International Journal of Innovations & Research Analysis (IJIRA)
ISSN :2583-0295, Impact Factor: 5.449, Volume 02, No. 04(I), October- December, 2022, pp 39-42

# MEASURES OF FINANCIAL STABILITY IN INDIA: A REVIEW

Dr. Vijaylaxmi Pareek*

**ABSTRACT**

Given the interdependence and sophisticated interactions of the various elements of the financial system and the real economy, financial stability isn't easy to define or measure. This is often further complicated by the temporal and transnational dimensions of such interactions. Over the past 20 years, however, central bankers and other researchers have attempted to capture financial stability through various indicators of monetary system vulnerability. In fact, in their Financial Stability Reports (FSRs), many central banks try and assess risks to financial stability by focusing on a few key indicators. Additionally, there's an ongoing effort to develop a single aggregate measure that can indicate levels of financial vulnerability or stress.

A comprehensive quantitative measure of monetary system stability that could be indicative of these conditions would help policy makers and financial system participants to:

- Better monitor the financial stability of the system;
- Predict the sources and causes of the financial system.
- Communicate the impact of such situations more effectively;

Approaches to developing these financial stability indicators have changed over the years because the focus of attention has shifted from financial stability micro-prudential to macroprudential. From analyzing early warning indicators to monitoring the health of the banking industry, particularly the danger of individual institution defaults, the main target has shifted to a broader system-wide assessment of risks to financial markets, institutions and infrastructure. Recently, the main target of analysis has shifted further to behavioural dynamics, the building instabilities and the transmission mechanisms of shocks. A key issue underlying these analytical developments is the need to fill data gaps in several areas. This is clearly an ongoing discussion and work.

---

***Keywords:*** *Financial Stability, FSRs, Financial Markets, Micro-Prudential, Transmission Mechanisms.*

---

## Introduction

Financial stability may be a difficult concept to define and even harder to measure. The economic system is stable without undue volatility, stress or crisis. While this narrow definition is comparatively easy to formulate, it fails to capture the positive contribution of a well-functioning economic system to overall economic performance. Indeed, the broader definition of monetary stability includes the smooth functioning of financial markets, infrastructures and sophisticated networks of institutions operating within specific legal, fiscal and accounting frameworks.

Such definitions are more abstract but are more inclusive of the macro-economic dimension of monetary stability and interactions between the financial and real sectors.Financial soundness indicators are methodological tools that help quantify and qualify the soundness and vulnerabilities of monetary systems according to five areas of interests: capital adequacy, asset quality, earnings, liquidity, and sensitivity to plug risk. From this attitude , financial stability are often defined as “a condition in which the financial system – comprising financial intermediaries, markets and market infrastructure – is capable

* Principal, SSG Pareek PG Girls College, Jaipur, Rajasthan, India.

of withstanding shocks and therefore the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions within the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.

In India, the pursuit for financial stability became intense in 1992-93, within the aftermath of a severe balance of payments crisis. Financial sector restructuring and fortification was undertaken well beforehand of the financial crisis of 1997-98, an element grossly under emphasised the explanations available in the literature as to why India remained insulated from the contagious turmoil in the neighbourhood. Inspired by the recommendations of the economic system Board [GoI, 1991], the primary phase of the reform aims to increase the functional autonomy, competitive efficiency, transparency and accountability of the economic system. We've achieved global standards for stressed and robust financial systems. and a stable economic system. the main target of the second stage of financial sector reform is to essentially continue the progress achieved so far based on the recommendations of the Banking Sector Reform Commission (GOI, 1998), that specialize in professionalization, technological, increased openness and therefore the blurring of the lines between banks and non-banks. India's experience suggests that financial stability is often defined in a 'composite' sense.Five components of monetary stability are systematically assessed in the remainder of this paper by comparing policies and performance in the Indian context. After a quick overview of the historical context in which the responsibility for financial stability has evolved. The research also deals with the main elements of financial stability, macroeconomic policies for financial stability; which include the fiscal, monetary and external sector policies, progress made within the ongoing restructuring and improvements in the efficiency of the financial sector; and analyses of the impact of financial sector restructuring on the performance of Indian Banks. The section addresses the efforts to create the infrastructural framework of institutions, markets, payment and settlement systems and provides some Indian perspectives on the fifth element of financial stability, the acceptable international financial architecture. Further, the impact of monetary sector reform on the performance of Indian banks had also been elaborated with the help of panel regressions.

