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Macroeconomics | First cut

Rangebound tightening of financial conditions

August 2022

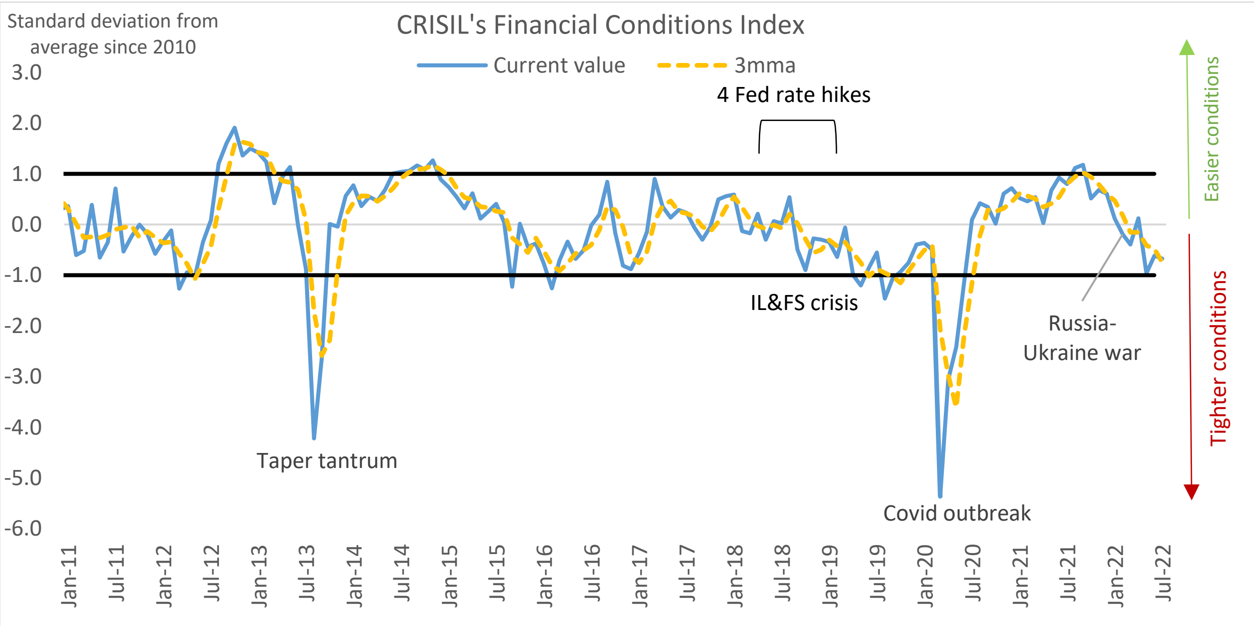
External factors and domestic monetary policies play tug of war on the FCI

Continued monetary tightening domestically has kept financial conditions under pressure in India, despite some respite from external headwinds. Different sub-segments of financial markets have reacted differently to the contrasting domestic and external cues. In July, CRISIL's Financial Conditions Index (FCI) stayed put at the same level as June and within the defined comfort zone. On a trend basis though, the FCI tightened steadily since October 2021.

FCI — based on 15 parameters across money, debt, equity and foreign exchange markets, policy, and lending conditions — came in at -0.7 in July, close to previous month. A value below 0 indicates tighter conditions than the long-term average[1], and a value below 1 standard deviation indicates significant tightening.

The shock of the Russia-Ukraine war is getting replaced by growing concerns of a global economic slowdown. For domestic financial markets, this has brought a mix of positive news (falling commodity prices) and negative news (strengthening dollar). Reserve Bank of India (RBI) has been steady on rate hikes and withdrawal of excess liquidity and tightening bias continues as inflation remains above the upper tolerance band of 6%.

Domestic financial conditions remained mildly tight in July



Note: Higher index value indicates easier financial conditions and vice versa; 3mma refers to 3-month moving average
Source: CRISIL

