

Financial Stability Mandate of Central Banks Issues in the International and Indian Context¹

- Duvvuri Subbarao

Financial stability has come centre stage in the post crisis scenario. The discourse has been quite broad spectrum - ranging from first principles such as the definition of financial stability to intellectually involved issues like the implication of financial stability for growth and welfare. Although the crisis originated in the advanced economies, we, in emerging economies too have been affected by it, and indeed by much more than we had thought possible. This contagion brought home a simple message. In a rapidly globalizing world, national and international financial stability are inter-linked. They are really two sides of the same coin.

2. From that perspective, the international efforts now under way to put in place institutional arrangements and policies for preserving financial stability are relevant for us here in South Asia too. That explains the choice of the topic 'Financial Stability' for this SAARC Governors' Symposium.

3. I have great pleasure in welcoming all the delegates to this symposium. In particular, I want to acknowledge the presence here of colleague Governors and Heads of Delegation from Afghanistan, Bangladesh, Bhutan, the Maldives, Nepal,

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Pakistan and Sri Lanka. A special welcome to Jaime Caruana, General Manager of the Bank for International Settlements (BIS) and formerly Governor of the Bank of Spain, and to our very own Dr. Y.V. Reddy, my distinguished predecessor at the Reserve Bank and now an internationally renowned expert on financial stability. Between the two of them, they bring not only years of rich central banking experience but valuable international expertise and enormous intellectual acumen. Lastly, and importantly, a special welcome to Shri T.N. Ninan, President, Editors Guild of India, one of India's most erudite economic journalists and a very influential thought leader, who will be moderating the Governors' panel discussion later today.

4. Holding this symposium on financial stability here in the backwaters of Kerala, God's Own Country, was a deliberate decision. It has now become fashionable to refer to the global crisis that we had just gone through as a financial tsunami. Maybe we can extend that metaphor. If the crisis was a tsunami, the placid backwaters of Kumarakom represent the financial stability that we aspire to.

5. Given the depth and breadth of exposure that all of you, especially colleague Governors, bring to this forum, it will be presumptuous on my part to anticipate and debate all the issues that will come up. I will attempt something much less ambitious. Just by way of a curtain raiser, I will try to give an assessment of the global debate on financial stability and outline what we are doing here in India.

Financial Stability and Central Banks

6. Given that central banks have been at the heart of this crisis - being blamed for getting the world into the crisis and being praised for leading from the front in getting the world out of the crisis - a question that naturally arises is whether the crisis could have been averted if central banks had an explicit mandate for financial stability. There are two presumptions behind this question: first, that central banks neglected financial stability because they had no explicit mandate, and second that in some sense, financial stability falls within the purview of a central bank mandate. Evidently, there are no settled views on these presumptions but they do raise a host of important issues. Let me try and flag them.

Financial Stability - Why is It Important?

7. Given the enormity of the crisis the world has just gone through, to ask why financial stability is important will sound inane, perhaps even outlandish. But that perception comes from the benefit of hindsight. Remember financial stability was not on anyone's radar screen during the period of the Great Moderation. So, let me address the question of why financial stability is important.

8. That financial stability is important for the macroeconomy is perhaps obvious. What clearly distinguishes a financial crisis from other types of economic crises, as evidenced by the history of crises since the Great Depression of the 1930s, is that financial crises are deeper, the recovery from them is protracted and they leave behind deep scars by way of output and employment foregone. The Great Recession of 2008/09 bears this out. Global income, trade and industrial

production had fallen more sharply in the first twelve months of this crisis than in the first twelve months of the Great Depression. Two years after the crisis, much of the world is still in a recovery phase. And there are apprehensions that there may be a permanent loss of output - a new normal as it were. So, on all parameters, the depth of the crisis, the length of the recovery and its lasting impact, this crisis has taken a devastating toll on global growth and welfare - conclusive evidence of why financial stability is vital from a macroeconomic perspective.