**Macroeconomic Policies for Financial Stability**

While the load of recent evidence traces the sources of financial instability to microeconomic and institutional fragility, it's almost invariably in an unstable macroeconomic environment that these weaknesses give way to ‘demand-driven’ financial crises, especially during a phase of structural transformation.Macroeconomic instability contributes to sudden swings in asset prices and misallocation of resources; the selection and sequencing of policy instruments can exacerbate this volatility Thus, there's a strong complementarity between financial stability and macroeconomic stability. India needed to form the aggregate demand-supply balance more sustainable prior to the introduction of financial sector reforms. The political reaction was partly orthodox and targeted the standard suspects. Fiscal deficits, monetary adjustments for overspending, and controlled rate of exchange overvaluation. At the identical time, the important sector was deliberately liberalized in in order to minimize macroeconomic adjustment losses and to create new growth stimulus as structural changes in the financial system took place.

- Fiscal Policy Although significant fiscal corrections were achieved within the early stages of the reforms, when the Center's public sector deficit fell below 5% of GDP in 1996-1997, economic activity cyclically Providing fiscal stimulus to an economy in recession and wish added pressure. Budget failures occur at the national and native levels. As a result, new government debt issuance pushed up interest rates and restrained the implementation of monetary policy to make sure an interest rate regime conducive to a rapid resumption of growth. On the opposite hand, the experience of the Asian financial crisis suggests that "traditional policy responses supported simple indicators such as the size of the fiscal deficit are not useful tools for assessing progress." Moreover, the main target on fiscal health has deprived affected countries of a potential tool to manage capital inflows.
- In India, the correction of fiscal imbalances has created an environment for broader financial stability measures. particularly , liberating monetary policy from the passive monetization of budget deficits has enabled the establishment of an institutional framework for financial stability. However, recent experience shows that quantitative approaches to budget adjustments have limitations and ultimately face 'quality constraints'. However, actual budget results show a deterioration within the quality of budget adjustments. Spending cuts came almost exclusively in capital spending. Continued decline publicly sector investment has long-term negative effects on

economic growth. The imposition of market interest rates on public sector loans didn't significantly reduce the extent of Fisc's preference for market borrowable resources. On the one hand, interest payments increased sharply. Tax efforts have focused on lowering tax rates instead of broadening the tax base. As a result, the tax/GDP ratio has been steadily declining and therefore the economic structure is tilting towards non-taxable sectors such as agriculture, exports and services. there's now mounting evidence that the federally focused fiscal consolidation process of has lifted fiscal pressures from the national level. Consumer spending has increased and business investment has decreased in states where finances directly impact quality of life.

- Monetary Policy Financial stability considerations have always been important to the conduct of monetary policy in India. In fact, price stability and financial stability are seen as 'mutually reinforcing objectives'. within the 1990s, several factors influenced the stance and structure of India's monetary policy, redefining the pursuit of traditional goals during a fundamental sense: the automatic and Passive monetization, phasing out exchange market considerations after the second half of 1993 Development of various maturity government bond markets and indirect instruments of monetary policy i.e. open market operations, repos, refinancings, debt Management, active debt management policies towards exchange trading with various major financial price corridors. Monetary policy implementation has enabled the creation of monetary conditions that leave simpler interest rate regimes and orderly nominal exchange rate adjustments against overvaluations.
- Foreign national trading policy. The Mexican crisis of 1995 and therefore the recent Asian crisis showed that large current account deficits were a common denominator (Feldstein, 1998). In India, the 1990 crisis showed that his accounting deficit of over 3% of GDP was unsustainable in Indian conditions. External sector action to make sure a sustainable balance of payments in the medium term, that specialize in the axioms of sustainability. a rise in the current account balance relative to GDP can increase the current account deficit relative to GDP. Conversely, if the present account to GDP ratio declines, the present account deficit to GDP ratio should be reduced, and in any case the debt service ratio shouldn't exceed 20% of current income.The implementation of rate of exchange policy in India came under scrutiny and scrutiny, especially during the financial crisis, when emerging markets suffered the consequence of offering speculators a target. Since 1975, exchange rates are pegged to a basket of currencies that make up India's major trading partners.A 20% currency devaluation in 1991, followed by a learning period on dual exchange rates, paved the way for the introduction of a market-based rate of exchange system in March 1993. Floating rate of exchange interventions may require orderly market conditions without a pre-determined target or range to secure the exchange rate.The performance of the Exchange Market Pressure (EMP) and Intervention Activity (IIA) indices [updated June 2000 by Patra and Pattanaik, 1998] developed as a part of the asset market approach to determining exchange rates Most exchange rate movements are in the opposite direction of intervention.

