Banking Soundness, Monetary Policy and Macro-economic Management: Random Thoughts*

Mr. Chairman and friends,

I would like to thank the organisers and in particular, Chairman, Shri T. R. Sridharan, for inviting me to deliver the valedictory address at the Bank Economists' Conference `98.

I enjoyed reading the excellent papers circulated for the Conference. I found them well researched, thought provoking, analytical, and wide ranging with operational relevance. I also read the keynote speeches and heard rapporteur's reports. It is clear that the speeches and deliberations were of a very high standard, giving a fine balance between the present and future, theory and practice, and knowledge and experience.

In this address, I will share with you my random thoughts on the subject of banking soundness. I will start with a general account of financial sector reform, i.e., pace, sequence, components and impact to show how different approaches are possible and also to show that there is no settled position. I will, thereafter, briefly recall major features of Indian experience on financial sector reform. Then, we will explore what is new about banking soundness that we had to have deliberations such as these. We can then go on to appreciate the link between macroeconomic management and banking soundness, and the feedback effects. More specifically, the relationship between monetary policy and banking soundness should be appreciated. I will conclude with some remarks on what could be important areas of research/analysis for bank economists.

Financial Sector Reform: Review of Approaches

The term financial sector reform is used interchangeably with the terms financial liberalisation and financial deregulation. Financial liberalisation is a process of removal/reduction of financial market distortions, mainly created by Government or central bank interventions. There is a debate with regard to financial sector liberalisation as to what should be the appropriate pace, sequencing, components, etc. It is necessary to recognise that there is no settled wisdom on many of these aspects. Each country proceeded at its own pace, decided its own sequencing and packaged the components of measures.

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* Valedictory Address by Dr. Y. V. Reddy, Deputy Governor, Reserve Bank of India at Bank Economists' Conference at Bangalore on December 18, 1998.

Pace

The pace of financial sector reforms could be conveniently classified as gradual or rapid. Similarly, liberalisation could be almost total or liberalisation may co-exist with elements of Government control. Experience has shown that countries that liberalised rapidly are more prone to reversals – examples are Chile, Argentina, Turkey. However, countries that have phased out controls gradually, such as South Korea, Malaysia, Thailand and Philippines have also faced difficulties.

Sequencing

The sequencing of reform can be analysed with regard to the linkage with general macroeconomic situation, ownership, regulatory and supervisory framework, and external sector liberalisation.

Financial sector liberalisation could be initiated during a period of macroeconomic instability or as part of the overall reform process during conditions of macro economic stability.

Argentina and Chile decontrolled interest rates during a period of high inflation but undertook a large number of measures during a period of macroeconomic stability. Chile, New Zealand, Peru and Turkey began financial sector deregulation under conditions of macro instability but implemented reforms as part of a larger reform process during a period of stabilisation.

As regards ownership, some countries could successfully tackle the process of reducing the role of State Enterprises either prior to or in conjunction with financial sector reform (Chile and Mexico), while others implemented privatisation program after initiation of financial liberalisation.

With regard to the regulatory and supervisory framework, a few countries strengthened regulation and supervision prior to reform (Peru, Israel) while others (Egypt) strengthened supervision at the same time that they liberalised.

On external sector liberalisation, a number of countries liberalised the capital account after domestic financial liberalisation, an important exception being Indonesia. Many countries have also embarked on external sector liberalisation in conjunction with financial sector reform.

Components

The components of reform involved dismantling certain directed credit programmes, lowering cash and liquidity requirements, reducing barriers to entry in the banking sector, privatising the public sector banks, improving payments system, adopting international standards for capital adequacy and prudential norms and improving the legal, regulatory and supervisory infrastructure. The components were packaged in different ways in each country, within the overall framework of appropriate pace and sequencing.

Effects

The impact of financial liberalisation has to be seen in the context of its both immediate effects and in the longer term. To broadly generalise, first, there is evidence that efficiency in the allocation of credit improved after liberalisation. Despite weaker economic conditions, private investment has grown or financial constraints have eased. Second, financial deepening has increased. Third, evidence regarding the impact of liberalisation on saving and/or consumption is mixed. Experience has shown that while liberalisation permitted a consumption boom and reduced saving in many countries, saving did increase in some other countries. Fourth, the immediate impact on interest rates was disparate, with rates sometimes rising and in some countries falling. Fifth, after liberalisation, financial crises have taken place with some countries experiencing more than one crisis. Sixth, financial liberalisation has generally resulted in more effective monetary control.

I will conclude this section by drawing some broad conclusions from experience with financial sector liberalisation in India.

