

Foreword

This issue of the Financial Stability Report (FSR), the 7th in the series, coincides by happenstance with the fifth anniversary of the collapse of Lehman Brothers that triggered the biggest financial crisis of our times. Subsequently, the Euro Area sovereign debt crisis added fuel to the fire. Concerted action by governments, central banks, regulators and multilateral institutions helped to douse the inferno, but the embers still glow.

This FSR is set in an environment of continued uncertainty at the global level and diffidence on the domestic front. The slowdown in growth is the most worrisome factor, as industrial activity is stubbornly subdued and services remain below trend. Policy measures initiated to improve the fiscal situation have, however, provided some reassurance, and international investors are taking note of this in their assessment of the outlook for India. Following the measures taken to ease the supply bottlenecks, the growth outlook for 2013-14 is relatively optimistic as evidenced by the forecasts of the International Monetary Fund (IMF), the World Bank and the Reserve Bank's own estimates. The asset quality of banks has shown improvement, albeit marginal, since the last FSR (December 2012), but it is too early to make a definitive inference about whether this is a trend.

This FSR highlights *inter alia* the risk to macroeconomic stability from the rising current account deficit (CAD). Cross border volatile capital flows have made India vulnerable to sudden stops and reversals, as evidenced recently, following the slightest hint of exit from quantitative easing (QE) by the Federal Reserve. Both the Government and the Reserve Bank have taken measures to dampen the import of gold in order to restrain the CAD to a more sustainable level. In the short-term, our efforts have been directed at financing the CAD as that will give space and time to put in place structural reforms that will address the more deep-seated problems confronting the economy. While stress tests reveal that the financial system is resilient to shocks currently, deteriorating macroeconomic stability can eventually erode financial stability.

The perception that India is a difficult country to do business in persists, and is inhibiting investment, especially foreign investment. We need to introspect why we rank so low on indices like the Economic Freedom Index (111/144)¹ or Global Competitive Index (59/144)² and why we keep slipping in these rankings.

This FSR also takes stock of the progress in the implementation of the post crisis G20/ Financial Stability Board (FSB) reforms in India in areas like Basle III, regulatory framework, OTC derivatives, supervision of Systemically Important Financial Institutions (SIFIs), oversight of shadow banking, legal entity identifier (LEI) and the like. The nature of the problems and the pace of recovery have differed across jurisdictions, so have their policy responses. The impediments to progress in the implementation of reforms in the form of cross border issues and extraterritorial implications of certain national laws have also been discussed.

In the years before the crisis, the financial sector took on a life of its own with a growing belief that real growth can be generated by sheer financial engineering. That myth is now demolished. We now know that the financial sector has no standing of its own; it matters only to the extent that it aids the growth of the real sector. It is this wisdom that must guide the ongoing global effort at financial sector reforms; it is this wisdom that must inform the Reserve Bank's policies and actions.

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¹ Fraser Institute Canada. (www.freetheworld.com)

² World Economic Forum: The Global Competitiveness Report 2012-2013