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Macroeconomics | First cut

Edge of the ledge

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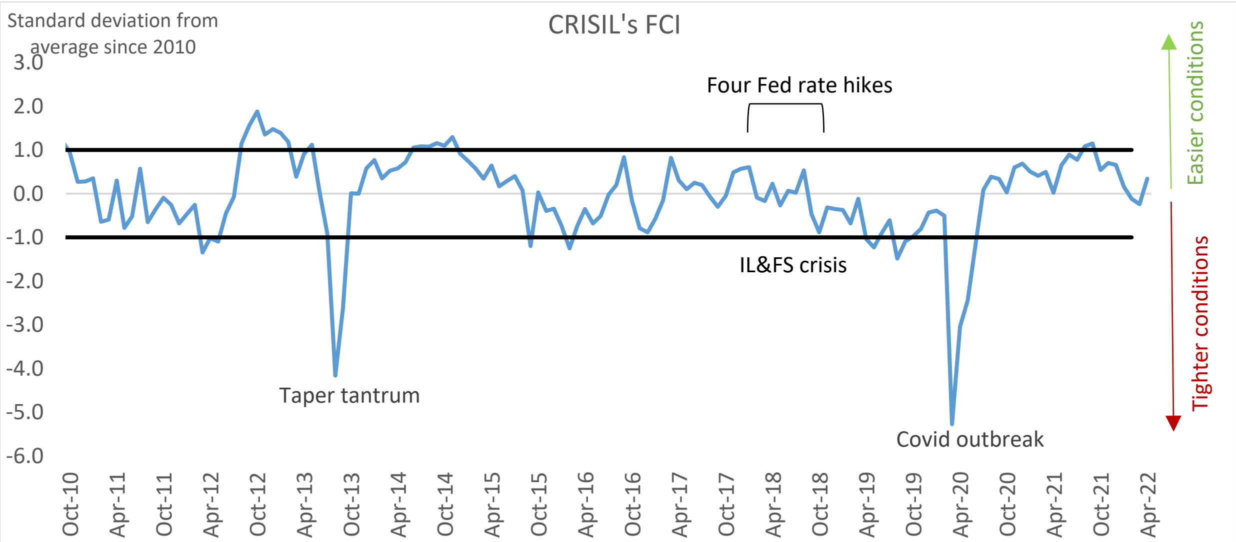
CRISIL's Financial Conditions Index slips back into 'easy zone' in April

Geopolitical developments, and actions by the Reserve Bank of India (RBI) and other major global central banks have made for volatile domestic financial conditions in India this year. CRISIL's Financial Conditions Index (FCI)[1] entered the 'tight zone' in March, as the sudden outbreak of the Russia-Ukraine war triggered massive capital outflows and a surge in global oil prices, causing a debilitating impact on the rupee. In April though, some of these global headwinds stabilised.

On the domestic front, some tightness of interest rates was seen post RBI policy in April, as it announced moves towards further exit from its easy monetary policy, while keeping benchmark repo rate unchanged. This led to a sharp rise in money market and government security (G-sec) yields, transmitting to an increase in lending rates by some banks. Yet, real policy rate stayed negative (as inflation remains higher than repo rate), while bank lending rates remained at decadal lows. This, coupled with improving economic activity, contributed to a recovery in credit growth.

So far, it seems rising interest rates have not constrained supply of credit to the broader economy. Even as RBI is reducing excess liquidity in the system, it remains adequate to support credit growth.

Slight improvement in financial conditions in April



[1] CRISIL's FCI is a monthly tracker based on 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.

Note: Higher index value indicates easier financial conditions and vice versa
Source: CRISIL

External headwinds show some respite

- **Foreign portfolio investment (FPI) outflows reduced** to $3 billion (net) in April compared with $6.6 billion outflows previous month. Paring of outflows, mainly seen in equity markets, helped the benchmark stock indices to recover. The Sensex gained 3.1% on average in the month
- **Brent crude oil prices dropped** to $105.8 per barrel on average in April, compared with $115.6 per barrel the previous month. This eased risk-off sentiment towards India, whose macros are significantly affected by crude price movement. That said, crude prices stayed above $100 per barrel, remaining a pressure point
- **The rupee stabilised** with the reduction in capital outflows and fall in crude prices. It averaged 76.2 per US dollar in April, almost the same level as in the previous month. The RBI's foreign exchange interventions also seem to have helped cushion the rupee.

Flow of credit to broader economy improves

- **Bank credit growth rose markedly** to 11.1% on-year in April compared with 9.6% previous month. This is the highest offtake seen since December 2019. A look at sectoral data (available until March 2022) indicates a broad-based revival in credit across industry, services and retail segments. Improving economic outlook is supporting the credit recovery, as bank lending rates remain benign.
- **While some banks began raising lending rates post April RBI policy, on average, they did not move much in April.** The 6-month marginal cost of funds based lending rate (MCLR), auto loan rate, and housing loan rate remain not only lower than their respective pre-pandemic levels, but also relative to the past decade
- **Money supply improved,** with growth in M3 (broad money) increasing to 10.2% in April from 8.7% previous month. This was driven by increase in growth of currency in circulation and time deposits parked with banks.

