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Macroeconomics | First cut

Financial conditions begin to tighten

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CRISIL Financial Conditions Index entered the 'tighter zone' in March

CRISIL's Financial Conditions Index (FCI) dropped below the 'zero' mark in March, indicating deterioration in domestic financial conditions.

The index provides a comprehensive monthly update on India's financial conditions by combining 15 key parameters across equity, debt, money and forex markets, along with policy and lending conditions. It is constructed to have an average value of zero and a standard deviation of one over the period starting from 2010. Positive values of the index are associated with easier-than-average financial conditions, while negative values are associated with tighter-than-average financial conditions.

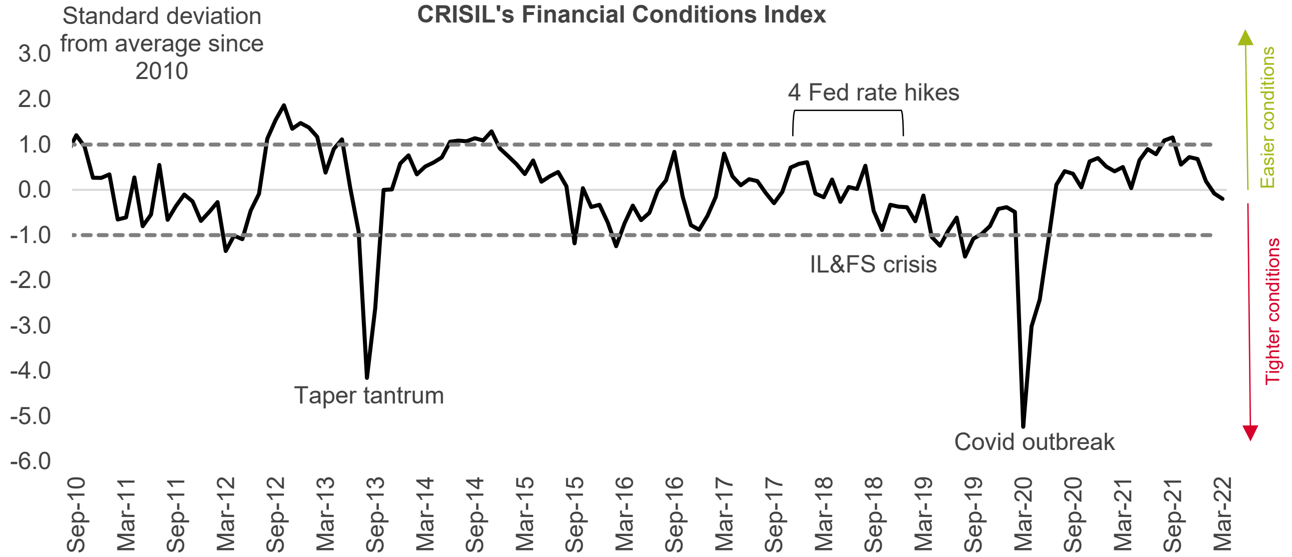
In March, the financial conditions were not only tighter than in the previous month but also relatively tight compared with average conditions in the past decade.

So far, the Reserve Bank of India's (RBI's) accommodative policy has been the key tailwind for domestic financial conditions. However, external headwinds, which were building up in anticipation of the US Federal Reserve's (Fed's) policy tightening, have gained momentum amid the Russia-Ukraine war.

CRISIL's FCI is responding to adverse impact from the external channel. Surging crude oil prices — a major influence on India's macros — is weighing on investors. The US Fed hiked policy rates by 25 basis points (bps) in March and has indicated aggressive tightening this year. This has led to foreign portfolio capital outflows from India, a depreciating rupee, losses in equity markets, and rising yields on government securities (G-secs), all of which pushed domestic financial conditions into the 'tighter zone' in March.

The situation, though, is better — conditions are less tight — than during external shocks of 2013 (taper tantrum) and 2018 (peak US Fed rate hikes post the Global Financial Crisis).

Index slides below ‘zero’ mark



Source: CRISIL

What pushed the index into the ‘tighter’ zone?

One of the fallouts of the Russia-Ukraine war is a tightening of global financial conditions. Significant geopolitical uncertainty, surging commodity prices, overshooting inflation, and tightening monetary policy have all weighed heavy on markets across the globe. These external shocks have also trickled into India’s financial conditions, which have tightened over the past two months.