First, financial sector reforms appear to have better chances of success in an environment of macroeconomic stability. Fiscal consolidation and liberalisation of industrial and trade policy regimes do constitute an integral part of reforms.

Second, for maintaining internal and external stability, it appears essential that the inflation rate is not too high and is stable. In such an environment, it is possible to ensure that real rates of interest are not too high, which deter investment and are not too low, which discourage savings.

Third, institutional development has to go hand in hand with financial sector reforms. Institutions may be sponsored by the central bank and as they develop, central bank can vacate – as done in the case of the Discount and Finance House of India Ltd., and the Securities Trading Corporation of India Ltd.

Fourth, interest rate deregulation needs to be phased carefully. During transition from a repressed market to a free market, the tendency for interest rates to overshoot their equilibrium levels could be damaging for the real sector. Moreover, the borrowers, especially small borrowers in the productive sectors of the economy need to be insulated from too much of interest rate volatility

Fifth, in the transition phase, the prudential requirements of provisioning for bad debt and capital adequacy perhaps need to be phased over a period to ensure that the institutions concerned respond, adjust and comply without their viability being threatened.

Sixth, the financial sector reforms need to be complemented by reforms in the legal system, not only in those laws which affect financial institutions directly but also related aspects such as tenancy laws or procedural laws impinging on debt recovery.

Seventh, deregulation should be accompanied by improvements in supervisory mechanisms including those of off-site supervision with on-site examination and effective follow-up action.

Eighth, though deregulation is desirable, the risk profile of the banking sector may still need to be controlled.

Ninth, as monetary transmission mechanisms improve, in terms of operating procedure of monetary policy, the central bank may gradually move from direct instruments to indirect instruments.

Finally, credibility, continuity and commitment are enhanced if the reform agenda emanates out of a group of distinguished persons of great standing, made public, debated upon and then implemented.

What is New About Banking Soundness?

Traditionally, soundness of banking system was considered essential for efficient financial intermediation. However, the costs of financial-repression were recognised in seventies and a wave of deregulation and marketisation occurred. Soon, it was realised that both on theoretical and empirical grounds, financial sector in general and banking sector in particular need to be carefully regulated – though who should regulate, how it should be regulated, with what objectives and instruments are still being debated. There are, without doubt, valid reasons for this vigorous focus and debate on the banking soundness and strength.

First, the soundness issue is not merely a developing country issue. Both developed and developing countries are addressing these issues, with the Bank for International Settlements taking initiatives and more recently the International Monetary Fund.

Second, the banking crises occurred in both developed and developing countries - S&L in U.S.A., banking failure in Nordic countries, Japan's financial system of 'nineties, more recently in Latin America, Russia and East Asia.

Third, there is realisation that the soundness of banking system ensures capacity to absorb shocks – external and internal. At the same time, macro economic stability helps soundness of banking system.

Fourth, banking crises can easily spillover into the real economy and crisis in real economy affects banks almost simultaneously. This is clearly the consequence of financial deepening and widening.

Fifth, as globalisation occurs, banking crisis and currency crisis get closely linked. In this sense, Tarapore Committee (CAC)'s insistence on a robust banking system as a pre-condition for further progress in liberalisation of capital account is significant.

Sixth, the pre-occupation with macro aspects and neglect of micro aspects, especially those relating to institutional, governance and transparency aspects could conceal potential for crises. Causes, cures and dimensions of banking crisis, therefore, go well beyond the realm of the community of economists.

Seventh, with globalisation and threat of contagion, alignment of regulatory regimes and commonly accepted standard as between various national authorities becomes critical, i.e. there is increasing emphasis on harmonisation. This came into bold focus in early 'eighties after Latin American crisis and more so after the East Asian crisis.

Eighth, banks are critical, and are special but non-banks are playing an increasingly crucial role in financial intermediation.

Ninth, promoting and ensuring soundness is an ongoing process to cope with financial innovations and increasing cross-border flows facilitated by technological advancements. Interface between banks, non-banks, financial intermediaries and regulators is also coming to the fore as an issue. Further, financial markets are getting integrated globally and there is increasing emphasis on harmonisation of polices and procedures to ensure banking soundness.

Macroeconomy and Banking Soundness

It will be useful to recall some important linkages between macroeconomy and banking soundness.

First, large fluctuations in the real economy mean that uncertainty increases and banks find it difficult to manage risks.

Second, in a cyclical context of performance of an economy, banks tend to behave procyclically. In the upward phase or boom phase, profits rise and lending increases. In the downward phase, banks tend to withdraw from commercial lending. In fact, with prudential norms and capital adequacy, there is greater likelihood of such procyclical behaviour, if not countered by other policies.

