Foreword

This Financial Stability Report (FSR), the 5th in the series, is being released against a backdrop of worrisome global and domestic macroeconomic developments. Sovereign default concerns and the need for substantial bank recapitalisation in the Eurozone have escalated fears of contagion and recession. Even as governments respond by reducing public expenditure, widespread dissent against austerity and other harsh measures in times of rising unemployment have led to the fall of several incumbents. Globally, decision making in democracies has become hostage to political polarisation. Confidence in the financial system is low and investors seem to have turned risk averse.

On the domestic front, slowing growth, elevated inflation and large fiscal and current account deficits are serious concerns. The already high fiscal deficit leaves little room for the Government to stimulate the economy. The current account deficit is being increasingly financed by debt flows, threatening long-term sustainability.

On the positive side, the recent decline in petroleum prices, if sustained, can provide some relief. The projected normal monsoon and the inherent resilience of the Indian economy could provide the needed momentum to growth, provided appropriate policy actions are initiated to contain the deficits and improve the investment climate. Further, despite some negative indicators, particularly on asset quality, the Indian financial sector has remained sound and resilient. Banks continue to be well capitalised with leverage at healthy levels.

Through these half-yearly FSRs, the Reserve Bank hopes to share the results of its macro prudential surveillance with the market, to encourage debate, to create awareness of the vulnerabilities in the system and even to initiate prompt corrective action. As in the case of the previous FSRs, this issue of the Report reflects the collective assessment of the Sub Committee of the Financial Stability and Development Council (FSDC) on potential risks to financial stability.

The dictum for central bankers used to be akin to how mothers, across cultures and across time, have admonished their children: 'If you can't say anything nice, don't say it at all'. That dictum is no longer valid. Today central banks and regulators have to bear the responsibility of striking the right balance between presenting a candid and accurate picture and not causing unnecessary alarm. Robert Shiller, in an interview published in Central Banking Journal regarding his latest book on 'Central Banks and their Role in a Good Society', says "*... This gets back to a basic issue about central bank policy that they have a sense that they are criticised whenever they rock the boat; whenever they say something that alarms markets. There might be a bias in central bank thinking towards short run stability when they should be making provocative statements from time to time...*"

The endeavour of our FSRs has been to explain the known knowns and indicate the known unknowns. Making people aware of the problem goes a long way in mitigating it. Timing of an alert or a warning is, of course, crucial. As the French novelist, Marguerite Yourcenar, commented "*being right too early is being wrong*".

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