Financial Stability: Issues and Challenges*

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I. Global Banking - Paradigm Shift

Thank you for inviting me to participate in this FICCI-IBA conference on “Global Banking: Paradigm Shift”. I understand this is one of the important banking conferences in the annual calendar, and so I struggled through what I should say at this valedictory that is central to the theme of the conference.

2. Quite understandably, public discourse over the last one year has been dominated by the global financial crisis; and the future of global banking has clearly been one of the important facets of this discourse. How the regulatory architecture around the world is reinvented will be a critical determinant of the paradigm shift in global banking. In his 1962 book, ‘Structure of Scientific Revolutions’, Thomas Kuhn argues that when evidence against a prevailing scientific theory piles up, that theory is jettisoned and a new one is adopted signalling a paradigm shift. As we contemplate the lessons of the crisis, the questions that arise are what is the evidence against the old model of central banking and regulation, and what is the new model. What is the paradigm shift required? I will position my speech this afternoon on some of the issues in this paradigm shift.

II. Financial Stability - Key Lesson of the Crisis

Breakdown of Trust

3. There appears to be broad agreement around the world that the worst of the crisis is behind us. The risk of a descent into a second Great Depression - which seemed to be a threat as recently as March - has greatly
diminished, if not disappeared. Nevertheless there is a furious debate on the pace and shape of global recovery. Regardless of one’s position on this debate, everyone is agreed on one thing which is that restoration of trust in the financial system is central to the pace and shape of recovery. What this crisis has witnessed is a massive break down of trust across the entire financial system - trust in banks and non-banks, trust in central banks and other regulators, trust in credit rating agencies and investment advisers, trust in brokers, dealers and traders, and trust in the financial markets, if not in the market system itself.

Anatomy of Financial Instability
4. It was the abrupt breakdown of trust following the collapse of Lehman Brothers in mid-September 2008 that caused financial markets in advanced economies to go into seizure. Suddenly, there was a great deal of uncertainty not only about the extent of losses and the ability of banks to withstand those losses, but about the extent of risk in the system, where it lay and how it might explode. This uncertainty triggered unprecedented panic and almost totally paralysed the entire chain of financial intermediation. Banks hoarded liquidity. Credit, bond and equity markets nearly froze. Signalling a massive flight to safety, yields on government securities plunged while spreads over risk free government securities shot up across market segments. Several venerable financial institutions came to the brink of collapse. Massive deleveraging drove down asset prices setting off a vicious cycle. Trust totally dried up.

5. The epicentre of the crisis lay in the advanced economies, but it soon spread in two directions. First, in the advanced economies, it spread from the financial sector to the real sector severely hurting consumption, investment, export and import. Second, it spread geographically from the advanced economies to the emerging market economies and soon engulfed almost the entire world through trade, finance and confidence channels. In short, financial stability that we had grown to take for granted got impaired.

Financial Stability Comes Centre Stage
6. That indeed is one of the many lessons of the crisis - that financial stability cannot be taken for granted. We have learnt that financial stability can be jeopardised even if there is price stability and macroeconomic stability. We have learnt that a threat to financial stability anywhere in the world is potentially a threat to financial stability everywhere. We have learnt that financial stability has to shift from being an implicit variable to an explicit variable of economic policy.

7. Financial instability, as we have seen, can hurt even the most advanced economies, but the damage it can cause in poor and developing economies can be particularly severe. People with low levels of income have no headroom to bear downside risks, and their livelihoods can be disrupted by financial instability. It is, therefore, even more important that countries such as ours pay particular attention to preserving financial stability even as we deepen and broaden our financial sector at home and integrate with the rest of the world.

8. All of us in the financial sector have a role in managing financial stability. Given the
centrality of this topic to our mandate, I would like to focus my comments this afternoon on financial stability. I will start by examining how and why central banks let financial stability fall through the cracks, and then review the international initiatives under way to remedy the system. I will then explain the Indian approach to financial stability, in particular highlighting the stability enhancing features of our policy and regulatory framework. Finally, I will look ahead to some issues and challenges on the way forward.

