Market Intelligence & Analytics

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Safe zone vibes

India looks better placed to weather emerging global financial risks

Insight May 11, 2023

Research

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Turbulence and spillover

Financial markets are watching anxiously as the effects of rate hikes by the United States (US) Federal Reserve (Fed) unravel.

Over the past 15 months, the Fed has hiked its policy rate by 500 basis points (bps), the fastest pace of hikes since 1980, to 5.00-5.25%. The sharp rise, after a decade of record low interest rates, has already tested segments such as the tech sector, and small regional banks in the US.

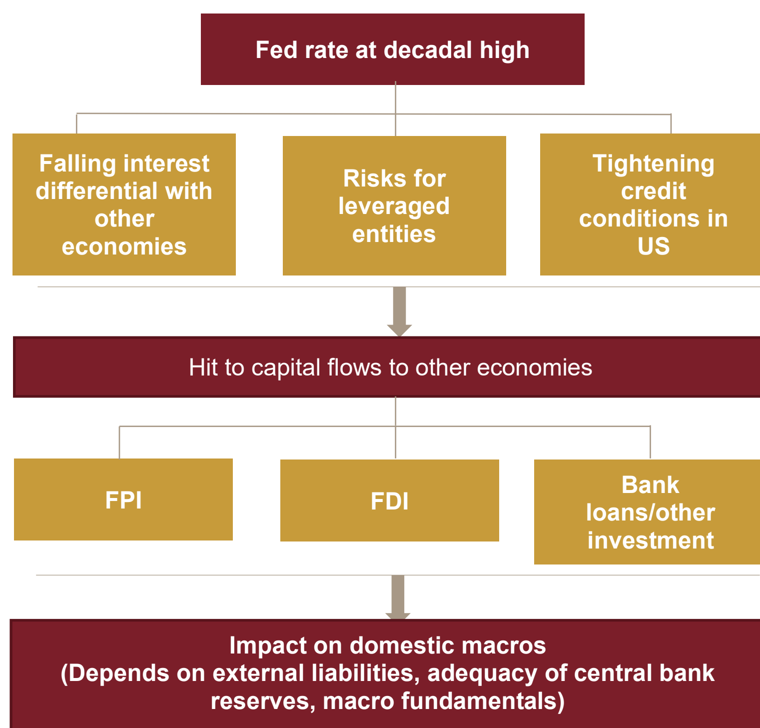
Risks of more malfunctions and further tightening in global financial conditions remain high. The International Monetary Fund (IMF) had equivocally noted this in its April outlook: "Below the surface, however, turbulence is building, and the situation is quite fragile, as the recent bout of banking instability reminded us".

In this insight, we examine how this bubbling cauldron of financial risks could spill over to India. We bring together the risks to watch, the channels of impact, and India's vulnerability to such shocks.

In doing so, we observe that:

1. **Global financial risks remain high:** Uncertainties stem from elevated interest rates in the US and the European Union; a narrowing interest rate differential with other economies, including India; possibility of complications in leveraged market segments, and expectation of tightening credit conditions in the US amid the banking turmoil. These can induce weakness and volatility in capital flows to the world.
2. **Impact on India will be felt more through FDI and FPI flows:** Foreign direct investment (FDI) constitutes the largest share of India's external liabilities, followed by foreign portfolio investment (FPI). Historically, FPIs have been impacted more than FDIs in a rising interest rate scenario. While the pace of FDI has moderated during episodes of a sustained rise in interest rates, they have been trending upwards.
3. **Impact of US banking turmoil on India's banking and lending conditions is expected to be limited:** India's dependence on external loans remains low. The domestic banking system is better positioned to tackle rising interest rates.
4. **India's external funding requirements will likely shrink this fiscal:** Though external financing conditions can be challenging, India's dependence on such funding is expected to reduce this fiscal. India's key external liability – current account deficit (CAD) – will likely be pared this fiscal on lower crude oil prices. This, coupled with the Reserve Bank of India's adequate forex reserves and India's good growth prospects, should cushion the impact of a global spillover on overall macros.

Chart 1: Assessing implications of high US interest rates



Source: CRISIL

Why are global financial risks elevated?

Sharp rise in global interest rates: The primary factor driving financial risks this year are the high interest rates in major advanced economies (AEs).

The Fed has hiked its policy rate to the highest since August 2007. Similarly, the European Central Bank has hiked its policy rates by 375 bps and the Bank of England by 400 bps in the current cycle[1].

And no respite is in sight. Interest rates are expected to stay elevated next year. Even after rate cuts in 2024, S&P Global expects Fed rate to be at 4% until late 2024.

