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Role of Central Bank in Financial stability

Dr. Ashutosh Kumar Singh
East Lohanipur, Pustakalaya Lane Patna- 800003 (Bihar)

Abstract
Financial stability is one of the main mandate of a central bank as a stable financial system promotes economic development. An unstable financial system adversely affects the intermediation process and retards economic growth. The financial crisis has reinforced the importance of financial stability and there is recognition that financial instability anywhere can be a threat to financial stability everywhere. The build-up of systematic risk and the use of macro prudential tools to deal with them have emerged as the main planks financial stability policy framework.
Key Words:- Financial stability, Financial Crisis, Economic Growth, Financial Intermediaries,

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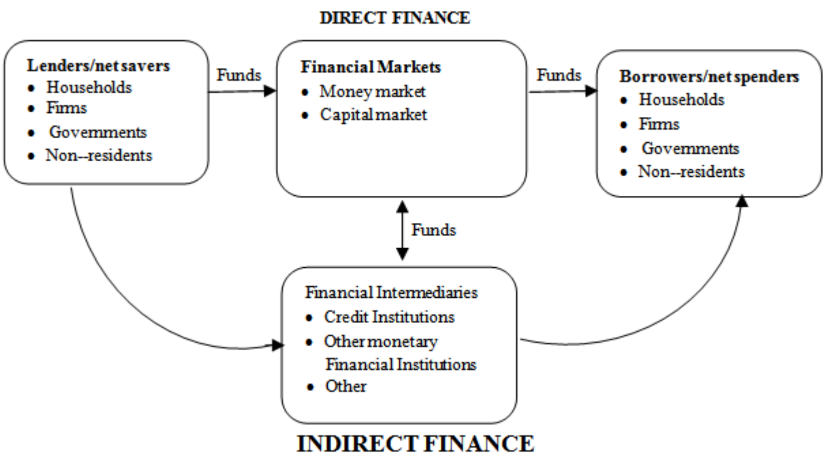
I. Introduction

A well- functioning financial system- comprising financial markets, financial intermediaries (such as, banks, insurance companies, non-banking finance companies etc.) and financial infrastructure (responsible for payment, clearing and settlement)- is critical for economic growth, as it ensures the efficient transfer of resources from lenders to borrowers. If anyone who wants to start a business- a restaurant, a software firm, a consumer electronics shop- and had to do so only with their hard-earned savings or with the help of their parents, relatives or friends, many bright ideas would go unrealized. At the same time, in the absence of avenues for investment, savings will remain idle or be wasted. Similarly, if you invest in a company and we can't sell our shares or bonds and invest somewhere else, you remain invested forever, it would be very hard for promising enterprises to raise capital and grow. Thus stable financial system, by allocating society's accumulated savings to the most productive available uses, not only provides access to finance, which is essential for economic development, but also plays a key role in the managing risk and promoting entrepreneurship. Finance can be obtained through two channels : directly by issuing securities or indirectly through financial intermediaries, such as banks and non-bank finance companies. This is depicted below:

Functions of financial systems



OBJECTIVES :
1) To study the functions of Central Bank in terms of Financial Stability.
2) To study functions of financial system.
3) To assess the Institutional and governance structure for financial stability.
4) To analyze the Implementing policies to mitigate identified systematic risk.

The two channels are mostly complimentary. However, depending upon the nature of development of financial system in a country, one channel may play a greater role than other. For example, in countries, such as the United States or the United Kingdom where financial markets are more developed, direct or market-based finance is more popular. On the other hand, in European countries, such as France and Germany, banks play a dominant role in the financing of the economy. In India, banks not only are the main source of financing of households and corporate, but also the main savings vehicle. In the absence of a healthy financial system, the intermediation process will not happen and economic development with slitter.

Financial systems, most of the time, perform its role efficiently. However, when they do not, it leads to financial instability and episodes of financial crisis. A financial crisis in itself, if it doesn't transmit to the real economy, though a cause for concern, is not catastrophic. If the financial system can absorb the shocks and thereby keep the real economy immune from the distortions, it is said to be resilient and well-functioning. However, there have been many episodes of financial crisis in the modern economy, when the shocks in the financial system spilled over to the real economy resulting in massive unemployment and recession. In particular, banks, either due to losses in its balance sheet or due to low level of capital, may stop lending or stop rolling over maturing loans. It could also be due to a sudden liquidity crunch as assets in bank's balance sheet are generally long- term and liquid. In a market based economy, the lenders may lose trust in the borrower's ability to repay and would not be willing to invest in their securities or provide any short- term finance. As a consequence, financing declines with attendant adverse implications for consumption and investment and ultimately economic growth. The financial literature categories such an event as Systematic risk - the risk wherein "the provision of necessary financial products and services by the financial system will be impaired to a point where economic growth and welfare may be materially affected". A build-up of systematic risk leads to financial instability. Therefore, financial system is a state whereby the build-up of systematic risk is prevented.