III. Central Banks and Financial Stability

9. Central bankers around the world are clearly in the forefront battling the crisis. While they are clearly part of the solution, questions are being asked about whether they were, in fact, part of the problem. In particular, did they fail to see the crisis coming? Were they behind the curve in preventing excesses from building up? Did they neglect financial stability in their zealous pursuit of price stability? More importantly, did they behave like this because the accountability mechanisms were weak? To address these questions, let me refer to three egregious failures attributed to central banks.

First Failure - Exclusive Focus on Price Stability

10. The years before the crisis saw a powerful intellectual consensus building around inflation targeting. A growing number of central banks, starting with New Zealand in the late 1980s and currently numbering over 20, geared monetary policy almost exclusively to stabilising inflation. Even where central banks did not target a precise inflation rate, their policy objectives were informed, if not dominated, by price stability. This approach seemed successful. There was an extended period of price stability accompanied by stable growth and low unemployment. The presumption that price stability would deliver financial stability too seemed to have been validated. Having beaten the nasty bouts of stagflation of the 1970s and tamed business cycles, central banks declared victory. They had discovered the holy grail.

11. The crisis has blunted that sense of triumph. It has called into question the wisdom of exclusive inflation targeting and even challenged the notion of price stability being the only objective of monetary policy. It has underscored the importance of acknowledging financial stability as an explicit variable in the policy matrix of central banks.

Second Failure - Failure to Prevent Asset Price Bubbles

12. A second and related feature of central banking that led to the crisis was the benign neglect of the build-up of asset bubbles and financial imbalances. In particular, the monetary policy stance of studied indifference to asset price inflation stemmed from the now notoriously famous Greenspan orthodoxy which can be summarised as follows. First, asset price bubbles are hard to identify on a real time basis, and the fundamental factors that drive asset prices are not directly observable. Second, monetary policy is too blunt an instrument to counteract asset price booms. And third, a central bank cannot presume to know more than the market. After all financial markets
are efficient, rational and self-correcting. Any central bank action to correct the market is not only uncalled for, but is bound to be suboptimal. The surmise, therefore, was that the cost-benefit calculus of a more activist monetary stance of "leaning against the wind" was clearly negative. It was considered more cost effective for monetary policy to wait for the bubble to burst and clean up afterwards rather than prick the bubble in advance.

Third Failure - Lightness of Regulation

13. A third lapse attributed to central banks, and to financial sector regulators where they are separate from central banks, was the lightness of regulation. A host of factors - innovation of complex products by slicing and dicing, the originate and distribute mode of lending, misuse of derivative products, securitisation that encouraged aggressive off-balance sheet activity, loose supervision and regulation - all culminated in the build-up of systemic risks, and this despite the growing sophistication of risk management systems. Regulation typically focussed on individual institutions, not recognising the fallacy of composition - that systemic stability could be threatened even if individual institutions within the system are stable. A whole network of bank-like institutions - now called the 'shadow banking system' - grew and flourished outside the regulatory regime of banks. Regulatory arbitrage became common practice as banks shifted risk to affiliated entities in the shadow system and evaded capital requirements.

Warnings Ignored

14. It is not as if the risks to financial stability were brewing silently. Several international fora were discussing growing threats from macro economic imbalances, asset price build-up, credit expansion and depressed risk premia, and some had even issued alerts and warnings about the impending crisis. But central banks largely refrained from strong corrective action for a variety of reasons - the perceived inefficiency of monetary policy to redress asset price bubbles, separation of monetary and regulatory policies and misplaced faith in the self-correcting forces of financial markets. At least some of the central banks actually believed that the Great Moderation permanently changed the macroeconomic dynamics and that the good times will roll on for ever. The net result of all this was financial stability failed to receive central bank attention it warranted.