- **Foreign portfolio investment (FPI) outflows:** FPI outflows increased to $6.6 billion (net of inflows) in March compared with $5.1 billion the previous month. The equity market saw higher outflows of $5.4 billion, compared with outflows of $0.7 billion from the debt market. A series of external factors hit risk sentiment.
  - Crude oil prices surged 20.7% on-month to average $115.6 per barrel in March. This is a key variable of concern as an upswing here impacts most of India’s macros negatively
  - Global financial conditions are tightening with the US Federal Reserve proceeding with monetary policy tightening. It announced its first post-Covid-19 pandemic policy rate hike of 25 bps in March, and has indicated six more hikes for this year. It has also hinted that it would begin reducing its balance sheet (by selling bonds) as early as May. This put pressure on yields in the US as well as globally. Yield on the 10-year US Treasury rose 19 bps on-month to average 2.13% in March, the highest since May 2019.
- **Depreciating rupee:** Rising FPI outflows led the rupee to depreciate 1.7% on-month against the US dollar in March, faster than the depreciation of 0.8% the previous month. The rupee is also facing headwinds from a bloating trade deficit because of rising crude oil prices. The RBI’s intervention in the forex market is taming some of the sharp depreciation.
- **Equity losses:** The equity market was dragged down by negative global cues and large FPI outflows in March. The Sensex declined 2.2% on-month. The market also saw higher volatility, as indicated by Nifty India VIX rising to 25.1 in March from 22.1 in the previous month, and above the long-term average of ~20.

- **Rising G-sec yields:** G-Sec yields hardened across the benchmark yield curve, driven by rising crude oil prices, beginning of US Fed rate hikes, increasing US Treasury yields, and large FPI outflows. Yield on the 10-year G-sec rose 7 bps on-month to average 6.83% in March, the highest level since June 2019.

  External factors are having a bigger impact on yields now that the RBI is unwinding its support to the bond market. The central bank has not been buying G-secs under its open market operations since November 2021. It has also been draining excess liquidity through variable rate reverse repo (VRRR) operations.

- **Weakening domestic liquidity:** While systemic liquidity remains in surplus, it was lower in March than in the previous month. This is evident from the RBI absorbing a lower quantum under its liquidity adjustment facility (LAF; Rs 6.42 lakh crore daily on average in March, compared with Rs 6.88 lakh crore in the previous month). The reduction in liquidity was a result of domestic factors (the RBI's VRRR operations, rising currency in circulation, and bank credit growth) as well as external factors (FPI outflows and the RBI's dollar sales in the forex market).

- **Increasing money market rates:** Reducing excess liquidity is gradually raising money market rates, though they remain below their pre-pandemic levels. In March, the interbank call money rate rose 3 bps on-month to average 3.30%, 91-day Treasury bill increased 2 bps to 3.78%, and 6-month commercial paper grew 4 bps to 4.84%.

Which segments are less affected?

- **Policy rate**: The RBI has kept the repo rate unchanged since the onset of the pandemic. Given the trends in retail inflation, the implied real policy rate (i.e. the repo rate adjusting for inflation based on the consumer price index) has been negative since November 2019. The gap has widened in the last 6 months with rising inflation.

- **Unchanged lending rates:** Bank lending rates as indicated by the 6-month MCLR (marginal cost of funds based lending rate), auto loan rate, and housing loan rate have been unchanged for the past 6 months, all lower than their respective pre-pandemic levels. Benign lending rates, along with improving economic prospects, is leading to a gradual revival in bank credit growth, which rose to 9.6% in March, the highest since December 2019

- **Stable corporate bond yields:** In contrast to rising G-sec yields, yields on corporate bonds — both high and low rated — have been stable. Supply of corporate bonds has been low on account of corporates tapping banks for their funding needs, and reluctance to increase capex.

Outlook

Rising external shocks, coupled with greater domestic vulnerability, could increase capital outflows from the Indian markets, resulting in tighter domestic financial conditions in the coming months. India's vulnerability critically hinges on crude oil prices because they impact its major macros, including the gross domestic product, inflation, current account deficit, rupee and, in some cases, fiscal deficit.

That said, India is expected to be in a better position than during the 2013 taper tantrum, as the current account deficit and inflation are likely to be relatively lower. Moreover, foreign exchange reserves are adequate to cover the country's short-term liabilities. This will help mitigate, if not eliminate entirely, the impact of external shocks on the rupee.