9. More specifically, financial stability is particularly important to central banks because their ability to deliver on the growth and inflation objectives is conditional on a financially stable environment. At the heart of the monetary policy actions of a central bank is the adjustment of short-term interest rates in the expectation that it will transmit to interest rates at the long end and thereby influence aggregate demand and inflation. The channel for this monetary transmission can get clogged, or in extreme cases even completely choke, if there is no financial stability. Recall that at the depth of this crisis, when credit and money markets went into a seizure, advanced country central banks tested the limits of policy action. Finding that they were unable to revive market confidence even after pushing policy interests down to near zero or even zero, they had to top up interest rate action with initiatives variously termed quantitative easing and credit easing. What this experience demonstrated is that financial stability is a necessary precondition for monetary policy effectiveness.

The Role of Central Banks in Financial Stability

10. So, the surmise, from the experience of the crisis, is that financial stability is a necessary - although not sufficient - condition for the central bank to deliver on its mandate. The follow on question then is what is it to do about it? More precisely, what is the role, if any, of a central bank in preventing financial instability, and what is its role in managing financial instability should it occur?

11. Before the crisis, the stereotype view was that price stability and financial stability complement each other i.e. monetary policy and policies for financial stability are mutually reinforcing. The crisis has proved that wrong. Note that we saw the global financial sector come to the brink of collapse in the midst of a period of extraordinary price stability. Indeed the experience of the crisis has prompted an even stronger assertion - that there is a trade-off between price stability and financial stability, and that the more successful a central bank is with price stability, the more likely it is to imperil financial stability. The argument goes as follows. The extended period of steady growth and low and stable inflation during the Great Moderation lulled central banks into complacency. They thought they had discovered the holy grail and declared victory. Only with the benefit of hindsight is it now clear that the prolonged period of price stability blindsided policy makers to the cancer of financial instability growing in the underbelly.

12. So that much is now clear. Central banks should be mindful of financial stability concerns. But does it necessarily mean that they should take care of it themselves? A review of the pre-crisis institutional arrangements for financial

sector regulation across different countries suggests different answers. Abstracting from the details, it is possible to see two stylized models. The first is a model where the central bank is just a minder of inflation with no regulatory responsibilities, the rationale being that a central bank will be able to deliver on its price stability objective more effectively if it is not burdened by other responsibilities. The other model is one where a central bank has also some, and in a few cases, the entire responsibility for regulating the financial sector, and hence has an implicit responsibility for financial stability.

13. The experience of the crisis has generated a vigorous debate on whether a central bank can remain immune to financial stability concerns no matter how limited its mandate. Using a metaphor which is by now notoriously famous, is the central bank's job confined just to mopping up the mess after the bubble has burst? This is not a totally settled debate, but the dominant view post-crisis is that central banks should have a substantial role in the financial stability function. Once again, abstracting from all the nuanced positions, there are three main arguments.

(i) The first argument is that monetary policy and financial stability are generally inter-linked. Policies in one dimension have implications for the other. For example, monetary policy can affect systemic risk through the asset price channel. Interest rates represent the opportunity cost of holding assets and an accommodative monetary policy can influence credit expansion for financing asset purchases. Should this happen in times of excessive optimism, it can lead to asset price bubbles threatening systemic stability. The causation can run in the reverse direction too - policies for financial stability can influence the monetary dimension. For example, as I said earlier, measures aimed at strengthening the resilience of the financial

system potentially buttress monetary policy by preventing sharp financial disruptions. This inter-dependency between the two dimensions suggests that the central bank, with inherent responsibility for monetary policy, should also act as a systemic regulator in charge of financial stability. With such a mandate, a central bank can take a holistic view of policy options by factoring in costs and benefits in both dimensions.

- (ii) The second argument in favour of giving central banks a more substantive role in the financial stability function flows from the lesson of the crisis that a collection of healthy financial institutions does not necessarily make a healthy financial system. Systemic safety can be jeopardized by procyclicality. As the crisis demonstrated, there is a strong collective tendency among financial entities to overexpose themselves to the same type of risk during an upturn and become overly risk averse during a downturn. Importantly, individual institutions, indeed microprudential oversight too, fail to take into account the spillover impact of the actions of the rest of the financial system on them. Hence the growing emphasis, as part of the post-crisis regulatory reform, on macroprudential supervision at the systemic level to complement microprudential regulation at the institutional level. There are synergies to be gained by co-locating the responsibility for both microprudential regulation and macroprudential supervision in one institution. The grass root level knowledge from microprudential regulation can be used to look out for fault lines at the systemic level; vice versa, systemic level insights from macroprudential supervision will be useful in instituting safeguards at the micro level. The logical candidate for housing both the microprudential regulation and macroprudential supervision is the central bank.
- (iii) By far the strongest argument in support of integrating financial stability and monetary policy flows from the lender of last resort (LOLR) function of the central bank. The central bank, it is argued, can discharge its LOLR function more efficiently if its mandate extends beyond merely monitoring