IV. Global Action Towards Financial Stability

15. Expectedly, the crisis has triggered a vigorous debate on how financial stability should be safeguarded. Even as the crisis is not fully behind us, several lessons are clear. First, the received wisdom is that prevention is better than cure and that central banks should take countercyclical policy actions to prevent build-up of imbalances. Second, a consensus is emerging around the view that central bank purview should explicitly include financial stability. Third, there is growing acknowledgement that financial stability needs to be understood and addressed both from the micro and macro perspectives. At the micro level, we need to ensure that individual institutions are healthy, safe and sound; we need in addition, to safeguard financial stability at the macro level.
16. Some of the significant actions already taken to bolster the resilience of the international financial system include the enhancement of the Basel II capital framework, particularly with regard to trading and off-balance sheet securitisation activities of banks, setting strong risk management standards for banks and financial institutions on governance, management and disclosure of liquidity risk and stress testing, integrating sound compensation principles in the Basel capital framework, introducing central counterparties for derivatives trading, developing new accounting standards to enhance the consolidation of special purpose vehicles, making transparent banks’ relationships with such entities and the issue of internationally agreed principles for the oversight of hedge funds.

17. Beyond actions already taken, work is under progress on several initiatives to strengthen stability and I want to highlight some of the more important ones.

- Strengthening the regulatory capital framework: recognising that the banking sector entered the crisis with an insufficient level and quality of capital, the Basel Committee on Banking Supervision is developing concrete proposals to strengthen the quality, consistency and transparency of the capital base of banks.

- Strengthening the supervision of cross-border entities: given the growing number of cross-border financial conglomerates and their role in transmitting risk, arrangements are being put in place for cross-border cooperation among regulators and for establishing supervisory colleges.

- Strengthening the macroprudential framework: regulation has typically focussed on individual institutions, which as has become evident now is necessary but not sufficient. It is equally important to monitor systemic stability. The Basel Committee is now developing macroprudential regulations to address procyclicality and systemic risk issues.

- Reviewing international accounting standards: there is a view that some of the current accounting standards have contributed to market volatility. The Financial Stability Board and the accounting standard bodies are consulting on revising standards, in particular those relating to financial instruments and their valuation.

- Extending the perimeter of regulation: work is under way to develop a global framework governing the registration, regulatory disclosure and reporting requirements to be imposed on non-banks. The principle being put forward is that if an institution looks and behaves like a bank, then it should be regulated like a bank, regardless of its legal form.

- Strengthening the oversight of credit rating agencies: the crisis has questioned the integrity, conduct and
business model of credit rating agencies. Corrective initiatives under way include stronger regulation of credit rating agencies, measures to address conflicts of interest, differentiation between ratings of structured and other products, and strengthening the integrity of the rating process.

- Rationalising compensation structures: it is agreed that compensation structures in large financial institutions have given rise to perverse incentives for staff to maximise profits at the cost of long-term sustainability. A key objective of the proposed changes is to promote compensation schemes that reflect the underlying risks taken that include back loading payoffs and claw back clauses that retrospectively adjust bonuses on the basis of future position losses.

18. As a member of G20, the expanded Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), India is actively engaged in several of these international initiatives. The task for us will be to draw the lessons of the crisis, understand international best practices and adapt them to our context.

V. Financial Stability - Indian Approach Financial Stability in India During the Crisis

19. Even in the midst of such a cataclysmic crisis, our financial sector remained safe and sound, and our financial markets continued to function normally. Sure, we have been hurt by the crisis, but much less than most others. It will be a folly though to let that lull us into complacency and to believe that there is something inevitable about India’s financial stability. As India further integrates with the rest of the world, as it inevitably will, we will increasingly be exposed to the forces of globalisation. We cannot be globalising, and at the same time expect to remain ‘decoupled’. Indeed, this crisis has shown that ‘decoupling’ is a God that failed. If financial stability anywhere in the world is jeopardised, our financial stability will become vulnerable too.

