Simple Rules for Financial Stability

Ensuring financial stability is the goal of all governments and central banks. However, this is easier said than done. According to the IMF, the unconventional monetary policy steps taken by some of the governments – specifically in US, Eurozone, China and Japan have been effective in containing the economic and financial crisis at the same time reduced tail risks. These policies have reduced deflationary pressures, improved growth prospects and restored market functioning in the U.S., the U.K., Japan, and Euro area. However, the effects on other economies have been mixed. This is one step that the governments across the world used to ensure financial stability. The BFSI Research team explores four simple rules to ensure continued financial stability across the globe – the role of fiscal policy on financial stability, focus on macro-prudential norms, implement a rules based monetary policy and take a look at the "Living Will" policy for SIFIs.

FOR decades economists have been warning anyone who cared to listen about the unsustainable fiscal policy of developed nations. No one thought it fit to look at countries like India. We too are no exception. It is quite obvious to anyone who cares to look, that India has an unsustainable fiscal deficit. The recent financial crisis has had one beneficial impact - an increased awareness of the importance and the multifaceted nature of the interrelations between fiscal policy, monetary policy and financial stability. It is true that the governments across the globe, in an unprecedented show of unity managed to prop up the financial sector through rescue packages (Some debate the use of taxpayer's money to rescue institutions and the moral hazard it creates) and helped the real economy – the manufacturing and services sector through a series of stimuli. All this reiterated one fact – fiscal policy is key to monetary stability.

One of the failures the crisis has thrown up is in the siloed approach to fiscal, monetary and prudential policy making. The Reserve Bank of India is tasked with the job of chalking out a monetary policy stance that primarily targets inflation, and then growth. Off late the emphasis has been on inflation targeting which has led to the decline in manufacturing output. We are at one of the lowest growth trajectories since the "New economics" era began in 1991. The government is tasked with crafting a fiscal policy that will ensure that the economy maintains its growth trajectory, creates jobs (remember we add around 20 million youth to the job queue every year) and also spend on social causes and positive discrimination initiatives. The macro-prudential regulation of the various markets is left to the relevant regulator, with the RBI looking at the Banking system. The RBI has done quite well in ensuring institutional stability and depositor protection quite well. Its track record on the issue of moral hazard – where bankers are sure of being rescued in case of their bets going wrong – needs some attention.

Designing an institutional framework for fiscal policy, fine tuning the governance frameworks, responsibilities, accountability etc, is a complex task. There are many reasons for this complexity. Fiscal policy has multiple objectives, quite a few of which are extremely difficult to quantify. There are trade-offs among this multiplicity of objectives, especially those that involve significant redistribution of resources. And unlike monetary policy, where there is a clear consensus about the long-run neutrality of money and the high costs of inflation, there is no such