Key Macroeconomic Indicators of monetary Vulnerability in the wake of the recent global financial crisis, there has been a surge within the literature on early warning indicators of financial crises, especially in emerging markets. The interest in developing early warning indicators stems from the big costs and lingering aftereffects that crises impose on affected economies. this enables authorities to anticipate vulnerabilities to crises and take preventive measures. supported Goldstein's (1997) study, Reinhart's (1997) and earlier Turner's (1996) study, a 'consensus' indicator for India was identified. Tracking Export Growth - 1990s. consistent with Goldstein, hisoptimal thresholds for every indicator are determined through an iterative process, albeit in country-specific settings. This involves summarizing observations for every indicator over 30 years and choosing a threshold as the upper or lower (as the case may be) upper or lower bound of the distribution containing the worst levels of the indicator in question over the period considered here consists of Relationships with optimal thresholds for these indicators in the 1990s.This section attempts to empirically examine banks' reactions to structural changes within the financial system brought about by changes in the political system. Between 1995 and 1996, RBI published bank-related information on various health, efficiency and financial performance indicators. This data provides invaluable insight into how banks are responding differently to the changing political environment. This reflects, among other things, different risk profiles and different delays in response. This disaggregated information is out there for the various configurations of the Indian banking system through panel regressions extrapolated from key bank data for all commercial banks projected for the period 1995-96 to 1998-99. Allows comparative evaluation of elements. Panel regression may be a useful technique for analyzing the impact of key changes in policy that result in broader motion response functions rather than shifts along the response curve. this sort of analysis typically uses longitudinal data (cross-section observations of variables over a short period of time). Traditional statistic analysis is not applicable in this context thanks to the small number of time points and the aggregated nature of the data. Panel data analysis also removes aggregation bias, allowing analysis of changes in behavior at the firm level. Panel regression also provides a tool to differentiate between the effects of economies of scale and the effects of technological change. Cross-sectional data provide information about economies of scale, while time-series data capture the underlying temporal factors. Panel data analysis combines both to assist resolve apparent dead ends.

## Conclusion

The reform agenda within the 1990s cantered on measures to create financial stability. Approaches to financial stability responsibilities have country-specific characteristics. there's still work to be done to find a dynamic, well-diversified and competitive financial sector with multiple intermediaries operating in several segments of the financial market, but the demand from financial intermediaries, especially banks the initial adjustment response is reassuring. The complementarity between macroeconomic and monetary policies has provided a solid infrastructure for overhauling the financial system in pursuit of international standards. This minimized negative selection and multiple equilibria within the banking system. Stylized facts and empirical results show that banks that have achieved the best deleveraging have made the greatest profits in terms of profitability, or a minimum of in terms of the release of financial capacity through policy interventions. In-crease. Capital adequacy ratios have nearly always led to improved performance. For public sector banks, evidence of flight-to-quality suggests that the appliance of capital adequacy ratios may not have led to 'riskier' portfolio selection as has been the case in some other countries. Suggests. Generally, the Indian banking industry has adjusted to macro- and micro-prudential regulation relatively quickly, although the pace of adjustment varies across industries.

Given the experience of the financial crisis and therefore the chaotic process in the face of market downturns, create an appropriate international architecture that acts as a breaker in a system of multiple equilibria and prevents, or a minimum of mitigates, the occurrence of crises. Efforts to try to to so are intensifying around the world. cost of their occurrence.

## References

1. Ajit, D and R.D. Bangar (1997), “Banks in Financial Intermediation”, Reserve Bank of India Occasional Papers, Special Issue, June and September, 1997.
2. Bery, S.K. (1994), “Financial Rehabilitation of Public Sector Banks: Conceptual and Policy Aspects”, Economic and Political Weekly, XIX, 5 (January 29, 1994).
3. Bhole, L.M. (1999), Financial Institutions and Markets - Structure, Growth and Innovations,
4. Tata McGraw Hill Publishing Co., New Delhi. BIS (1997), Core Principles for Effective banking Supervision, Basle. BIS (1997),
5. Financial Stability in Emerging Market Economics, Report of the Working Party on Financial Stability in Emerging Market Economics, April. BIS (1998), Annual Report, Basle.
6. Crockett, A. (1997), “Why is Financial Stability a Goal of Public Policy”, in Symposium on 'Maintaining Financial Stability in a Global Economy', Federal Reserve Bank of Kansas City, August, 1997.
7. Diamond D.W. & P.H. Dybvig (1983), “Bank Runs, Deposit Insurance and Liquidity”, Journal of Political Economy, 59, 401-19.
8. Fry, Maxwell (1990), “Financial Sector and Economic Development”, The 18th SEANZA Central Banking Course Lectures, RBI, 1990.
9. Stiglitz, J (1997), Statement to the Meeting of Finance Ministers of ASEAN plus 6 with the IMF and the World Bank, December 1, 1997,
10. Vasudevan, A., (1998), “Analytical Issues in Monetary Policy in Transition”, Reserve Bank of India Bulletin, January.