Third, when there are significant developments in world demand and supply, unduly affecting exports and imports, banks portfolio gets affected.

Fourth, volatile forex markets also create uncertainty in banks.

Fifth, large fluctuations in interest rates, usually the effect of high and fluctuating inflation, exacerbates the problem. The effect of increase in interest rates on market value of investment portfolio, in particular government securities, is well known. Mark to market increases transparency but does not reduce the risks.

Sixth, when banks are perceived to be inefficient or subject to excessive costs of regulatory compliance to be borne by banks, depositors may desert banks. So, effectiveness of monetary policy in pursuing objectives of price stability or credit availability is reduced.

Seventh, even fiscal stimulus to boost demand may not get fully realised if there is limited supply of working capital from the banking system to the commercial sector.

Eighth, other things being the same, capital adequacy requirements may make banks prefer safe government paper to commercial lending if there is no assured expansion of capital.

Ninth, with the presence of vulnerable banks in the system, effectiveness of monetary policy instruments diminishes; and inefficiencies in credit allocation also creep in.

Lastly, in the context of liberalised capital flows and rightly assuming that banks will play critical role in such flows, the extent of soundness of the banking system will get reflected in the degree of efficiency of use of such capital flows.

Monetary Policy and Banking Soundness

What are the special links between monetary policy and banking soundness? I will highlight some aspects to supplement what I have already said on macroeconomic linkages.

First, it is well known, but let me repeat, banking system continues to be, and will continue for quite sometime, especially in developing countries, as the main vehicle for monetary policy signals.

Second, the banking system enables transmission of monetary policy. So, transmission channels, especially credit channel is important.

Third, payments system is critical to monetary policy and crisis of banking system spills over to payments system.

Fourth, those banks that are in unsound position are unable to respond to signals. Furthermore, contagion among banks is natural and hence, concern regarding the health of individual banks is also natural.

Fifth, while ideally, monetary policy on the one hand and regulation/supervision on the other should operate independent of each other, in practice the two often get intertwined. Thus, monetary policy initiatives, such as tightening liquidity, credit conditions and interest rates may on occasions take into account impact on banks profitability, especially fragile banks.

Sixth, unsound banks could become captive to insolvent debtors, and their response to market signals could get perverse.

Seventh, as already mentioned, managing capital inflows, exchange rate, monetary base, are facilitated (or hampered) by banks which are sound (or not solvent).

Eighth, it is possible that credit channel is choked due to non-economic or institutional rigidities usually ascribed to principal-agent relationships in banks. The effectiveness of

monetary policy, and perhaps even regulatory/supervisory regime could be influenced by such non-economic factors.

Ninth, monetary policy has to recognise the strains of deregulation on the banking system. Also, the data needs keep changing with transition, apart from the importance of timely and reliable data from banks if monetary policy has to cope with fast changing realities and markets.

Finally, and as a sum-up, there is a clear two-way intimate inter-relationship between monetary policy and banking soundness.

Concluding Remarks

In this background, let me highlight some areas which may require special attention of bank economists in India.

First, is it possible or necessary to focus research on links between banking soundness and macroeconomic management, especially in the current second-generation reforms in India?

Second, in the current context, should there be a review of two aspects related to banking supervision, viz., deposit insurance system and lender of last resort function? Now, with entry of new private sector banks and competition such a review may be worthwhile.

Third, during the reform-era, how to counter the possible short-run, temporary effects on credit-direction, as a result of tightening prudential norms?

Fourth, how to reconcile the needs of harmonising our supervisory standards and accounting practices with international standards and the demands of our unique requirements in India.

Fifth, and finally, while the merits or demerits of public/private ownership of banks is a current subject of debate, there has been insufficient attention to the implications of banking soundness for government finances. It is not inconceivable that private sector banks get into trouble. If such failures have systemic implications, governments all over the world may bail them out. Even if the central bank takes the burden as a lender of last resort, in effect it is at the expense of transfer of resources to government. In regard to public sector banks, government has a more direct fiscal stake. Thus, in the interest of soundness, where restructuring either through recapitalisation or a possible less costly, Asset Reconstruction Company route is attempted, the ultimate cost if any, has to be borne by government. In brief, whether banks are in the public or private sector, government has a stake in ensuring bank soundness. Ensuring soundness of banks is in the long-term interest of fiscal management just as prudent fiscal management is in the long-term interest of bank soundness. But fiscal prudence does not guarantee banking soundness while bank soundness avoids possible contingent liabilities on government.

I am thankful again to the organisers for provoking me to read, listen, think and interact with you on a subject of great contemporary relevance, especially to the management of reform of the financial sector.