Foreword

This FSR, the sixth in the series, is set in an environment of global and domestic macroeconomic instability and uncertainty. The unconventional tools, which central banks and governments used effectively at the beginning of the crisis, have lost some of their edge and effectiveness. The space for fiscal and monetary actions is getting squeezed. Some unintended consequences of the unconventional measures have started manifesting, and the timing and pace of exit from these policies could bring on fresh risks and destabilize the system. Confidence in the financial sector remains low, uncertainty persists and investment climate globally is yet to revive. Europe and Japan are technically in recession. Growth in the US is slow, and if the "fiscal cliff" problem is not resolved effectively and in good time, the adverse macroeconomic impact on the US economy would be large and abrupt, with ramifications for the entire world. China is looking poised to grow reasonably well, but the euphoria over BRICS as a growth engine has been dented.

Economic growth in India has moderated in recent quarters, buffeted by global headwinds and domestic policy uncertainties. Growth, however, needs to accelerate if the momentum of poverty reduction, employment generation and pay off from the demographic dividend is to be accelerated.

The Reserve Bank has been managing the balance between its multiple objectives of price stability, financial stability and sovereign debt management - the holy trinity - under conditions of persistent inflationary pressures, slowing growth, widening current account deficit and a depreciating exchange rate.

The deteriorating asset quality of the banking sector has been engaging the attention of the Bank even though stress tests reveal that the system is still resilient to severe shocks. But one has to be aware that as Julie Dickson[1] says," A shock is a shock because the unexpected happens – the system does not behave the way you think it might". Thus, stress tests cannot capture the entire dynamics of distress. The FSR has therefore, been using a multiplicity of tools and techniques to make an assessment of the shocks to the system.

The recent financial crisis has taught us some very important lessons. The general disenchantment with 'casino banking' in certain developed economies underscored the dangers of over-financialization of the real economy. Stephen G Cecchetti and Enisse Kharroubi in their recent paper on 'Reassessing the impact of Finance on Growth state', "*we estimate that for private credit extended by banks, the turning point is closer to 90% of GDP - somewhat lower than for total credit. Many countries are close to or beyond this level, suggesting that more credit will not translate into higher trend growth. For example, in Portugal, private credit by banks was 160% of GDP at the onset of the financial crisis. The corresponding figure for the UK was 180% of GDP and even reached 200% of GDP in Denmark. By contrast, a country like India, where bank credit is less than 50% of GDP, can still reap significant benefits from further financial deepening in terms of increasing productivity growth.*"

Over the past 60 years, we have seen several episodes of economic growth in different parts of the world. One clear lesson of this experience is that growth is sustainable only if it is inclusive. Governments around the world are therefore anxious that even as they pursue economic growth, they must make that growth process inclusive. There are many ways of understanding inclusive growth: the way I understand it is that inclusive growth is a process where the poor contribute *to* growth and the poor benefit *from* growth. A growth process that increases inequity lacks durability, and indeed even legitimacy, eventually threatening economic and social stability. Given the strong linkage between stability and inclusion, this FSR covers the initiatives by various financial sector regulators towards financial inclusion and literacy and the progress achieved.

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[1] Julie Dickson is the current Superintendent of the Office of the Superintendent of Financial Institutions, Canada.