financial institutions to taking preventive action. This becomes possible if the central bank is also the systemic regulator in charge of financial stability.

14. Even as the case for giving a substantive responsibility for financial stability to the central bank is persuasive, the central bank itself will have a challenging task in managing the relative prioritization across its multiple objectives. This is less straight forward than it seems especially as there are important trade-offs. For example, in India we mandate banks to hold 24 per cent of their net demand and time liabilities (NDTL) in a liquid portfolio under the statutory liquidity ratio (SLR) regime.² While the SLR regime provides strength to the banking system and is hence stability enhancing, the large preemption that it entails reduces the flow of credit to productive sectors with potentially adverse impact on investment and growth. As such, the SLR regime poses a growth-stability trade-off dilemma for the Reserve Bank.

15. Such conflicts across the multiple objectives of the central banks can become more common in crisis situations. During the Asian Crisis, for example, countries raised interest rates to stem capital outflows and contain currency depreciation. These external sector adjustments took a heavy toll on the domestic macroeconomic situation by way of corporate losses, higher NPAs for banks, lower output and higher unemployment, all of which eroded financial stability. The management of the recent crisis is an example in the reverse. To restore financial stability, central banks stretched conventional expansionary policies to the limits

² Incidentally, Basel III package finalized last year has a liquidity buffer provision similar to our SLR requirement.

and also pursued unconventional policies. Some analysts contend that the costs of this extraordinary monetary accommodation will unfold over time by way of lower output and higher inflation.

Regulatory Architecture for Financial Stability

16. I have argued the case for central banks having a substantive role for financial stability. Clearly, this cannot be an exclusive responsibility. In most jurisdictions, there are other financial sector regulators, and the government too, who have to share this responsibility. That raises the question: what regulatory architecture is best suited for preserving financial stability? There is no definitive answer. As several analysts have pointed out, the crisis hit countries alike, irrespective of their regulatory architecture. For example, the US with multiple regulators and the UK with a unified regulator were both hit alike. But as we emerge out of the crisis, some broad contours of reform are emerging.

17. These contours reflect two clear trends: first, a decisive shift towards giving increased responsibility for both macroprudential oversight and microprudential regulation to central banks; and second, institutionalisation of collegial arrangements involving the central bank, other regulators and the government, with the primary responsibility of identifying threats to financial stability. The councils can make recommendations for appropriate prudential standards in the interest of safety of the financial system, but notably, not for forbearance or relaxations. The two seemingly paradoxical trends make eminent sense and supplement each other.

18. A brief review of the situation across advanced economies shows that even as details differ, the thrust is the same. In the US, the Financial Stability Oversight Council (FSOC) is headed by the Treasury Secretary and comprises the Fed chairman and the heads of all the regulatory agencies. The FSOC will monitor systemic risks, designate non-bank financial firms as systemically important and subject them to Fed supervision, approve proposals from Fed to break up large banks and allow orderly resolution of failing systemically important financial institutions.

19. The European Union (EU) has opted for a council approach with significant responsibility for the central banks. An agreement has been reached on creating new supervisory bodies for the EU which became operational at the beginning of 2011, subject to approval by individual member states. The European Systemic Risk Board (ESRB) is chaired by the President of the European Central Bank (ECB) and is a part of the European System of Financial Supervision which also comprises the three newly created systemic authorities for banking, insurance and occupational pensions and for securities markets.