India’s Approach to Financial Stability

20. In contrast to the minimalist formula of ‘single objective, single instrument’, the conduct of monetary policy by the Reserve Bank has been guided by multiple objectives and multiple instruments. In general, our three main objectives have been price stability, growth and financial stability, with the inter se priority among the objectives shifting from time to time depending on the macroeconomic circumstances.

21. What have been the key features of our approach to safeguarding financial stability? On financial globalisation, our stance has been gradualist - of making haste slowly. We view capital account liberalisation as a process and not an event. The extent of opening is contingent upon progress in other sectors. The policy framework encourages equity flows, especially direct investment flows but debt flows are subject to restrictions which are reviewed and fine-tuned periodically. The exchange rate is largely market-determined and we intervene in the foreign exchange market in times of excessive volatility.

22. Our approach to financial sector regulation has been informed by the fact that our system is dominated by
commercial banks. Thus, as early as mid-1990s, the Reserve Bank instituted the prudential framework governing banks, especially commercial banks, as a part of the overall structural reforms. As of April 2009, all our commercial banks are Basel II compliant.

23. We established a Board for Financial Supervision for focussed regulation and supervision of banks and other financial institutions under the Reserve Bank’s jurisdiction. We widened and deepened the financial markets in terms of instruments, products and participant, while continuing with a cautious approach towards exotic products.

India - Important Measures Towards Financial Stability

24. It may be relevant to highlight some of the specific features of our system that have contributed to financial stability:

- Banks are required to hold a minimum percentage of their liabilities in risk free government securities under the statutory liquidity ratio (SLR) system. This stipulation ensures that banks are buffered by liquidity in times of stress.

- We managed the capital account actively. In the face of large capital inflows during 2006-08, we sterilised the resultant excess liquidity through calibrated hikes in the cash reserve ratio (CRR) and issue of market stabilisation scheme (MSS) securities. When the flows reversed during the last quarter of 2008, we reversed the measures too. We cut the CRR and bought back the MSS securities to inject liquidity into the banking system.

- Through pre-emptive countercyclical provisioning and a differentiated risk weight stipulation for ‘sensitive sectors’, we were able to contain the adverse impact of high credit growth in some sectors and asset price fluctuations on banks’ balance sheets.

To ensure that securitisation is value adding, we insist on ‘true sale’, and credit enhancements and liquidity support are subject to capital regulations. We also require profit from sale of assets to SPVs to be amortised over the life of the securities issued.

- Access to overnight unsecured call market is restricted to banks and primary dealers. Other entities can access the overnight market only through collateralised instruments which are cleared and settled on a guaranteed basis through a central counterparty.

- Regulation and oversight have been extended to systemically important non-deposit taking, non-banking finance companies, and this has limited leverage and space for regulatory arbitrage.

- Systemic interconnectedness has been addressed by bringing banks’ exposures to non-bank finance companies within the prudential framework.

- Central counterparty (CCP) clearing and guaranteed settlement is currently operative for government securities transactions and inter-bank rupee-USD forex transactions. CCP guaranteed arrangements for forex forwards and OTC rupee interest rate swaps are underway.
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Financial Stability Unit in the Reserve Bank

25. As you will note from the above listing, we have used both monetary and regulatory measures to maintain financial stability. This synergistic approach has been possible because the Reserve Bank is both the monetary authority and the regulator of banks, non-banks and a large segment of the financial markets. On the way forward, our financial markets will deepen and broaden further and we will also be increasingly exposed to the forces of globalisation. All this will have implications for our financial stability. The Reserve Bank is conscious of the need to pay increasing attention to financial stability and to improve our skills in this area. As a beginning in this direction, we have set up a multi-disciplinary Financial Stability Unit in the Reserve Bank and are planning to put out a regular Financial Stability Report. The first report is planned in the next few months. These reports will present an overall unified assessment of the health of the financial system with a focus on identification and analysis of potential risks to systemic stability.

VI. Financial Stability: Challenges on the Way Forward

26. Like all other policy measures, maintenance of financial stability involves trade-offs and throws up a number of challenges. I want to highlight five important challenges that we will need to address on the way forward. In doing so, I will draw from global experience.

