Management

FINANCIAL STABILITY: IS MONETARY POLICY SUFFICIENT?

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ABSTRACT

This Paper highlights the causes, management, preventions of financial crises, including banking, securities market, payments and currency crises with respect to the financial stability. The paper also highlights the attributes that would be useful in managing public policy with respect to financial stability. The paper discusses how the monetary policy may not be sufficient to handle financial instability.

Keywords: exchange rate, financial instability, IMF, Monetary policy, RBI

Introduction

The meltdown of financial markets in 2008-2009 was the result of institutionalized fraud and financial manipulation. The "bank bailouts" were implemented upon the instructions of the Wall Street, leading to the largest transfer of money wealth in recorded history, while simultaneously creating an insurmountable public debt in the US economy.

With the worldwide deterioration of living standards and plummeting consumer spending, the entire structure of international commodity trade is potentially in jeopardy. The payments system of money transactions is in disarray. Following the collapse of employment, the payment of wages is disrupted, which in turn triggers a downfall in expenditures on necessary consumer goods and services. This dramatic plunge in purchasing power backfires on the productive system, resulting in a string of layoffs, plant closures and bankruptcies.

Financial Stability

In India, financial stability has emerged as a key consideration in the conduct of monetary policy since the 1990s. Consequent to the structural reforms initiated in the early 1990s, the gradual opening up of the Indian economy, the financial system has transformed from a planned and administered regime to a market-oriented financial system. Financial stability in India would mean (a) ensuring uninterrupted settlements of financial transactions (both internal and external); (b) maintenance of a level of confidence in the financial system amongst all the participants and stakeholders and (c) absence of excess volatility that unduly and adversely affects real economic activity. (*Y.V. Reddy*,2004)

Financial Markets

Financial market encompasses in broad terms any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are defined by having transparent pricing, basic regulations on trading, costs and fees and market forces determining the prices of securities that trade.

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Some financial markets only allow participants that meet certain criteria, which can be based on factors like the amount of money held, the investor's geographical location, knowledge of the markets or the profession of the participant.

Financial markets can be found in nearly every nation in the world. Some are very small, with only a few participants, while others – like the New York Stock Exchange (NYSE), Shanghai Stock exchange, London Stock exchange and Hong Kong Stock exchange. These markets trade trillions of dollars daily.

Most financial markets have periods of heavy trading and demand for securities. During such periods, prices may rise above historical norms. There are complementary phases of downturns also that may cause prices to fall past levels of intrinsic value, based on low levels of demand or other macroeconomic forces like tax rates, national production or employment levels.

Information transparency and information symmetry is important to increase the confidence of participants and therefore foster an efficient financial marketplace.

Financial Institution

Financial institution provides financial services for its clients. The most important financial service provided by financial institutions is to act as financial intermediaries. There are three major types of financial institutions:

1. Deposit-taking institutions: These accept and manage deposits and make loans.
2. Insurance companies and pension funds; and
3. Brokers, underwriters and investment funds.

Regulatory measures

Keeping in pace with times, various regulatory prescriptions were being issued by the central bank from time to time. These steps are taken to basically ensure banking stability vis-à-vis exposures and risks. Kishori J. Udeshi, former Deputy Governor of the RBI outlined some of the key measures:

- Capital adequacy norms at 9% which is higher than the 8% international norm
- Income Recognition and Asset Classification (IRAC) norms
- Exposure norms – individual and group norms 15% and 40%, respectively with additional 10% in case of infrastructure funding.
- Cap on foreign currency borrowing and lending as well as policy measures on hedging of such foreign currency loans
- Cap on Capital market and sensitive sector exposures
- Building up of Investment Fluctuation Reserve (IFR) to a minimum of 5% by March 2006.

(*Kishori Udeshi*,2005)

In India, the degree of compliance with Basel Core Principles has been high. The RBI has introduced consolidated accounting for banks along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities. A scheme of Prompt Corrective Action (PCA) was introduced effective from December 2002 to undertake 'structured' and 'discretionary' actions against banks exhibiting vulnerabilities in certain prudential/financial parameters. The RBI has also introduced the Know Your Customer (KYC) norms for better monitoring of financial markets. The RBI has fined Axis Bank, HDFC Bank and the ICICI with Rs.

10.5 crore for violating the KYC norms on 10th June, 2013 after a sting operation by Cobrapost.cost, a news website.

With liberalization, financial conglomerates are emerging. Banks have accordingly been advised to prepare and disclose consolidated financial statements and prepare consolidated prudential reports. The inter-regulatory coordination has also been streamlined with the establishment of a monitoring system in respect of Systemically Important Financial Intermediaries (SIFIs), coupled with the establishment of three Standing Technical Committees constituted by the High Level Coordination Committee on Financial and Capital Markets (HLCCFCM) to provide a more focused inter-agency forum for sharing of information and intelligence.(*Udeshi*,2005)

Review of Literature

Somesh K. Mathur succinctly reviews the sources of market failure in financial institutions and markets and various measures that can be undertaken to alleviate them (*Mathur*,2001)

The IMF is bringing regular Global Financial Stability Report to strengthen bilateral and multilateral surveillance of international financial markets, with a view to promote global financial stability. Issues considered in such reports include, inter alia, developments and sources of risk in the major financial centers; emerging market developments and financing; and emerging local bond markets.