Such a marked rise in interest rates can significantly alter capital flows and asset prices, as noted by the IMF in its Financial Stability Report of April.

Fragilities stemming from leveraged market segments: The sharp rise in interest rates has exposed fragilities in segments that had benefitted from ultra-low rates and surplus liquidity in the past decade. Any crises in these segments can hit global risk sentiment and capital flows. There have been several such instances in the past six months, such as the UK pension fund crisis in October 2022, Silicon Valley Bank collapse, along with takeovers of Credit Suisse and First Republic Bank in 2023.

[1] Until May 10, 2023

Some potential sources of vulnerabilities could be as follows:

Stress in the US: According to S&P Global's Financial Fragility Indicator for the US, financial fragilities of the private sector are at the worst since the 2008 financial crisis[2].

Global non-bank financial intermediaries: The IMF Financial Stability Report highlights that non-bank financial intermediaries (NBFIs) such as pension funds, insurers and hedge funds have grown rapidly in a low interest rate environment post 2008, and account for 50% of global financial assets at present[3].

The IMF study finds vulnerabilities have increased in certain NBFI segments on account of leverage and liquidity mismatches. Moreover, their high interconnectedness with the core financial sector such as banks can amplify their stress through the global financial system.

Record global debt: Global debt is currently at a record high $300 trillion, or 349% of global gross domestic product (GDP), according to S&P Global[4]. Debt servicing could become a challenge with interest rates staying higher for longer.

Financial risks have grown at a time when the world has become more financially integrated. According to Lane and Milesi-Ferretti (2021), global external liabilities crossed 200% of GDP since 2019. By 2021-end, they were higher than 2007 levels *(see chart 3)*.

Chart 2: A sharp rise in US rates not seen in past 3 decades

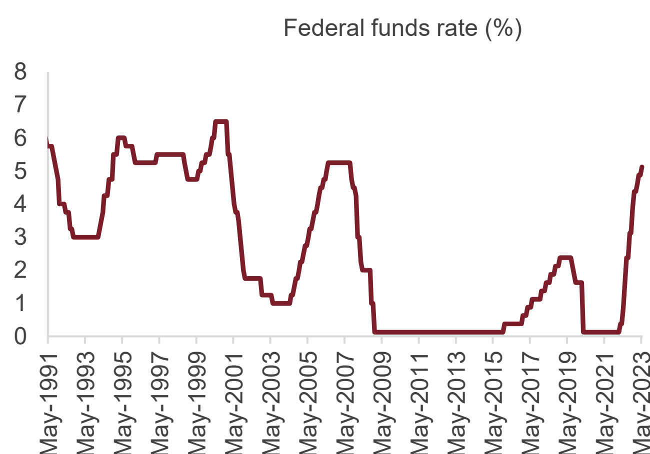
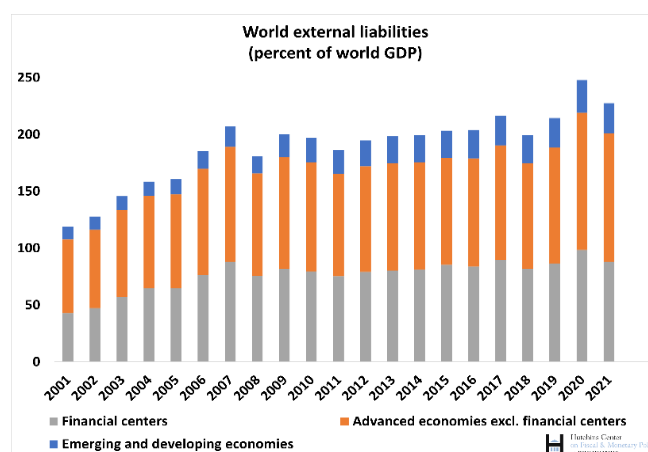


Chart 3: Rising global capital flows increased chances of spillovers of financial risks



Source: US Federal Reserve, CRISIL; Milesi-Ferretti, Brookings[5]

[2] S&P Global (April 2023). *Financial Fragility For US Households And Businesses Hits Its Highest Level Since The Global Financial Crisis*
[3] IMF (April 2023). *Non-Bank Financial Intermediaries: Vulnerabilities amid Tighter Financial Conditions*
[4] S&P Global (March 2023). *Is a Great Reset Coming?*
[5] Milesi-Ferretti (2022). *2021 was a year of strong global capital flows*. Brookings

What could be the channels of impact to the Indian financial system?

Impact of rising interest rates on capital flows: Add the rising interest rates in AEs to their lower country risk, and they become more attractive for capital flows than emerging markets (EMs).