First Challenge: How to Define and Measure Financial Stability

27. It came to light in several countries during the crisis that the responsibility for financial stability fell through the cracks as no agency or regulator was definitively mandated with it. Now, there are moves to explicitly indicate which agency/agencies will be responsible for financial stability as also to specify a protocol for addressing threats to financial stability, much like the ones we have developed for managing natural disasters. But this requires, in the first place, for financial stability to be precisely defined.

28. Despite widespread usage, financial stability is difficult to define let alone measure. This is in contrast to price stability which can be defined and quantified. Some define financial stability as the absence of financial instability which, of course, is tautological. From a macro-prudential perspective, financial stability can be defined as a situation where the financial sector functions without any discontinuity. This definition is conceptually neat but is not useful for policy purposes unless it can be quantified for measurement purposes. Policy makers and analysts at international fora are actively engaged in fleshing out the definition so that it is precise, measurable and comprehensive. Some critical elements of any financial stability framework, aspects that need to inform the definition of financial stability, are the following:

- Excessive volatility of macro-variables such as interest rates and exchange rates which have direct impact on the real economy;
- Build-up of significant leverage in financial, corporate and household sector balance sheets;
- The moral hazard risks posed by institutions that have become ‘too-big-to-fail’ or too interconnected or complex to resolve;
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Internal systemic buffers within the financial sector, both at the institution and systemic levels, to counter potential shocks to the economy;

Strong policy and institutional mechanisms to lean against the wind even as “the music is playing”;

Prevalence of unregulated nodes in the financial sector which, through their interconnectedness with the formal regulated system, can breed systemic vulnerabilities.

Second Challenge: Financial Stability - Exclusive or Shared Responsibility?

29. The crisis has triggered an active discussion on an appropriate regulatory structure that is best suited to safeguard financial stability. There are several regulatory models around including those where the central bank is a pure monetary authority with bank regulation and supervision vested with another agency. Post-crisis, the emerging view is that the crisis was caused, at least in part, by the lack of coordination and communication between the separate bodies and that it is optimal, in the interest of financial stability, to entrust the function of regulation of banks and non-banks also to central banks. The argument is that only the monetary authority, as the lender of last resort, can provide emergency liquidity support. Also, being the regulator, the monetary authority gets a better sense of the market conditions and can, therefore, manage liquidity more efficiently.

30. But this model raises fresh questions. In particular, can the central bank have exclusive responsibility for financial stability? Conversely, can the government completely delegate this responsibility to the central bank under a principal-agent model?

31. Consider, for example, a situation where the banking system is under threat of instability. Decisions have to be made on which banks to bail out and how much support to extend. In all this, fiscal support may need to be extended. Would a government, especially if it is democratically elected and accountable to a legislature, not want to have a say in this regard? This calls for the following question to be resolved. How should the responsibility for financial stability be shared between the government and the central bank? What should be the protocol for decision making? Who should prevail, and under what circumstances, in the event of a deadlock?

Third Challenge: Growth and Financial Stability - Managing the Trade-offs

32. In order to safeguard financial stability, we have traditionally used a variety of prudential measures such as specifying exposure norms and pre-emptive tightening of risk weights and provisioning requirements. But these measures are not always costless. For instance, tightening of risk weights arguably tempers the flow of credit to certain sectors, but excessive, premature or unnecessary tightening could blunt growth. Similarly, exposure norms offer protection against concentration risks; however, such limits could restrict the availability of credit for important growth sectors. This is a live issue in our country in the context of the immense needs of infrastructure financing. Thus, as in the case of price stability, central banks face the
challenge of managing the trade-off between financial stability and growth.

