Foreword

The Financial Stability Report (FSR) for Dec 2013 is being released once again in uncertain times. The US Federal Reserve (Fed) having announced tapering of its QE-3 has finally laid to rest uncertainties on the timing of the initiation of exit, but the pace of exit and the market reaction and adjustment to the withdrawal of liquidity will have to be watched carefully. The commencement of taper should signal a calibrated return to normal liquidity and credit conditions in the global markets and also better pricing of risk. This will mean a repricing of certain assets with consequent volatility. In India, a potential additional source of uncertainty is the coming general election. A stable new government would be positive for the economy. With confidence in the financial system still fragile, six years into the crisis, policy certainty is something investors look for in the current environment.

Despite evidence that the outcomes of the recent spells of easing have had diminishing positive effects on the real sector, central banks seem likely to continue their easy policies to support asset prices. The global financial system appears to have become acclimatized to the current levels of liquidity, so eventual exit could be disruptive. Efforts during the past few months have been directed to make the Indian economy more resilient to the ultimate withdrawal of liquidity from the system and less reliant on unstable external capital for growth. The Fed's announcement that it will phase out QE-3 is a welcome signal that conditions have started on the path of normalization.

The previous FSR was released at a time of volatility unleashed by the Fed's announcement of tapering. As tapering got postponed, EMDEs like India got time to put their house in order. Macroprudential policy measures initiated by the Reserve Bank and the Government have brought some stability to the markets and exchange rate volatility has been contained thus far. The current account deficit has narrowed to sustainable levels. Foreign exchange reserves are adequate and fiscal consolidation is in progress. The outlook for the economy has improved, with export growth regaining momentum, but growth is still weak. The challenges of containing inflationary pressures limit what monetary policy can do. To maintain the momentum gained by the respite, it is imperative that long-delayed legislative reforms are pushed through, stalled infrastructure project clearances continue and fiscal consolidation remains on track.

Non Performing Assets (NPAs) of the banking sector need to be tackled on a priority basis to ensure that they do not grow to alarming proportions. The current level of NPAs do not pose a systemic concern as the CRAR of the banking system is above the prescribed levels and many projects are just delayed, not unviable. But we cannot be complacent.

The FSR outlines the macro financial risks to the financial system and brings out the results of a series of stress tests on the banking system. The report has an in-depth analysis of the asset quality in the banking system and traces the causes leading to the current state of affairs. In addition, the report attempts a study of the vulnerabilities in the corporate sector and developments in various market segments. The stress tests assume extreme conditions and tail events and show that the financial system in India is resilient to stresses at this point in time though continued vigilance is warranted. The report also covers the progress in implementation of post crisis reforms.

The ultimate objective of a stable financial system is to support a vibrant and growing economy and offer easy access to financial services across the country to all of its population. The FSR is a useful periodical health check of our financial system and I hope this issue once again provides useful inputs to all stakeholders.

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Governor

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