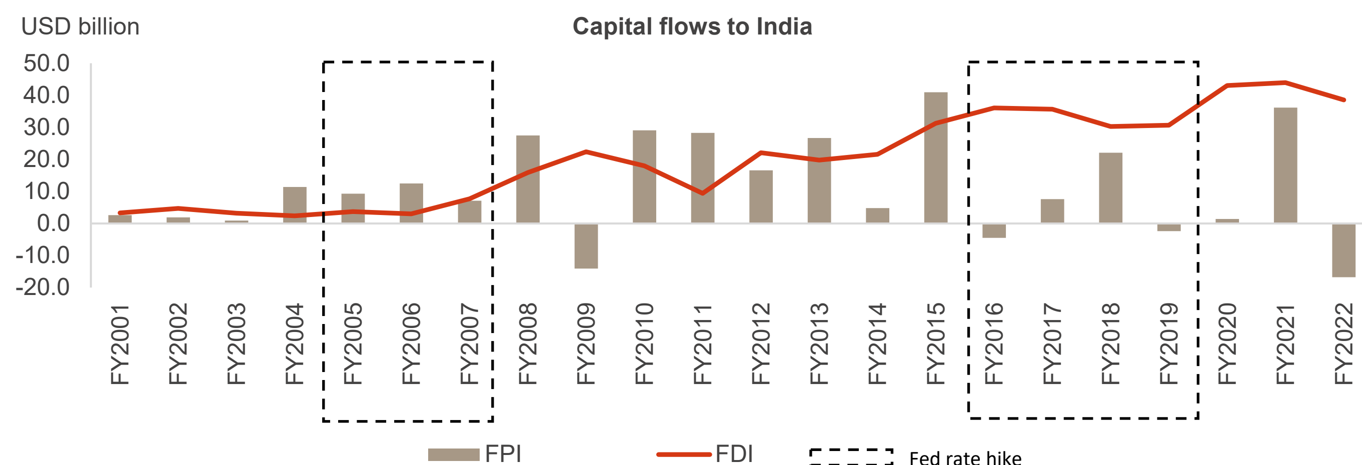
In fact, the 500 bps rise in the Fed rate is double the repo rate rise since 2022. The interest rate differential between the two policy rates is currently the lowest since 2006.

FDI and FPI flows to India have increased significantly post 2008 *(see chart 4)*. While FPIs have been very volatile, influenced more by global developments, FDIs have been on a rising trend.

Both FPI and FDI flows have been hit in periods of rising US interest rates, such as 2018-19, and 2022-23. FPIs were hit more than FDIs. In the first three quarters of fiscal 2023, net FDI was at $21.7 billion and FPI at -$3.5 billion, compared with $24.8 billion and -$1.6 billion, respectively, in the same period of the previous year.

The good news is the FDI flows – considered more durable – are healthy. India's better growth prospects relative to most major economies, with improving macro fundamentals, have helped capital flows.

Chart 4: Capital flows to India hit moderately in periods of rising US rates



Source: RBI, US Federal Reserve, CRISIL

Impact of US banking crisis to cross-border lending: Credit conditions are likely to tighten in the US financial system on account of rising interest rates, and troubles in small banks. This can constrain global lending, especially for those entities and economies linked to the US banking system.

However, India's dependence on the global banking sector remains small. A greater share of capital flows to India are in the form of FDI and FPI flows *(see chart 5)*.

A study by Bank of International Settlements[6] also points out that India and China remain less financially integrated with the world relative to other large EMs.

Therefore, India is likely to see the impact of global shocks mainly through FPIs and FDIs. Contagion risks from the US banking crisis are limited. Moreover, India's dependence on capital flows is expected to reduce next year, driven by the shrinking CAD.

More about that.

Chart 5: Loans from abroad constitute a smaller part of India's external liabilities

Source: RBI, CRISIL

India's vulnerability to global shocks expected to reduce this fiscal

Even as external financing conditions have become challenging, India's vulnerability will likely be lower this fiscal *(see Chart 6)*, driven by the reducing CAD.

CAD is India's major short-term external liability, which affects the exchange rate and investor sentiment.

After peaking at 3.7% of GDP in the second quarter of the previous fiscal, CAD shrank significantly to 2.2% in the third quarter, driven by falling oil imports, boost from services exports, and rising remittances. Lower crude prices will reduce CAD further this fiscal. We expect Brent crude to average ~85 per barrel in the fiscal compared with $95 per barrel in fiscal 2023.

We expect India's CAD to moderate to 2% of GDP this fiscal from an estimated 2.5% of GDP in the previous one.