33. It needs to be recognised that after a crisis, with the benefit of hindsight, all conservative policies appear safe. But excessive conservatism in order to be prepared to ride out a potential crisis could thwart growth and financial innovation. The question is what price are we willing to pay, in other words, what potential benefits are we willing to give up, in order to prevent a black swan event? Experience shows that managing this challenge, that is to determine how much to tighten and when, is more a question of good judgement rather than analytical skill. This judgement skill is the one that central banks, especially in developing countries such as India, need to hone as they simultaneously pursue the objectives of growth and financial stability.

Fourth Challenge: Reforming Regulatory Architecture

34. As the lessons of the crisis emerge, central banks are vigorously reinventing themselves and almost all countries are reviewing their regulatory architectures. Two key lessons are driving this change: first that the responsibility for financial stability cannot be fragmented across several regulators; it has to rest unambiguously with a single regulator, and that single regulator optimally is the central bank. And second, that there is need for coordination across regulators on a regular basis and for developing a protocol for responding to a crisis situation. I want to address three issues in the broad area of regulatory architecture.

35. The first issue has to do with regulatory coordination. In India, we have a host of regulators in the financial sector - RBI, SEBI, IRDA and PFRDA. In order to facilitate coordination between them, there is a High Level Coordination Committee on Financial Markets (HLCC-FM) comprising all the regulators and the Finance Secretary. While the Governor of the Reserve Bank chairs the HLCC-FM, the Ministry of Finance provides the secretariat. The hallmark of the HLCC meetings, and one that adds most value to them, is that the meetings are informal and there is free exchange of positions, views and opinions. There is a view that the HLCC-FM should be given a formal structure. While a formal structure will have the merit of enforcing accountability, the flip side is that it may make the forum excessively bureaucratic and detract from its other value adding features. This is an issue that we must debate further. One area where the HLCC-FM could have a more defined role relates to oversight of large financial conglomerates.

36. The second issue relating to regulatory architecture with relevance for financial stability has to do with changes, if any, warranted in the regulation of financial markets. Two recent reports, both influential, one by Percy Mistry on Mumbai as an International Financial Centre and the other by Raghuram Rajan on Financial Sector Reforms, have recommended that regulation of all trading of financial products and instruments be brought under SEBI. We need to seriously debate the advisability of such a unification.

37. Currently, the arrangement for regulation of financial markets is as follows. Apart from banks, NBFCs and other financial institutions, the Reserve Bank regulates the money market, the
government securities market, the credit market and the foreign exchange market and the derivatives thereon. In respect of OTC derivatives, only those derivatives where one party to the transaction is an RBI regulated entity have legal validity. In respect of products traded on the exchanges, procedures for trade execution fall within the regulatory purview of SEBI. Therefore, unlike many countries, India has established procedures for regulation of OTC derivatives.

38. By far the most important reason why the present arrangement should continue has to do with preserving financial stability. Unlike equity prices, interest rates and exchange rate are key macroeconomic variables with implications for monetary policy and overall macroeconomic stability. In addition, banks dominate the interest and exchange rate markets. By also being the regulator of these markets, the Reserve Bank is in a position to exercise oversight of institutions, markets and products, to monitor market developments, sense impending developments, take advance action, prevent excessive volatility and maintain financial stability at the systemic level. This is an arrangement that has stood to the test of time, has protected our financial stability even in the face of some severe onslaughts. This is an arrangement that we should not jettison lightly in quest of a unified market regulator.

39. The third issue in the reform of regulatory architecture is about whether a central bank should also be a banking regulator. Pre-crisis, there was a dominant argument for separation of the monetary and regulatory functions premised on a possible conflict of interest. According to this view, if financial stability becomes the dominant concern of a central bank, it could result in a moral hazard for banks. Banks will likely take excessive risks in the full confidence that the central bank, being also the regulator, will ease policy and extend regulatory forbearance to bail them out in a crisis. Paradoxically, the aggressive pursuit of financial stability can itself threaten financial stability over the long horizon.