Money and bond markets come under pressure

- **Interest rates rose in money and bond markets after RBI policy.** While RBI kept repo rate unchanged in April, it restored the policy corridor under its liquidity adjustment facility (LAF) to the pre-pandemic width of 50 basis points (bps). This was done by introducing a standing deposit facility (SDF) as the floor of the LAF corridor, 25 bps below the repo rate, and 40 bps above the reverse repo rate. The introduction of SDF at that rate indirectly raised the floor of the policy corridor by 40 bps. The RBI further indicated withdrawal of accommodation in the coming months
- **Money market rates rose with rising floor of policy corridor and withdrawal of surplus liquidity.** Call money rates rose 15 bps on-month to 3.45%, 91-day Treasury bill (T-bill) 14 bps to 3.92%, and 6-month commercial paper (CP) 6 bps to 4.89%.
- **Yields rose sharply across all tenors of G-secs.** The benchmark 10 year G-sec yield crossed 7% for the first time in 3 years. RBI's hawkish turn, coupled with rising US Treasury yields and continued FPI outflows, put pressure on yields.

CRISIL's FCI is composed of variables capturing cost as well as the supply of credit in the economy. While cost of funds is moving up, supply of funds is broad-basing (driven by higher credit growth and money supply).

Brace for more pressure ahead

External headwinds are expected to get stronger in the coming months as major central banks increase their pace of tightening to combat inflation. The US Federal Reserve has already raised its policy rate twice until May and outlined its plans for reducing its balance sheet from June. The magnitude of rate hikes has also increased with May seeing a 50 bps increase in the federal funds rate. S&P Global expects five more hikes in remainder of 2022. This will drive the tightening in global financial conditions, impacting capital flows to emerging markets including India.

India is also becoming more vulnerable to external shocks as crude prices remain over $100 per barrel, adversely impacting major macros such as current account deficit, inflation, fiscal position and gross domestic product (GDP) growth. Persisting high crude price environment could further weaken FPIs' appetite for Indian markets.

The RBI has joined the rate hike bandwagon with its off-cycle rate hike of 40 bps in May. Given the deteriorating inflation outlook and the need to move along with tightening global financial conditions, we expect another 75-100 bps hike in repo rate in the remainder of this fiscal.

All these factors are expected to tighten domestic financial conditions, and will reflect in rising interest rates, bank lending rates, weak capital flows and depreciating currency.

How financial conditions moved across various market segments

		Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22
Policy rate	Repo rate (%)	4	4	4	4	4	4	4	4	4	4	4	4	4
	Repo rate, inflation-adjusted (%)	-0.2	-2.3	-2.3	-1.6	-1.3	-0.3	-0.5	-0.9	-1.7	-2.0	-2.1	-3.0	-3.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (Rs bn)	-5508	-4621	-4794	-5774	-7438	-7876	-7485	-7618	-7388	-6372	-6881	-6422	-6545
Money market	Call money rate (%)	3.2	3.2	3.1	3.2	3.2	3.2	3.3	3.3	3.3	3.5	3.3	3.3	3.5
	CP 6-month spread^ (%)	0.1	0.0	0.0	0.1	0.1	-0.1	0.4	0.5	0.6	0.6	0.8	0.8	0.9
	91 day T-bill (%)	3.3	3.4	3.4	3.4	3.3	3.3	3.4	3.5	3.6	3.6	3.8	3.8	3.9
Debt market	10-year G-Sec (%)	6.1	6.0	6.0	6.1	6.2	6.2	6.3	6.3	6.4	6.6	6.8	6.8	7.1
	Term premium (%)	2.1	2.0	2.0	2.1	2.2	2.2	2.3	2.3	2.4	2.6	2.8	2.8	3.1
	AAA bond spread' (%)	0.6	0.7	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.1	0.1
	AA bond spread" (%)	2.4	2.0	1.9	1.4	1.3	1.3	1.8	1.9	2.1	2.8	2.8	2.6	3.0
Lending rates	MCLR (6 month) (%)	7.2	7.2	7.2	7.2	7.2	7.2	7.1	7.1	7.1	7.1	7.1	7.13	7.13
	Housing loan rate (%)	7.3	7.2	7.2	7.2	7.2	7.2	7.1	7.0	7.0	7.0	7.0	6.98	6.98
	Auto loan rate (%)	7.8	7.8	7.8	7.8	7.8	7.8	7.7	7.6	7.6	7.6	7.6	7.58	7.58
Credit availability	Bank credit growth (y-o-y,%)	5.7	5.9	5.8	6.1	6.7	6.7	6.8	7.0	9.1	7.1	7.9	9.6	11.1
Money supply	M3 growth (y-o-y %)	11.1	10.3	10.7	9.9	9.5	9.3	9.7	9.5	9.9	8.4	8.7	8.7	10.2
Equity market	Sensex (%*)	21.7	22.6	27.3	26.2	29.9	35.5	36.4	31.8	26.0	28.0	22.1	16.9	17.8
	NSE VIX	21.8	20.1	14.9	12.6	13.2	15.7	16.9	16.9	17.2	18.4	22.1	25.1	18.9
Forex market	Rs/USD (m-o-m %)	2.3	-1.6	0.4	1.3	-0.5	-0.8	1.8	-0.6	1.2	-1.2	0.8	1.7	-0.1
Foreign capital	Net FPI (USD bn)	-1.2	-0.3	1.8	-1.0	2.2	3.8	-1.7	-0.3	-3.9	-3.8	-5.1	-6.6	-3.0
Global conditions	S&P500 (%*)	27.6	26.5	26.5	28.0	28.4	25.9	24.3	27.6	25.7	21.1	16.1	13.6	11.6
	US 10Y Treasury yield (%)	1.6	1.6	1.5	1.3	1.3	1.4	1.6	1.6	1.5	1.8	1.9	2.1	2.7
	Brent ($/barrel)	64.8	68.0	73.1	74.4	70.0	74.6	83.7	80.8	74.3	85.5	95.8	115.6	105.8

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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