

## Foreword

The distinctly different conditions in advanced and emerging market economies pose significant risks for the global financial system. Recovery in advanced economies continues to be tenuous even as inflation concerns emerge. In the US, QE2 is scheduled to end by June 2011, and there is uncertainty about the post-QE2 scenario. The European Central Bank raised its main interest rate, for the first time since July 2008, in April 2011 in a move aimed at combating incipient inflation signals across the Eurozone. Heightened sovereign risk concerns, particularly in the Euro region, and fears of adverse fallout on the financial sector further cloud the sentiments. For the emerging economies, on the other hand, inflation is emerging as a key concern amidst strong domestic demand, rapid credit growth and large capital inflows.

India was one of the earliest movers in tightening the monetary policy to address inflationary pressures. A shift from absorption mode to injection mode since March 2010 has seen an effective rise in policy rates by 400 basis points. Bank lending rates firmed up responding to monetary policy signals as banks progressively passed on the increased costs. Global commodity prices, particularly oil, and performance of the monsoon are the key risk factors to inflation management in the months ahead. A slight moderation in growth is projected for the current year. Pressures on the expenditure side in the form of higher subsidy bill may pose further challenges for fiscal management.

Though the current account deficit for 2010-11 is expected to be around 2.5 per cent, a few external sector indicators suggest some deterioration. While FDI flows have been muted, net FII flows remain strong and ECB flows have seen a significant rebound. Consequently, un-hedged positions of corporates accessing foreign currency funding need to be monitored both by the banks from the credit risk angle and by the systemic regulator from a stability perspective.

The Indian financial sector has remained stable. Banks are well capitalised; the Reserve Bank continues to be vigilant and has taken certain prudential as well as macro-prudential measures in order to enhance the soundness of the banking system. While the focus of regulating the non-banking space continues to be on leverage and systemic interconnectedness, a comprehensive review is underway to revisit certain broad principles that underpin the regulatory architecture keeping in view the economic role and heterogeneity of this sector and the recent international experience.

The two-tier institutional arrangement in the shape of Financial Stability Development Council (FSDC) and its Sub-Committee, for monitoring financial stability on an ongoing basis has been operationalised. Both the main FSDC and its Sub-Committee have so far held two meetings each. Apart from making an assessment of the developments in financial markets and the financial system, the deliberations have focused *inter alia* on strengthening the financial conglomerates monitoring framework, addressing regulatory gaps and inter-regulatory issues related to systemic risk.

Within the Reserve Bank, a number of initiatives have been taken to improve the financial stability analytics to take full account of the different sources of systemic risk. Though systemic risk measurement is in its early stages of evolution, an effort has been made to identify, monitor and address systemic linkages through network analysis model and analyse soft spots in the system using banking stability measures. Reflecting deepening inter-regulatory collaborative process for financial stability, this FSR carries significant contributions from the Securities and Exchange Board of India (SEBI) and the Insurance Development Regulatory Authority (IRDA) on systemic issues pertaining to the respective segments.

Ensuring financial stability cannot be a formulaic rule-based task. The endeavour for the policy makers should be to not get trapped in "commoditised ideas, reductive categories and prepackaged narratives" – trying to fit everything to 'The Bed of Procrustes'<sup>1</sup>.

Mumbai  
June 14, 2011

D. Subbarao  
Governor

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<sup>1</sup> Talib, Nassim: "The Bed of Procrustes", 2010, Random House