20. In the UK, there is a paradigm shift underway in terms of the institutional arrangements for micro-prudential as well as macro-prudential regulation. The Government announced plans to: (i) shift the responsibility for prudential oversight from the Financial Services Authority (FSA) to a new Prudential Regulation Authority (PRA) under the Bank of England; (ii) set up a Financial Policy Committee (FPC) within the Bank of England to “monitor macro issues that may

threaten economic and financial stability”; and (iii) set up a Financial Conduct Authority (FCA) which will be responsible for the conduct of business across various financial services and for consumer protection. The FPC will be a committee of the Bank of England’s Court of Directors and is to be chaired by the Governor. It will also comprise a representative each of the Treasury, the PRA and the FCA. In anticipation of a legislation to create the FPC, an interim FPC has been established with its composition closely mimicking that of the proposed statutory body.

21. The above trends implicitly acknowledge that while all financial sector regulators, and indeed the government, have a role in maintaining financial stability, from an effectiveness and accountability perspective and for preventing as well as managing a crisis, it is imperative to enjoin the executive responsibility for financial stability to a single entity and that the central bank is best positioned to be that single entity. The participation of, and indeed coordination by the finance ministry, underlines its role in crisis management and resolution.

Financial Stability and Central Bank Autonomy

22. The much prized autonomy of central banks has come under assault post-crisis with an influential view gaining ground that one of the principal causes of the crisis was the unbridled autonomy of central banks. The standard argument for central bank autonomy is that autonomy enhances the credibility of the central bank’s inflation management credentials. Monetary policy typically acts with a lag, and price stability therefore has to be viewed in a medium term perspective. Having

autonomy frees the central bank from the pressure of responding to short-term developments, deviating from its inflation target and thereby compromising its medium term inflation goals. Even as the importance of central bank autonomy in monetary policy is now broadly accepted, there is a growing view that central bank decision making has to become transparent and that central bankers have to be more accountable for the outcomes of their decisions.

23. With central banks assuming increasing responsibility for financial stability, the autonomy question has acquired an additional dimension and greater urgency. The main apprehension is that a formalized mechanism for coordination between the government and the central bank for financial stability will alter the level, content, process and frequency of interaction between the two, and over time this will erode the autonomy of the central bank. It is argued that it will be difficult to keep monetary policy and policies for financial stability strictly apart, and a formal forum for coordination would facilitate ‘spillover’ into monetary policy.

24. This issue is non-trivial, and can become quite contentious in maturing economies where institutions for checks and balances are not ingrained. Nevertheless, it is not an insurmountable problem. It is possible to build and respect Chinese walls between decision making for monetary policy and decision making for financial stability. In the US for example, the FOMC (Federal Open Markets Committee) is responsible for monetary policy decisions while the Board of Governors of the Federal Reserve is responsible for financial stability decisions. Countries like Brazil and Sweden have a different model - they aim at extracting

synergies between monetary and financial stability decisions through a single board.

25. The burden of my argument therefore is that with sensitivity and understanding on both sides and through appropriate institutional mechanisms, it is possible to ensure that a central bank is able to effectively discharge its financial stability responsibility without compromising its autonomy.

Indian Position on the Issue of Financial Stability

26. Where do we in India stand on this issue of financial stability? Historically, the Reserve Bank has played an important role in preserving financial stability - drawing from its wide mandate as the regulator of the banking system and of the payment and settlement systems, regulator of the money, forex, government securities and credit markets, as banker to banks, as also the lender-of-the last resort. This unique combination of responsibilities for monetary policy combined with macroprudential regulation and microprudential supervision with an implicit mandate for systemic oversight has allowed the Reserve Bank to exploit the synergies across various dimensions. The micro-level information coming from supervision of individual institutions has been a valuable input for shaping the macro perspective. On the other hand, the broad understanding from macroprudential regulation has been effective in instituting prudential safeguards at the micro institution level.

27. Even as the Reserve Bank has implicitly been the systemic regulator in India, financial stability cannot be its exclusive responsibility. Other financial

sector regulators such as the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority (IRDA) and the Pension Funds Regulatory and Development Authority (PFRDA) too have important responsibilities. Beyond the regulators, the crisis has demonstrated the importance of the coordinating role the Government has to play, especially in crisis times.

