Foreword

The global economy is in a tumultuous phase with significant rise in sovereign vulnerabilities in certain advanced economies against a backdrop of weaker outlook for global growth. Emerging markets like ours, on the other hand, face the risk of sudden capital outflows and / or a rise in funding costs, both of which could jeopardise the stability of the domestic economy.

On the domestic front, the growth-inflation dynamics continue to unfold. Growth in 2011-12 is likely to moderate while inflation and inflation expectations continue to remain elevated, although there are some recent signs of easing of inflationary pressures. Elevated global energy prices continue to stress the country's external position. The sharp depreciation in the exchange rate has once again brought focus on the Reserve Bank's exchange rate policy. Fiscal slippages have added to the pressures confronting the domestic economy. The uncertain global environment and domestic headwinds have contributed to increased volatility in domestic financial markets.

The Indian financial sector continues to be sound and resilient. Banks remain well capitalised and are not excessively leveraged. Implementation of the Basel III provisions and migration of some of the larger banks to the advanced approaches under Basel II are expected to improve the alignment of regulatory capital with the risk profile of the banking sector. Some concerns were discernible on the asset quality front even though the NPA ratios of Indian banks continued to compare favourably with those in advanced as well as emerging economies. The Reserve Bank remains vigilant in respect of the underlying trends in asset quality, as well as exuberant credit growth in select sectors and is working on a forward looking provisioning framework.

A year into the functioning of the Financial Stability and Development Council (FSDC), the Sub Committee of the FSDC has evolved as the primary operating arm of the Council while the Council continues to provide broad oversight. The Sub Committee is focusing on issues impacting systemic stability while working towards improved inter-regulatory coordination and greater financial inclusion and literacy in accordance with the mandate of the Council.

This is the fourth issue of the Financial Stability Report (FSR). Each issue has evidenced substantive progress in the assessment of risks to financial stability - both in terms of coverage and in analytical tools to measure and quantify systemic risks.

This issue of the FSR represents, for the first time, the collective views of the Sub Committee of the FSDC on risks to systemic stability and, therefore, hopefully, presents a more holistic assessment of the risks facing the financial system than its earlier versions. The Report has benefitted from the contributions of other financial sector regulators - SEBI, IRDA and PFRDA - and has been enriched by the comments of the members of the Sub Committee of the FSDC.

Systemic risk assessment has been strengthened with the introduction of the Reserve Bank's first Systemic Risk Survey, capturing the views of a wide cross section of market participants and stakeholders. The earlier analytics have been improvised - the network analysis model has been extended to cover non-bank entities; stability indicators spread across different Chapters of the Report have been combined to arrive at a composite indicator that provides direction of risks to financial stability; and a series of single factor sensitivity stress tests as well as macro financial stress tests have been carried out to assess the resilience of the various segments of the financial system.

The global financial crisis and its aftermath have demonstrated that 'risk' is all-pervasive and, often, the point of its impact difficult to gauge beforehand. In an earlier issue of the FSR, I had likened the task of central bankers to that of Sisyphus' rolling a huge boulder up a steep hill, only to watch it roll down. I fall back on Sisyphus once again - this time for his handling of his thieving neighbour, Autolycus[*], by marking the bottom of the hooves of his cattle, to track their passage through the muddy ground. So if the final resting place of risk is hard to observe, we should try to track its path and passage in order to be alert to the risks on the way forward.

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[*] Goodhart, C A E (2004): "Some New Directions for Financial Stability"