So far, the RBI's accommodative policy has been the major cushion for domestic financial conditions. However, rising inflation and external risks will make the central bank tighten its policy this fiscal. Policy normalisation was already underway with liquidity normalisation through VRRR operations. The RBI has hastened the process of normalisation by restoring the LAF policy corridor to its pre-pandemic width, and indicating withdrawal of accommodation in the coming months. Given the shifting stance, we believe the RBI will hike repo rate by 50-75 bps over this fiscal, which will transmit to market rates and tighten financial conditions. Banks have already begun raising their MCLR rates post April monetary policy, indicating turn of the rate cycle.

Financial conditions across different segments through the last fiscal

		Mar-21	Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22
Policy rate	Repo rate (%)	4	4	4	4	4	4	4	4	4	4	4	4	4
	Repo rate, inflation-adjusted (%)	-1.5	-0.2	-2.3	-2.3	-1.6	-1.3	-0.3	-0.5	-0.9	-1.7	-2.0	-2.1	-3.0
Liquidity conditions	Net absorption(-)/injection(+) under LAF (Rs bn)	-5160	-5508	-4621	-4794	-5774	-7438	-7876	-7485	-7618	-7388	-6372	-6881	-6422
Money market	Call money rate (%)	3.2	3.2	3.2	3.1	3.2	3.2	3.2	3.3	3.3	3.3	3.5	3.3	3.3
	CP 6-month spread^ (%)	0.2	0.1	0.0	0.0	0.1	0.1	-0.1	0.4	0.5	0.6	0.6	0.8	0.8
	91 day T-bill (%)	3.3	3.3	3.4	3.4	3.4	3.3	3.3	3.4	3.5	3.6	3.6	3.8	3.8
Debt market	10-year G-Sec (%)	6.2	6.1	6.0	6.0	6.1	6.2	6.2	6.3	6.3	6.4	6.6	6.8	6.8
	Term premium (%)	2.2	2.1	2.0	2.0	2.1	2.2	2.2	2.3	2.3	2.4	2.6	2.8	2.8
	AAA bond spread' (%)	0.7	0.6	0.7	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.1
	AA bond spread" (%)	2.1	2.4	2.0	1.9	1.4	1.3	1.3	1.8	1.9	2.1	2.8	2.8	2.6
Lending rates	MCLR (6 month) (%)	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.1	7.1	7.1	7.1	7.1	7.1
	Housing loan rate (%)	7.3	7.3	7.2	7.2	7.2	7.2	7.2	7.1	7.0	7.0	7.0	7.0	7.0
	Auto loan rate (%)	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.7	7.6	7.6	7.6	7.6	7.6
Credit availability	Bank credit growth (y-o-y,%)	5.6	5.7	5.9	5.8	6.1	6.7	6.7	6.8	7.0	9.1	7.1	7.9	9.6
Money supply	M3 growth (y-o-y %)	12.2	11.1	10.3	10.7	9.9	9.5	9.3	9.7	9.5	9.9	8.4	8.7	8.7
Equity market	Sensex (%*)	26.0	21.7	22.6	27.3	26.2	29.9	35.5	36.4	31.8	26.0	28.0	22.1	16.9
	NSE VIX	21.9	21.8	20.1	14.9	12.6	13.2	15.7	16.9	16.9	17.2	18.4	22.1	25.1
Forex market	Rs/USD (m-o-m %)	0.0	2.3	-1.6	0.4	1.3	-0.5	-0.8	1.8	-0.6	1.2	-1.2	0.8	1.7
Foreign capital	Net FPI (USD bn)	2.3	-1.2	-0.3	1.8	-1.0	2.2	3.8	-1.7	-0.3	-3.9	-3.8	-5.1	-6.6
Global conditions	S&P500 (%*)	22.5	27.6	26.5	26.5	28.0	28.4	25.9	24.3	27.6	25.7	21.1	16.1	13.6
	US 10Y Treasury yield (%)	1.6	1.6	1.6	1.5	1.3	1.3	1.4	1.6	1.6	1.5	1.8	1.9	2.1
	Brent ($/barrel)	65.2	64.8	68.0	73.1	74.4	70.0	74.6	83.7	80.8	74.3	85.5	95.8	115.6

Favourable Adverse Neutral

*Note: ^spread over the repo rate; term premium is 10-year G-sec's spread over the repo rate; 'spread over 10-year G-sec; "spread over five-year G-sec; *% change with respect to a 2-year moving average; a positive % rupee change implies depreciation against the US dollar and vice versa*

Source: RBI, National Securities Depository Ltd, US Treasury department, CEIC, CRISIL

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