Y V Reddy: Financial sector reform and financial stability

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, at the 8th Global Conference of Actuaries, Mumbai, 10 March 2006.

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Mr. President and distinguished friends,

It is a privilege and an honour to be invited for this 8th Global Conference of Actuaries. Dr. R. Kannan has been a respected colleague of mine for several years in the Reserve Bank and I am thankful to him for persuading me to join you. Also, Mr. C.S. Rao, Chairman, IRDA and Mr. D. Swarup, PFRDA have been my friends and colleagues in the Government of Andhra Pradesh and Government of India. Financial sector reform and financial stability are subjects of high priority to central bankers, are of relevance to all financial regulators and may be of interest to a gathering of finance professionals like actuaries. My address will, therefore, focus on the features of the financial sector reforms in India; the initiatives taken to assure financial stability; the links between reforms and stability in the financial sector and conclude with some observations in the current context.

Financial sector reform

The financial sector reforms in India, like almost all other countries, have some common and a few unique features. They were undertaken early in the reform cycle, in early 1990s. They were designed by eminent professionals in the country, and implemented pragmatically. This is evident from the dynamic mix between public and private ownership and transition of Development Financial Institutions as well as Unit Trust of India into their new incarnations. Fiscal support has not been burdensome and legacy problems such as non-performing loans have been absorbed by banks and not transferred to fisc. New regulatory bodies such as those for securities markets, insurance and pension funds have been legislated or are underway. While prudential regulation of banks has been in vogue for decades, independent regulatory framework for other entities has been a recent phenomenon. Enhanced competition has been induced with the entry of private foreign entities and foreign capital in financial sector. In brief, there has been progress in the three inter-related pillars of financial sector, namely ownership, regulation and competition.

Let me illustrate the pragmatic nature of reforms in the fiscal-monetary policy interface. Reserve Bank entered into a Memorandum of Understanding to limit the issuance of ad hoc Treasury Bills to the central government and terminate automatic monetisation of the government's financial needs in 1994 and 1997, respectively.The Reserve Bank avoided participation in the primary issues in recent years except to prepay external debt or as a transition measure, last week. These *de facto* arrangements, proven to be workable, are coming into effect through legislative sanction only on April 1, 2006.

Financial stability

Financial Stability is difficult to define and thus difficult to measure. Basically, it refers to the smooth functioning of the financial markets and institutions but it does not mean absence or avoidance of crisis but presence of conditions conducive to efficient functioning without serious disruption. The relevant legal, institutional and policy frameworks are wide ranging and policy instruments at the disposal of authorities very varied. In a way, the financial stability objective is shared with a set of public policy bodies and professional bodies like auditors and actuaries but the primary responsibility for overall financial sector efficiency and stability generally rests with the central bank. The plausible reasons for such a responsibility are the major elements contributing to financial stability, namely, the oversight of the financial infrastructure, in particular payments systems; regulation and supervision of financial institutions; crisis management and provision of liquidity; and macro financial stability encompassing monitoring not only the behaviour of all important players in the financial sector but also non-financial sector balance sheets as well as that of the governments.

Financial sector reforms and stability

National authorities have typically adapted the design of financial sector reforms - the pace, sequencing direction and ambit - to country-specific situations, mindful of the threats to financial stability. The relevant considerations may be summarized here.

First, there is substantial consensus, backed by some historical and cross-country evidence, that there are strong complementarities between financial stability and macroeconomic stability.

Second, a key issue in the design of financial sector reforms is the pace of reforms in the context of ensuring financial stability. Opinion remains sharply divided over the choice between a big-bang approach or shock therapy and a cautious or gradualist strategy. On balance, it appears, the reforms need to be introduced more as a process than as a short-lived event while the process moves fast enough to produce reasonable results without running the risk of disruption in the short run.

Third, in case the gradualist approach is adopted, the question that arises is what should be the optimal sequencing of reforms which secures financial stability. Such sequencing is crucial for ensuring inter-sectoral balances and avoiding the chances of disproportionality.

Fourth, no reform process, however, paced and sequenced, can be consistent with financial stability if it is widely perceived as temporary and lacking credibility. In a market-based environment, the expectations of the economic agents are extremely important for economic decisions. The reform process can succeed only if the economic agents, especially investors, believe that the reforms are enduring. The issue of credibility is inter-related with the choice of the pace of reform. Our experience has been that a graduated pace wins credibility since it avoids disruptions and roll-backs in the short run while at the same time allowing the beneficiaries to build a consensus in favour of continuing reforms. A key issue is that of managing expectations.

There is reason to believe that the financial reforms process in India has greatly aided in strengthening and reinforcing financial stability. The financial sector has acquired the strength to absorb shocks, largely facilitated by regulatory actions. The financial system is now robust and resilient, contributing to public confidence and overall stability.

At this stage, the optimism generated by impressive macroeconomic performance and the modest success in implementing financial sector reforms has intensified pressures for significantly accelerating the pace of external financial liberalisation. It is essential to take into account the risks associated with it while resetting an accelerated pace of a gradualist approach. It needs to be emphasized that the existing international financial architecture is not adequate to prevent or mitigate the domestic and external effects of a financial crisis in large economies like India. The impact of instability in times of crisis appears largely to be borne by the home or domestic public sector rather than the global private sector. The issue of setting the pace of financial liberalisation revisits the issue of trade-off between sustained growth and a growth rate that could potentially turn volatile and unstable. While it is necessary to add to the pace of growth, it is also equally important to minimize the risks of instability, and the experience shows that more than desirable pace of financial liberalisation was often followed by financial instability and crises. Avoiding crises is ultimately a national responsibility. The approach to managing the financial sector, the choice of instruments and the timing and sequencing of policies are matters of informed judgment, given the imponderables.

Current context

Some thoughts on the issue of financial stability in the current context, are perhaps in order. Low growth accompanied by high inflation is a nightmare for a central banker. High growth coupled with low inflation is indeed a central banker's dream. I have reason to be happy, considering the growth and inflation numbers in India now. So are all my brother or sister central bankers who seem to have similar positive trends. However, currently almost every central banker in this globalised world keeps wondering whether the night ahead will continue the dream run and if so, when will it run out of steam. The concerns of central bankers today arise out of what has been described as stable disequilibrium - with every day adding to potential disequilibrium while continuing to be stable. The perceived risks arise mainly out of global imbalances and outlook for oil prices, particularly in the light of emerging geo-political situation. Most market participants seem to sense these risks but this sentiment does not appear to be reflected in the pricing of risks. Risks do not disappear but they get transferred to another part of the system. The macro policies in emerging markets in particular have to factor in these risks while continuously balancing financial sector reform and stability considerations. More important, for the regulators, monitoring where the risk lies has become very difficult due to emergence of large conglomerates, sophisticated market instruments such as derivatives and presence of players like hedge funds. The good news is that there is international cooperation among central bankers to mitigate the impact of such risks. The Actuaries can certainly help the process of analysing the risks in insurance sectors that do affect a large segment of population that in fact seeks to minimize such risks through insurance.

Let me conclude by thanking the organisers for provoking me to think aloud and share my thoughts on a subject of common interest to all of us assembled here. I wish the conference fruitful deliberations, well balanced by pleasant stay and memories.