Subir Gokarn: Financial stability

Welcome remarks by Dr Subir Gokarn, Deputy Governor of the Reserve Bank of India, at the SAARCFINANCE Governors' Symposium, Kumarakom, Kerala, 10 June 2011.

*   *   *

Governor Dr. Subbarao, distinguished Governors, Dr. Reddy, Mr. Caruana, Mr. Ninan, Mrs. Thorat, Deputy Governors, our guests from SAARC central banks and friends. On behalf of the Reserve Bank of India, I extend a warm welcome to you all to the SAARCFINANCE Governor's Symposium 2011 on the theme of Financial Stability. Just to refresh your memories, the last Governors Symposium organized by us under Dr. Reddy was in 2005 at Mumbai which dealt with the theme of "Communications Policy of Central Banks".

Financial Stability is indeed a most appropriate theme for this meeting. The recent financial crisis also termed as "the great recession" clearly brought financial stability to the centrestage of public policymaking. The global financial crisis that swept the economic and financial systems across the world during the last three years has shaken our beliefs in some near truths.

One, it has questioned the premise that price stability and financial stability are complementary. Rather financial stability can be jeopardized even in an environment of price stability and macroeconomic stability.

Two, it is now impossible to imagine of sustained growth without financial stability. Any disruption in the financial system anywhere in the world has the potential of affecting the real economy not only in that country but also elsewhere. We have seen that domestic and global financial stability are not mutually exclusive domains. With increasing financial globalization, there was a growing realisation about this, but the extent of transmission of disruptions during the recent financial turmoil through different channels, namely finance, trade and confidence channel was unthinkable before the crisis. It also came as an unpleasant revelation that even those countries which had not contributed to the immediate causes of the crisis had to bear the brunt of an unwholesome international financial climate. Hence, domestic financial stability cannot become a realistic goal in the absence of a conducive global environment.

Three, the two-speed recovery, accompanied by a widening of global economic imbalances is at the centre of a new configuration of risks. These are visible on a variety of fronts – sovereign debt risks, financial fragility, the search for yield, and related stresses in emerging-market economies and foreign exchange markets. Hence, in the current environment, financial stability has to be viewed not only in terms of lessons from the crisis, but also in terms of the future risks and challenges.

There is, thus, a clear recognition of the importance of financial stability policy. However, several questions have arisen, to which we still do not have answers. We may attempt to address at least a few of them. I would like to highlight the prominent ones.

First, as increasing number of central banks start including financial stability in their policy mandates along with price stability, we need to consider whether financial stability has to shift from being an implicit variable to an explicit variable of the economic policy. As a recent IMF survey (December 2010) pointed out, although financial stability is a formal mandate in most of the countries, the definition of financial stability is informal in almost 80 per cent of the respondents. If financial stability is to be made an explicit objective for central banks, the search for an operational definition and measurment of financial stability come to the forefront.

In this context, it is important to recognise that financial stability, difficult enough to define, is even more difficult to measure. Though theoretically one would prefer composite indicators of financial stability (threshold or benchmark values) over individual variables as indicators of financial system stability, in practical terms, assessments of financial stability revolve around monitoring several indicators conveying about the health of the institutions, markets and infrastructure. Considering that the construction of a single aggregate measure of financial stability is a difficult task given the complex nature of financial systems, it would be useful to have an appropriate template and methodology for the key indicators.

As an initial step, the IMF in December 2010 conducted a stock-taking survey of international experiences with financial stability and the evolving macroprudential policy framework covering 63 countries and European Central Bank which also include all the G20 countries and those subject to mandatory Financial Sector Assessment Program (FSAP).

Second, the appropriate role of the central banks in maintaining financial stability and their relationship with other relevant bodies has intensified as new arrangements are being put in place in several countries and being planned in others. Under the reformed financial stability framework, the allocation of responsibilities with respect to financial stability and instruments to manage stability are still being rigorously debated worldwide.

Third, the financial stability mandate for central banks may have implications for monetary policy as well. Although a predominant focus on price stability may have yielded low and stable inflation in terms of prices of goods and services, the lowering of returns in the commodity/service producing sectors could have diverted the search for yields to the financial sector. This has called into question the pre-crisis consensus on the best practice in monetary policy framework as the one characterised by “a single target” (i.e., price stability) and “a single instrument” (i.e., short-term policy interest rate). The financial stability mandate and governance arrangements for central banks must be compatible with their monetary policy responsibilities.

Fourth, as it is being widely recognised that analysis through a micro-prudential lens makes policymakers prone to ignoring the implications for systemic stability of financial market imperfections, including those stemming from information frictions, moral hazard implicit in too-big-to-fail firms outside regulatory purview and the negative externalities when firms too-interconnected-to-fail failed. While supplementing micro-prudential approach by a macro-prudential approach, the role of the central bank regard need to be designed taking into account the synergies and conflicts in the assignment of functions to various policy agencies.

Fifth, the financial regulatory reforms spearheaded at the international level by the G20 aims at increasing the resilience of the global financial system. In the process, the international best practice trajectory itself has shifted upwards with the introduction of Basel III and other reforms. Nevertheless, when it comes to country specific implementation in an internationally consistent manner, there are several practical challenges. Any substantial adjustments in the financial sector in tandem with the international prescriptions in some SAARC economies might have implications for steady state growth in individual economies as well trade and financial cooperation within the region. Further, many countries are still recovering from the crisis and any new impositions may disrupt this. Moreover, unlike developed economies, the SAARC economies also need to factor in the inter-linkages between growth and socio-economic outcomes. Even a small decline in growth may have magnitudinally wider repercussions as growth is critically linked with inter-regional equity and poverty. Hence the region needs to calibrate the time and magnitude of adjusting to the global new normal.

Sixth, for SAARC countries, because they are at different stages of development there may be some other features of the financial sector which pose challenges to the stability of the system which are not there in advanced economies. For example, it is important to ensure that the crucial goals of financial literacy and financial inclusion are not ignored in the overdrive for financial stability. In India, the newly created FSDC has included financial literacy and inclusion in its mandate apart from those of macroprudential and financial stability responsibilities.

Against this backdrop, let me now introduce to you the format of the Conference. We will cover the conference theme in two special talks and two technical sessions. We begin with the key note address by our Governor Dr.Subbarao followed by presentation by two guest speakers, Mr. Jaime Caruana, General Manager, Bank for International Settlements and Dr. Y.V.Reddy, Former Governor, Reserve Bank of India. Then we move on to the presentation of papers and discussions where participants from fellow SAARC member countries shall share their country experience on financial stability. It will be interesting to notice the differences/similarities in mandates, powers and accountability arrangements that are needed in different circumstances. For convenience, we have spread the discussions over two technical sessions, with a lunch break in between. This will be followed up with a panel discussion of Governors, dealing with future challenges. The panel discussion will be moderated by Mr. T.N. Ninan, President of Editors' Guild of India.

Friends and Colleagues, I trust we will have fruitful discussions during the day that will set the outline of our reaction function to the global developments in financial stability. With these words, I once again welcome you all to the Conference. I wish you all a pleasant stay in Kumarakom. This is one of the premier tourist locations in the country, combining aesthetic appeal with the pursuit of ecological sustainability, which is an apt metaphor for the issues and concerns that we will talk about during the rest of the day.