प्रेस प्रकाशनी PRESS RELEASE

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Financial stability enables banking sector to absorb shocks, economy to bounce back

The Reserve Bank today placed on its website a Working Paper titled "Banking Stability - A Precursor to Financial Stability" under the RBI Working Paper Series. The paper has been written by Dr. Rabi N. Mishra, Shri S. Majumdar and Ms. Dimple Bhandia.

The issue of financial stability is closely linked with banking stability, especially in bank dominant financial systems like India. The historical evidences demonstrate that those financial crises which had stronger involvement of the banking sector had a more devastating effect on the real sector. The financial crisis of 2007-08 was no exception. Banking stability itself can be treated as a combined effect of several parameters, e.g., asset quality, liquidity, capital, costs and profitability, etc. The degree of stability varies during the period with changes occurring in one or more of its constituents. Though the stability of the banking sector gets affected positively or negatively with the conditions prevailing in the financial market and the real economy; ultimately it determines as to what extent financial stability is ensured in the economy by its ability to absorb the shocks. Stability of the banking sector may, therefore, be treated as a forerunner of financial stability in an economy.

This paper has made an attempt to develop a methodology for a banking stability indicator for India by way of combining some of those indicators which are important in gauging the health of the banking sector. The paper also analyses the linkage of banking stability indicator with the financial markets and the real sector.

Major findings:

- Banking stability indicator, constructed with five dimensions, provides insight into the performance of the banking sector and thus could be in a way considered a leading indicator.
- The paper establishes a link between banking stability and financial stability. Continued financial stability improves banking stability and enables the banking sector to absorb shocks during times of crises, thus minimising the impact and helping the economy to bounce back with minimum time lag.
- During the period under review, banking stress explains around 33 per cent variability of stress in financial markets, whereas, financial markets explain only 17 per cent of variability in banking stress.
- The impact of GDP growth on asset quality of the banking sector, assessed using Granger's causality test, shows that GDP growth impacts the asset quality significantly.
- The movements in banking stability indicator indicate that there are symptoms of a moderate rise in instability of the banking sector in recent periods mainly on account of deterioration in asset quality.

Note: The Reserve Bank of India introduced the RBI Working Papers series in March 2011. These papers present research in progress of the staff members of RBI and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not that of the Reserve Bank of India. Comments and observations may kindly be forwarded to authors. Citation and use of such papers should take into account its provisional character.

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