

Foreword

There is optimism on global economic prospects after years of sluggish growth. At the same time dilemmas seem to continue on normalisation of monetary policy in Advanced Economies. This might have lent comfort to the financial markets as seen from the record stock prices and benign treasury yields in the US. However, geopolitical risks remain elevated which could have implications for financial markets and the broader economy.

2. The domestic outlook remains positive with macroeconomic stability. Liquidity conditions remain easy. The current account deficit remains contained. Going forward, expectations of accelerated reforms and political stability reinforce the economic outlook. However, weak investment demand, partly emanating from the twin balance sheet problem (a leveraged corporate sector alongside a stressed banking sector) is a major challenge. Retrenchment of credit by public sector banks is partly offset by NBFCs, mutual funds and the capital market but they cannot fully substitute for banks in a bank-based financial system like ours. Hence, steps to restore the health of the banks assume urgency.

3. In this context, the Reserve Bank of India (RBI) and the Government are proactively taking steps to resolve NPA challenges in the banking sector. We have also activated prompt corrective action (PCA) to stem the slide in the banking system. However, nothing can replace credit discipline and appreciation of the sanctity of commercial contracts in order to ensure a robust financial system. Thus additional focus has to be on strengthening the internal governance framework of financial entities and observance of market discipline. This will have a salubrious impact on financial intermediation whereby assumption and sharing of risks is based on risk capacity and not on herd instinct or accounting and regulatory dispensations.

4. Against this backdrop, this FSR reviews the health of the financial system and focuses on the initiatives to strengthen overall financial stability.

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