Barry Eichengreen, Andrew K. Rose and Charles Wyplosz(1993) evaluate the causes and consequences of episodes of turbulence in foreign exchange markets. They found that the exchange rate market may be subject to multiple equilibria. They have argued that in pegged exchange rates,

> *"so long as the exchange rate peg is considered 'credible', the evolution of domestic factor costs is consistent with external equilibrium. However, once a change in the exchange rate occurs, a new set of expectations governing price formation evolves and the exchange rate ceases to be in equilibrium. The second type of exchange market instability occurs in a floating exchange rate situation, when the amplitude of fluctuations in the market exchange rate exceeds that which can be explained on the basis of underlying fundamentals. This is usually termed as volatility.*
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> (*Eichengreen, Rose, Wyplosz,*1993)

Douglas W Diamond has developed a theory of financial intermediation based on minimizing the cost of monitoring information which is useful for resolving incentive problems between borrowers and lenders.

Viral V. Acharya and Matthew Richardson describe how the financial theory need to be better adapted to the practical requirements of maintaining reasonable stability of markets and institutions while restoring the financial stability. Charles A. E. Goodhart and Dimitri P. Tsomocos, points out how there is an emerging consensus about the framework whereby a central bank should fulfill its macro monetary functions. In sharp contrast, there is no consensus about the framework for achieving its financial stability objective, either on the appropriate theory or practice.

Is Monetary policy sufficient?

Monetary policy determines only the level of prices and not the unemployment rate or other real variables. In this sense, it is monetary policy that has ultimate responsibility for the purchasing power of a nation's paper currency. Employment depends on other factors such as demographics, productivity, tax policy, and labor laws. But, many economists pit their hope upon short term monetary policy boost to temporarily stimulate real economic activity in the short run. Such activist monetary policy is quite difficult to do successfully for several

reasons. First, any boost to the real economy from stimulating monetary policy will eventually fade away as prices rise and the purchasing power of money erodes in response to the policy. The short term benefit can thus be mitigated if inflation expectations rise in reaction to the monetary accommodation. There is a lurking fear of a variety of shocks that can simultaneously buffet the economy. Shocks can occur to specific sectors, such as a sharp drop in housing prices or a sharp rise in the price of oil, or to specific regions. If monetary policy responds to one shock in an attempt to offset its possible effects, it may aggravate the effects of another shock. Thus, monetary policy's ability to neutralize the impact of shocks is quite limited.

For successful implementation of such financial stabilization policy, it is necessary to anticipate and plan much earlier. Ad-hocism cannot prove to be the panacea. The managers of the economy must be in a position to approximately predict the state of the economy more than a year in advance and anticipating the nature, timing, and likely impact of future shocks. But, mostly economists falter in their predication about the real economy. Thus, attempts to stabilize the economy will, more likely than not, end up providing stimulus when none is needed, or vice versa. It also risks distorting price signals and thus resource allocations, compounding instability further. In most cases, the effects of shocks to the economy simply have to play out over time as markets adjust to a new equilibrium. Monetary policy is likely to have little ability to hasten that adjustment. Monetary policy has its own limitations. It cannot retrain a workforce or help reallocate jobs to lower unemployment. It cannot help keep gasoline prices at low levels when the price of crude oil rises to high levels. Monetary policy cannot reverse the sharp decline in asset prices when the there is a house bubble. In all such cases, monetary policy cannot eliminate the need for households or businesses to make the necessary real adjustments when such shocks occur.

On the macro-economic policy side of the RBI, remarkable consensus has been emerging over the last two decades. This covers both the applicable theoretical framework for analyzing the transmission mechanism of monetary policy and the appropriate institutional structure for the Central Bank to deploy its macro-economic policies. There is no such consensus on the appropriate theoretical framework for the analysis of financial stability.

Financial stability has moved to centre-stage nationally as well as in discussions relating to the future of the global monetary and financial system. Several factors have brought this about: the disturbing intensity and frequency of financial crises, the move to strengthen domestic financial systems under Basel II and now Basel III and the deepening quest for the appropriate international financial architecture for crisis prevention and management. Unlike in some countries where the responsibility for financial stability has been allocated to an independent authority, Indian approach has been to deploy the synergies that exist between the conduct of monetary policy and the function of financial regulation. It is thus not a surprise that financial stability in India is an integral responsibility of the Reserve Bank. But, global experiences suggest that might not be sufficient if India undergoes instability in financial market. With a plummeting rupee that crossed Rs 60 per dollar, growing current account deficit, slowing economic growth ,declining investment grading and in a climate of uncertainty , the RBI might not be the safest bet to handle a financial tsunami in India!

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