28. Across most jurisdictions, the post-crisis focus has been on shifting responsibilities and mandates among regulators. India has been somewhat different in this regard; our focus has been more on establishing an institutional mechanism for coordination among regulators and between the regulators and the Government. This has culminated in the establishment, in December 2010, of the Financial Stability and Development Council (FSDC) to be chaired by the Finance Minister. The FSDC is to be assisted by a sub-committee to be chaired by the Governor of the Reserve Bank. This sub-committee has replaced the erstwhile High Level Coordination Committee on Financial Markets (HLCC-FM). The Government has held out a clear assurance that the setting up of the FSDC will not in any way erode the autonomy of the regulators.

29. In terms of governance structure, the two-tier framework of FSDC and the sub-committee presents an interesting case. The crisis has clearly demonstrated the need for explicit delineation of responsibilities for financial stability across agencies and an agreed protocol for coordination among such agencies. The crisis has at the same time brought forth the critical stake of the sovereign in ensuring financial stability - the spillover costs in a crisis have to be borne by the

governments. However, the sovereign itself may not be the agency best suited to take on the mantle of financial stability - in most jurisdictions, including India, it is the central banks which have the natural mandate for this responsibility. In the Indian context, the proposed structure attempts to strike a balance between the government's objective of ensuring financial stability to reduce the probability of a crisis and the operative arrangements involving the central bank and other regulators. While the Sub-Committee under the Governor of the Reserve Bank is expected to evolve as a more active, hands-on body for financial stability in normal times, the FSDC would have broad oversight and will assume central role in crisis times.

30. There is another interesting dimension to the mandate of the FSDC. Note that the acronym also includes the letter 'D' which stands for development. In the budget speech, the Finance Minister indicated that the development role will cover issues like financial inclusion and financial literacy which, by their very nature, are shared objectives of the Government and the regulators and have to be pursued synergistically. I am pointing this out to emphasize that in India we view financial inclusion as a fundamental aspect of financial stability.

31. Since the Reserve Bank has historically had a macroprudential overview, not all the governance issues surrounding financial stability are new to us. Nevertheless, there are always unknown unknowns, and the system should be able to respond to them when they turn into known unknowns. Now that the regulatory architecture of the FSDC is in place, it is important for the Government and the

regulators in India to develop conventions and practices which will serve the goal of preserving financial stability without eroding the autonomy of the regulators.

Summing Up

32. Let me now sum up. I have highlighted why financial stability is important for the macroeconomy and for the central banks. I have argued that central banks should have a substantive, although not exclusive, responsibility for financial stability even as this might involve the central banks having to manage some critical trade-offs. It is in recognition of the synergy between the basic monetary functions that the central bank conducts and of the policies required for preserving financial stability that, across several jurisdictions, including in more mature advanced economies, there is a post-crisis move towards giving central banks more formalized, explicit responsibility for financial stability.

33. At the same time, there is recognition everywhere, regardless of the regulatory architecture, that preserving financial stability requires coordination among regulators, and between regulators and governments. Even in the midst of a general refrain that central banks, and indeed all regulators, should become more transparent and be more accountable, it is generally acknowledged that these coordination mechanisms, especially as between the government and the regulators, must function in ways that do not compromise the autonomy of the regulators. How these coordination mechanisms will evolve and how much value they will add is yet too early to determine. The test really will be how effectively we can prevent the next crisis, and how effectively we will manage it, should one occur.

34. The recent best seller, *Lords of Finance*, likens central bankers to the Greek mythological character Sisyphus. Sisyphus was condemned by Gods to roll a huge boulder up a steep hill, only to watch it roll down and having to endlessly repeat the task. The challenge for central banks is still bigger. They have to manage multiple boulders at the same time. Only if they succeed in that multi-Sisyphian effort will they be able to preserve financial stability. Let me finish on that sombre note.

Chasing the Monsoon

35. Before I do so however, I want to let our foreign friends here know that ‘chasing the monsoon’ is a national pastime in India from June through September. The emotional well being of the country as well as our economic prospects are determined by the monsoon that breaks here off the coast of Kerala every year in early June. We invite you to enjoy this wonderful experience of celebrating the great Indian monsoon.