Y V Reddy: Financial stability - Indian experience

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, Zurich University, Zurich, Switzerland, 27June 2004.

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I am thankful to the BIS for inviting me to share some thoughts on financial stability issues in the Panel of four Governors. It is an honour to address the galaxy of central bankers assembled here in connection with the annual meetings of the BIS. My observations are based on the Indian experience and would focus on rebalancing of efficiency and stability in the context of financial sector reforms in India.

In India, we have been moving from a government-dominated financial system to a market oriented one. In the past, the Government domination was, in a sense, imparting too much stability through rigidity and too little efficiency. In this context, enhancing efficiency while at the same time, avoiding instability in the system, has been the challenge for the regulators in India.

The concept of financial stability needs to be understood contextually also. For us in India, it means: (a) ensuring uninterrupted financial transactions; (b) maintenance of a level of confidence in the financial system amongst all the participants and stakeholders; and (c) absence of excess volatility that unduly and adversely affects real economic activity. Such financial stability has to be particularly ensured when the financial system is undergoing structural changes to promote efficiency. The structural changes relate to ownership, regulation and competition, both, domestic as well as external competition. Integration of financial markets is another dimension of the process: the integration of domestic financial markets is one aspect while global financial integration is another though a related aspect.

While global financial integration does have beneficial impact, the volatility in capital flows can cause instability, specially if a country has not reached the “threshold”, as very ably explained by Professor Kenneth Rogoff of Harvard University. Many emerging market economies do not seem to have adequate self-correcting market mechanisms in respect of such cross-border capital flows. In such cases, the capital flows at critical times reflect more of changes in the risk appetite of the international investors than a country’s fundamentals. Hence, special defences need to be put in place for ensuring financial stability in the case of countries like India that are faced with the prospect of volatile capital flows. The issues relating to cross-border supervision of financial intermediaries in the context of greater capital flows are just emerging and these need to be addressed.

In the context of ongoing reforms in the financial sector in India, the regulatory regime has also undergone certain fundamental changes. New regulators like those for the insurance sector and capital markets have been created. The focus of regulation has also changed. The issues of regulatory co-ordination do arise often. However, the changes in the regulatory regime, meant for greater efficiency, may, on occasion, contain the risk of being a source of instability.

This leads us to the role of regulators in developing market-oriented financial system while maintaining the independence and credibility of the regulator. In India, this process involved development of technological and institutional infrastructure by the Reserve Bank of India, changing the interface with the market participants through consultations and communication - which was critical for mutual benefit. The relationship with the Government - as the majority owner of the financial entities, as the ultimate risk-bearer in the system and as the sovereign in law making - is also changing in the new environment.

In a way, in the development of a market-oriented financial system, the Reserve Bank of India is, what I may call, a “nurturing” regulator as well as an “independent” regulator. In the relationship with the government, the Reserve Bank of India emphasises: (a) autonomy in operations; (b) harmony with the government policies, specially due to the continuing dense linkage between fiscal and financial sectors in India; and (c) co-ordination with the government in bringing about structural changes, particularly in respect of public ownership and legislative framework.

In this background, would a single regulator, other than the central bank help? Will separating banking supervision from the central bank be of help? I would like to quote here Professor Charles Goodhart (2000): “I doubt whether the pressures to establish a unified supervisory agency are quite as strong in most developing countries.” He adds: “For such reasons, I do not believe that the case for separation, which has become stronger in the developed countries, should be transposed also to the developing countries." I hope the views of Professor Goodhart in this regard, since he made the above comments at a memorial lecture in RBI, have not changed over the past three-four years. As a pragmatic measure, we have banking supervision under an independent Board for Financial Supervision (but within the RBI) while some sort of co-ordination is sought to be achieved through a High Level Co-ordination Committee on Financial and Capital Markets, consisting of financial regulators and the Ministry of Finance, but presided over by the Governor, RBI.

In conclusion, I would like to highlight three aspects of financial stability. First, we keep in mind our vulnerability to real sector shocks which would affect financial stability. The major sources of such shocks in India are very sharp rise in oil prices and extraordinary monsoon failures. Second, we have political system stability in India though there have been coalition governments at the federal level. We are aware that most of the currency crises in developing countries occurred around the times of political elections, particularly in countries with the presidential form of government. Our experience in India is that political cycles have had a relatively muted impact on financial stability. In any case, socio-political preference for greater financial stability needs to be appreciated and the weight accorded to financial stability in India appears to be higher than in some other countries. Third, developing countries differ so much in size, nature and structure of the economy, level of development and socio-political conditions that my observations here are more of random thoughts to be mulled over rather than structured issues in respect of financial stability in developing countries.

Thank you.