The financial crisis of 2007-09 is a manifestation of systematic risk as many economies fell into the recession following the bursting of the housing bubble and failure of large financial institutions. The crisis brought to light several new risks that must be addressed to prevent systematic risk. These include, but not limited to, the build-up average, the complexity of new financial instruments, the opacity of markets and interconnectedness among institutions. Financial intermediation outside the regulatory perimeter, the so called Shadow Banking, and it's linkages with the regulated banking system, was also a major catalyst for the financial crisis. The build-up of systematic risk has been identified with two dimensions, viz., Cross-sectional and Time dimensions. The cross-sectional dimensions relates to distribution of risk within the system at any given point of time. Systematic risk in this dimension arises due to the interconnectedness of institutions, balance sheet entanglements, common exposures, and sometimes, even common business models. The time dimension, on the other hand, deals with how aggregate risk in the financial system evolve over time- the procyclicality issues in the financial system. The dynamics of the financial system and the macro economy interact with each other increasing the amplitude of booms and busts.

One way of limiting the spillover could be restrict the interconnectedness among the various sectors. However, this will come at a cost of reduced efficiency of the market and substantially enhanced cost of intermediation as well as a high level of inconvenience to the market entities and ultimate consumers of financial services. Therefore, the objective of financial stability should be to monitor, identify and minimize the build-up of systematic risk in the financial system and reduce the spillover effects of materialization of systematic risk in the most efficient and effective way. This involves a fine dovetailing between the objectives of maximum market efficiency, highest consumer protection and minimum systematic risks.

Objectives of financial stability can be achieved by establishing a framework broadly divided under the three categories, viz.,

(1) Establishing an institutional and governance structure for financial stability;
(2) Measuring and monitoring systematic risk;
(3) Implementing macro prudential policies to mitigate identified systematic risks.

Institutional and Governance Structure for Financial Stability

Post financial crisis of 2007-09, there is recognition of the need to pursue financial stability as an explicit policy objective of many central banks. However, given that the financial system is comprised of a number of financial intermediaries and market segments, increasingly the responsibility for financial stability is vested with the Government in most of the countries with the central bank playing a pivotal supporting role. In India, the Government in December 2010 set up Financial Stability Development Council (FSDC) as the apex level forum to strengthen and institutionalize the mechanism for maintaining financial stability, enhancing inter-regulatory coordination and promoting financial sector development. The Chairman of the Council is the Finance Minister and its members include the heads of financial sector Regulators (RBI, SEBI, IRDE, PFRDA, FMC), Finance Secretary and/or Secretary, Department of Economic Affairs, Secretary Department of Financial Services and Chief Economic Advisor. The Council can invite experts to its meeting, if required.

Without prejudice to the autonomy of regulators, the Council monitors macro prudential supervision with the economy, including functioning of large financial conglomerates and addresses inter – regulatory coordination and financial sector development issues. It also focuses on financial literacy and financial inclusion. A sub-committee of the FSDC was formed to help the FSDC, which replaced the previous High Level Coordination Committee on Financial Markets. The sub-committee is headed by the Governor, RBI and has representation from the RBI, GOL, SEBI, IRDA and PFRDA. The sub-committee meets regularly to review the developments in the macro economy and financial markets to maintain financial stability and monitor macro prudential regulation in the country.

The financial crisis of 2007-09 reinforced the importance of financial stability for macroeconomic stability and strengthen the existing architecture, the RBI setup an operationally independent Financial Stability Unit(FSU) in August 2009. The FSU prepares half-yearly financial stability reports, which reflects the collective assessment of the sub-committee of the FSDC on risk to India's financial stability. The other major functions of the FSU include, but not limited to, conduct of macro-prudential surveillance of the financial system on an ongoing basis, carry out periodic systematic stress to assess resilience of the banking system and development of models for assessing financial stability.