40. The crisis has clearly weakened this argument. The concern over regulatory forbearance is exaggerated. It is worth noting that some advanced economies where regulation and supervision are with an agency other than the central bank are themselves revisiting their regulatory structures and contemplating some unification. The crisis has also shown that there are clear synergies between monetary policy management and financial sector regulation. In particular, the central bank can perform its lender of last resort function more effectively if it has a clear view of the institution’s current and prospective balance sheet and its liquidity and solvency position.

41. The jury of course is still out on which model is the best as the crisis has discredited almost all models. I want to point out though that we need to reflect on the lessons of the crisis seriously before reforming our regulatory structures.

Fifth Challenge: Fiscal Policy, Financial Stability and Central Bank Independence

42. The emerging regulatory architecture geared, among other things, to preserving financial stability will have implication for...
the prized independence of central banks. Before 1970, it was typical across countries for monetary policy to be hostage to fiscal compulsions. But, following the stagflation of the 1970s and the ascendancy of monetary policy thereafter, a neat arrangement started to emerge. Governments started becoming fiscally responsible and monetary policy had started getting independent.

43. This arrangement is now unravelling as a result of the crisis. Unnerved by the scale and sweep of the crisis, governments and central banks around the world responded with an unprecedented show of policy force. Central banks cut policy interest rates and have resorted to injecting massive liquidity in the system through a slew of measures variously called quantitative and credit easing. Governments stepped in with fiscal stimulus packages raising fiscal deficits to levels not seen before in peace time. Even as governments and central banks cooperated, the familiar tensions between fiscal and monetary policy have started playing up. It is widely hoped though that once the crisis is behind us, these tensions will melt away and monetary policy will once again be conducted independent of fiscal compulsions. On the other hand, there are apprehensions that this may not happen soon because of the expected protracted recovery and also because of structural factors that may keep fiscal deficits at elevated levels into the medium-term.

44. These tensions between fiscal and monetary policies could potentially militate against financial stability. If governments continue to incur large fiscal deficits, it will be that much more difficult for central banks to maintain price stability. While the current crisis has shown that price stability is not sufficient to ensure financial stability, price stability is decidedly a necessary condition for financial stability. Higher inflation could also push the yield curve upwards. This could result in significant mark to market losses for fixed income instruments with potentially adverse implications for banks’ profitability. This again could impair financial stability.

45. In India too, we are confronting the dilemma of managing the tension between fiscal and monetary policies. The government has asked the Finance Commission to indicate a road map for returning to a path of fiscal consolidation. It is imperative that both the centre and states in India return to a path of fiscal consolidation, for a number of reasons, including the need to preserve financial stability.

VIII. Conclusion

46. Let me now conclude. To summarise, I have alluded to how financial stability has been impaired during this crisis and the flaws in the central banking paradigm that may have been responsible for this. I have narrated some of the important international initiatives under way to preserve and strengthen financial stability. I have argued that in the face of India’s rapid integration with the world, we need to be vigilant about protecting our financial stability as developments anywhere in the world can affect us. I have explained India’s approach to financial stability and indicated that the Reserve Bank is retooling itself to safeguard financial stability. Finally, I addressed five major challenges that the
world, India included, will need to address on the way forward.

47. The more we study and analyse financial stability, the clearer it becomes that preserving and strengthening financial stability is a complex challenge. We need to take measured and timely action, and make a balanced judgement - not to be too benign, but also not go over board with excessive or premature tightening.

48. There is a concern in some quarters that the crisis may have dented our enthusiasm for financial sector reforms. I believe that concern is misplaced. We will not slow down on reforms, but will surely rework the road map to reflect the lessons of the crisis.
Financial stability issues related to crowdfunding intermediaries appear limited for the time being given the amounts raised. The banking channel will continue to play an essential role as the primary financing source for small and medium enterprises, and intermediate-sized enterprises.


The growth of bank account helps banks to manage the financing service that provides for the community. This study examines the relationship of financial inclusion and financial stability, especially in Indonesia’s Sharia banking. Financial inclusion defined as community access to financial services which peroxided by deposits, while the financial stability of Sharia banking is measured by Non Performing Financial (NPF).