The other short-term liability, short-term external debt, has been broadly stable as a proportion of GDP. As of December 2022, short- term external debt was 3.8% of GDP, a tad lower than the pre-pandemic five-year average of 3.9%.

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[6] Bank of International Settlements (2018). *Financial spillovers, spillbacks, and the scope for international macroprudential policy coordination*.

Adequate forex reserves will further cushion the impact of external shocks. One way to measure the adequacy of forex reserves is to compare these with our short-term external liabilities, namely the sum of CAD and short-term external debt. This rule, formulated by economists Pablo Guidotti and Alan Greenspan (also former Fed chair) is known as the Guidotti-Greenspan rule. It requires the ratio of forex reserves to short-term liabilities to be at least 1 for reserves to be adequate. For India, this ratio has remained more than 1 for the past decade, and is estimated at 2.7 at fiscal 2023-end.

Chart 6: India's overall macros are well positioned to tackle external shocks

Indicator		FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24F
External liabilities	CAD (% of GDP)	2.7	4.3	4.8	1.7	1.3	1.1	0.6	1.8	2.1	0.9	-0.9	1.2	2.5*	2.0
	External debt (% of GDP)	18.6	21.1	22.4	23.9	23.8	23.4	19.9	20.1	19.8	20.6	21.2	19.9	19.1[$]	N/A
	- Short-term external debt (% of GDP)	3.9	4.3	5.3	4.9	4.2	4.0	3.8	3.9	4.0	3.8	3.8	3.8	3.8[$]	N/A
Adequacy of forex reserves	Months of import cover	9.4	7.6	7.2	7.7	8.7	11.2	11.5	10.4	9.4	11.4	18.0	12.4	9.6	N/A
	Reserves/(short-term debt + CAD)	2.7	1.9	1.6	2.5	3.0	3.4	3.6	2.8	2.5	3.6	7.5	3.8	2.7*	N/A
Domestic macroeconomic health	*GDP growth (% y-o-y)*	8.5	5.2	5.5	6.4	7.4	8.0	8.3	6.8	6.5	3.9	-5.8	9.1	7.0	6.0
	CPI inflation (% y-o-y)	10.4	8.4	9.9	9.4	5.9	4.9	4.5	3.6	3.4	4.8	6.2	5.5	6.7	5.0
	General government gross debt (% of GDP)	66.0	68.3	67.7	67.4	66.8	68.8	68.7	69.5	70.4^	75.1^	89.2^	84.2^	83.5^	83.9^

Vulnerability indicator High Low Neutral

F = CRISIL Forecast; *CRISIL estimate; [$]As of December 2022, ^IMF Article IV, India, December 2022

Source: NSO, IMF, CRISIL

Domestic banking system resilient to tightening financial conditions

According to CRISIL Ratings[7], India's banking system is relatively better positioned to tackle rising interest rates. It is largely insulated from the current banking turmoil emanating from collapse of few regional banks in the US. The root cause of the turmoil — rising interest rates — is less of a risk for our domestic banking sector for the following reasons:

a. The asset books of our banks are dominated more by loans (~70% of deposits) than investments (~30%). Investments are more vulnerable to interest rate risks; moreover, a large part of loans in India are at floating rates

b. Regulations allow banks to hold investments up to 23% of net demand and time liabilities (NDTL) under the held-to-maturity (HTM) category, which significantly shields banks from interest rate movements

c. Interest rates in India did not fall to the same extent as in AEs during the pandemic, while the quantum of rate hikes was lesser. The lower gap between trough and peak interest rates has meant lower sensitivity of bank investments to mark-to-market losses

[7] CRISIL Ratings (April 2023). *Ratings Round-Up, Second Half, fiscal 2023: Positive bias amid cautious clouds*

Better growth prospects than AEs could still attract capital

India’s growth prospects are much better than that of AEs, both in the short and medium term. We expect India to grow at 6.7% per year between fiscals 2024 and 2027. In comparison, US growth is expected to average 1.4%, and eurozone 1.2% during this period according to S&P Global. With these projections, India’s growth differential over these economies will be higher than the past decadal average. This could attract capital flows, especially durable ones such as FDIs. Steady progress on reforms could further improve India’s attractiveness as an investment destination.

In a nutshell, the sharp rise in interest rates in AEs has tightened global financial conditions and poses a risk to capital flows to EMs such as India.

Having said that, India’s reducing CAD will reduce the dependence on external funding this fiscal relative to the previous year. This, coupled with the Reserve Bank of India's adequate forex reserves, and good growth prospects should cushion the impact of a global spillover onto domestic financial conditions.

A caveat: authorities will need to monitor global volatility and maneuver policy accordingly.

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