet the requirements of the global financial issues. The G20 has been reasonably successful in ensuring global coordination for avoiding collapse in financial markets and depression. Agreement in regard to exit from measures relating to stimulus was more difficult. It has began efforts to moderate macro-economic imbalances. The issues of appropriate representation and its close relationship with IMF as its operating arm have been matters of considerable discomfort. At this stage, therefore, its effectiveness and its future relationships with the IMF, World Bank and United Nations, which have greater multi-lateral legitimacy are still open. Financial Stability Board continues to be an important technical arm. It has greater representation of developing countries now. While it could issue the guidelines, the actual regulation will have to be effected by the national authorities.

Simultaneously, efforts are being made to reform multi-lateral institutions such as World Bank and IMF in three directions, viz., reducing the governance deficit, correcting ideological deficit, and improving the resource base. In addition, the available instruments for providing liquidity have been expanded on a more assured basis. It is not very clear whether these initiatives are adequate while admittedly they are in the right direction.

Monetary system has been an area of considerable concern and recognized as such in G20. There has been some attention and extensive recommendations on the subject by Stiglitz Commission, and the Report of the Palais-Royal Initiative group. Fundamental differences still persist on basic issues such as what is monetary system and what is liquidity at a global level. There is some consensus on the need to expand use of SDR globally.

Disorderly debt-restructuring has been a fact of life in regard to many countries. Stiglitz Commission has given extensive recommendations for orderly debt-restructuring. The issue is gaining attention in the context of the difficulties faced by countries in southern Europe in discharging their debt obligations in a manner that is satisfactory to the global financial markets.

To sum up, several improvements have taken place to address the issues of financial stability in the global economy, but there is some legitimate doubt about their adequacy in fully resolving the crisis that was triggered in 2008, and in avoiding recurrence of a similar crisis in the very near future.

Broader Issues:

(a) The current approach by global initiatives to ensure financial stability is based on the belief in the efficiency of globally agreed standards of economic policy and of regulation of financial sector. There is no guarantee that such globally acceptable standards would be optimal. For example, if we had such an approach ten years ago, the global economy would be modeled on Anglo-Saxon framework and there would not be different systems (China or India?) to lead a recovery. In brief, the advantages of diversity on policies of countries could contribute to stability in global economy and finance. Are recent initiatives undermining the value of diversity, in policies and systems, in ensuring financial stability?

(b) A nuanced view of coordination and conflict of interest which discriminates between public and private sector may be worth exploring. To avoid conflicts of interest and ensure efficiency as well as accountability, arrangements like independent monetary authority were prescribed in the past. The lack of coordination in public policies in financial sector was one of the consequences. The private sector was allowed to expand to several areas in the interest of economies of scope and scale hoping that conflict of interest can be taken care by creation of firewalls. Obliviously they did not work. Clearly, incentives in public and private sector differ and hence good or bad consequences in terms of coordination and conflict of interest are different. Has there been adequate appreciation of this experience in designing institutions and policies so that there is more coordination in public sector and less scope for conflict of interest in private sector in financial markets?

(c) There is ample evidence of a comprehensive capture of the regulatory apparatus of financial sector and political economy (perhaps academic too, as illustrated in the movie "Inside Job"). Is there a sense of comfort that they are being addressed now?

(d) The design of regulation of financial structure now is oriented to ensure stability, the assumption being that the role of state should be strengthened since experience has shown markets are not smoothly self correcting. However, the assumption that market will efficiently allocate resources and bring about desirable developmental outcomes seems to persist, though empirical evidence of recent years in developing world does not support it. The idea that intervention by state is justified for ensuring stability but not necessarily for promoting growth suffers from contradictions. In any case, development or efficiency and stability are admittedly two sides of the same coin, both for public sector (state) and private sector (markets).

(e) The framework of countercyclical policies advocated, particularly in standards of regulation, should ideally capture both cyclical and structural developments in the economy. Further, a disaggregated, and perhaps a somewhat sectional view of such components may be realistic, particularly for developing countries. Do the globally agreed guidelines provide for this?

(f) Finally, are there prospects that the thinking on appropriate policies that has been advocated and being practiced by advanced economies will change dramatically after the consequences of the current crisis unfold? For example, the idea that IMF is a lender of last resort only for developing economies is no longer valid. That IMF would be averse to regional arrangements as it was in the case of Chang Mai initiative in Asia is no longer the norm, with its partnership in European Union. Ben Bernanke conceded that excess capital flows to USA was also responsible for crisis in financial sector. Some eminent economists anticipate recourse to financial repression by advanced economies that have to service large public debt. Some others anticipate greater tolerance to higher inflation as a means of reducing burden of taxation as a means of servicing high public debt. Some eminent scholars suggest that the function of managing public debt should revert to central banks. In brief, will there be, sooner than we anticipate, new thinking and new practices as global norms in the field of policies relating to financial sector? If so, what are the implications for developing countries?

To conclude, while there may or may not be new thinking and new practices in central banking also in the long run, to me the short-run appears full of uncertainties in economic prospects and volatilities in financial markets.

Perhaps, central bankers of South Asia have to, as Oliver Cromwell did, believe in God (or G20 or IMF or World Bank, as you wish), but keep their powder dry.

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