Maintaining financial stability had been a main objective of the RBI even prior to the crisis. The RBI over the years has been pursuing macroprudential policies, without explicitly labeling them such as, to address systematic risk. The Board for Financial Supervision and the Board for Payment and Settlement Systems, both committees of the Central Board of Directors, were constituted to aggregate information pertaining to the financial system as a whole and take informed decisions to deal with any signs of stability, both at the individual institution level and at the system level. Prior to the formation of FSDC for systemic risk, the RBI had a record of using time varying LTV ratios to dampen credit growth in commercial and real estate segment. In addition the cross sectional spillovers of financial markets are contained by imposing a strict exposure limit on equity market participation, tracking of unhedged foreign currency exposures of counterparties as well as directing banks to have an aggregate exposure limit on real estate. Similarly, the RBI, during times of foreign exchange pressure has resorted to implementing strict open position limits of banks and has also in coordination with capital markets regulator imposed higher margining norms as well as position limits on exchange traded currency derivatives. Thus, in India, macroprudential instruments were used much earlier before they became part of the international regulatory apparatus. The lender of last resort facility as well as central bank experience in ensuring price and exchange rate stability makes the central bank's role in maintaining financial stability even more significant.

Measuring and Monitoring Systematic Risk

Monitoring of systematic risk on an ongoing basis has become a mandate for most of the central banks and financial sector regulators. The monitoring is done with the help of various tools, such asstress tests at micro and macro level, analysis of interconnectedness among various financial market entities and sectors, use of various indicators such as banking stability indicator, systemic liquidity indicator ,credit-GDP growth trends for the whole economy as well as for different economic sectors. In most of the jurisdictions, these indicators and instruments are published in periodic reports called financial stability Reports of Financial Stability Reviews.

Implementing policies to mitigate identified systemic risks

Once the systemic risk has been identified ,the next task is to implement the policies to mitigate such risks .In modern economies .the regulation and supervision of financial institutions are distributed among a host of agencies. This made it difficult to coordinate the supervision of the activities of these institution and also share information that could post risk to the system. Therefore, even though financial stability is one of the key objectives of central banking, the role of central bank was limited to provision of liquidity, i,e. , lender of last resort. The financial crisis brought to recognition that the policies and tools to deal with financial stability issues were inadequate. Focus on microtprudential policies, which are aimed at safety of individual institutions, was found to be insufficient and macroprudential policies aimed at safeguarding the stability of the financial system and preventing the buil-up of systemic risk gained prominence.

The objective of macro prudential polices are two fold:

To mitigate procyclicality, i.e., prevent the excessive build –up or risk through debt and leverage, which amplifies boom and bust cycles (time dimension) to improve the resilience of the financial system, i,e, its ability to absorb shocks without major disruption to the real economy by limiting contagion (cross-sectional dimension) and targeting systemically important financial institutions (higher capital levels for example)

To achieve the above objectives, many instruments are identified. These instruments sometimes are standalone macro prudential tools or they can be an overlay on the existing micro prudential instrument. To achieve the first objective i.e., to mitigate procyclicality, leverage ratio (to reduce leverage and thereby curb lending of banks)

Limiting loan-to value rations (home buyers for example have bring in more of their money), dynamic provisioning ,higher risk –weights on bank loans, etc, are employed. Similarly, institutional investors can be precluded from investing in certain sectors or prescribed not to invest in instruments below a certain credit rating. At the system level regulators prescribe some across –the sector measures such as countercyclical capital buffer, which is released when a pre-decided threshold, say credit to GDP ratio, is breached. To enhance the resilient to the financial system ,capital buffers (accumulation of capital as precautionary reserves during economic upturns to use them in economic downturns) liquidity buffers (Presence of significant high- quality liquid assets in the balance sheet), higher capital requirements for systemically important institutions, stress tests to assess the strength of the balance sheet, etc., are used.

II. Conclusion

For sustainable economic growth, it is imperative to have a stable and healthy financial system that ensures smooth flow of funds between savers and investors and distributes risks across the economy. Central bank play a vital role in preserving stability in the financial system and thereby confidence in it, Thus, stable financial system, by allocating society's accumulated savings to the most productive available uses, not only provides access to finance, which is essential for economic development, but also plays a key role in the managing risk and promoting entrepreneurship.

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