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RBI Working Paper Series 8: A Financial Conditions Index for India

The Reserve Bank of India today placed on its website a Working Paper titled "[A Financial Conditions Index for India](#)" under the Reserve Bank of India Working Paper Series*. This paper is authored by Anand Shankar.

Financial market variables contain information about the future state of the economy. Changes in financial variables often translate into changes in the real economy. Very often financial variables send contradictory signals to economic agents. Further, acute information asymmetry exists in financial markets especially around trigger events during times of crises. Breaking information asymmetry assumes importance since lack of timely and correct information further perpetuates uncertainty and deepens the crisis. To overcome the problem of information asymmetry, financial condition indices (FCI) are constructed.

Even though financial market stress is not directly observable, it often manifests itself in movement of financial market variables. This paper attempts to capture the state of financial conditions by constructing an ordinal and contemporaneous financial conditions index for India. This index is the synthesis of information content in the money, bond, foreign exchange and stock markets. The index shows that tight financial conditions in one market can offset accommodative conditions in some other market thereby making the aggregate conditions tight. Therefore, it is necessary to account for financial conditions in all markets simultaneously in the conduct of policy. The paper also poses some interesting research questions in context of interaction of financial conditions and real variables like GDP growth.

** The Reserve Bank of India introduced the RBI Working Papers series in March 2011. These papers present research in progress of the staff members of the Reserve Bank and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not of the Reserve Bank of India. Comments and observations may kindly be forwarded to authors. Citation and use of such papers should take into account its provisional character.*