[1] Average since April 2010

Falling commodity prices bring relief, but dollar remains a sore point

- International commodity prices fell in July, with Brent crude oil plunging to $108.9 per barrel on average in July from a peak of $120 previous month. This helped improve investor sentiment, making foreign portfolio investors (FPIs) net buyers for the first time in 10 months. FPIs net-invested $0.2 billion in July, compared with $6.6 billion net-sales previous month. Sentiment on the equity market improved ($0.6 billion net FPI inflows in July versus $6.4 billion net outflows previous month), while remaining bearish on debt (-$0.3 billion vs -$0.2 billion).
- Despite the return of FPI flows, the rupee depreciated 2% on-month to average 79.6 per United States (US) dollar in July, the sharpest depreciation since April 2021. The key reason was the US dollar, which was the strongest in July since April 2020. India's trade deficit reaching a fresh record high added pressure on the rupee.
- The equity market gained with the return of FPIs, with benchmark Sensex rising 2.2% on-month on average in July. Lower volatility also augured well for the equity market, with NSE India VIX falling to 18.3 on average in July from 21.1 previous month.
- Domestic bond yields eased, driven by falling commodity prices, moderating domestic inflation and easing US Treasury yields. Yield on the benchmark 10-year government security (G-sec) fell 9 basis points (bps) on-month to average 7.39% in July.

Domestic monetary conditions tighten

- With the RBI's rate hikes and moderating inflation, the 'real repo rate', i.e. the repo rate adjusted for inflation, is increasing gradually, though it remains negative.
- The central bank is complementing rate hikes with withdrawal of excess liquidity. Systemic liquidity, while remaining in surplus, has reduced to the lowest level since August 2019. This is reflected in the RBI net-absorbing Rs 1.9 lakh crore (1.1% of NDTL[2]) in July on average, compared with Rs 2.9 lakh crore (1.7% of NDTL) previous month. The RBI's increased sales of G-secs under open market operations and variable rate reverse repo operations drove the liquidity reduction. Liquidity also decreased as bank credit grew (14.5% vs 12.1%) at a faster pace than deposits (9.1% vs 8.3%). The RBI's sales of US dollars to prevent excess rupee depreciation is likely to have contributed to reducing rupee liquidity as well.
- Rate hikes and liquidity reduction are leading to a surge in money market rates. The interbank call money rate rose 38 bps on-month to average 4.8% in July. It also crossed the repo rate intermittently in July during brief periods of liquidity crunch, which reversed with the RBI intervening with repo operations.
- Transmission of rate hikes is progressing to bank rates as well, with the deposit rate rising 27 bps on-month, 6-month Marginal Cost-based Lending Rate (MCLR) 32 bps, housing loan rate 30 bps, and auto loan rate 56 bps in July on average. Yet, both the deposit and lending rates remain lower than the pre-pandemic levels.

Credit continues upward march

- Despite the rising lending rates, bank credit growth accelerated for the sixth consecutive month, to 14.5% on-year in July, the highest since February 2019. Sectoral data available until June indicates a broad-based revival across agriculture, industry, services and personal loans.

Financial conditions not growth restrictive yet

The impact of the Russia-Ukraine war is on the wane. It is getting replaced by increasing signs of a global economic slowdown. The positive upshot for India has been falling global prices of crude and other commodities,

[2] Net demand and time liabilities

improving investor sentiment, and easing pressure on the rupee.

The monetary policy seems to be at a crossroads. So far, the RBI has been aggressive with rate hikes, as inflation has been above the target, and the US Federal Reserve (Fed) has been hiking its policy rate to a greater extent. Yet, any sustained change in inflation and Fed trajectory could alter the RBI's pace of tightening in the second half this fiscal.

1. Falling international commodity prices have reduced upside risks on domestic inflation. That said, the impact of monsoon on food inflation remains a monitorable.

2. S&P Global expects the Fed to raise rates by another 75 bps in 2022 and 50 bps by mid-2023. However, it could change its aggressive stance if recession does materialise next year.

Considering these factors, we expect the RBI to raise the repo rate by another 25 bps in the September meeting. Beyond that, the pace of hikes will be guided by incoming data on inflation and the Fed's actions in the second half this fiscal. The terminal repo rate is unlikely to cross 6% this fiscal. Broadly, though we expect financial conditions to gradually enter the tighter zone, we do not believe they will hinder growth this fiscal.

How financial conditions moved across various market segments

		Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22
Policy rate	Repo rate (%)	4	4	4	4	4	4	4	4	4	4	4.4	4.9	4.9
	Repo rate, inflation-adjusted (%)	-1.6	-1.3	-0.3	-0.5	-0.9	-1.7	-2.0	-2.1	-3.0	-3.8	-2.6	-2.1	-1.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (Rs bn)	-5774	-7438	-7876	-7485	-7618	-7388	-6372	-6881	-6422	-6545	-4390	-2921	-1903
Money market	Call money rate (%)	3.2	3.2	3.2	3.3	3.3	3.3	3.5	3.3	3.3	3.5	4.0	4.4	4.8
	CP 6-month spread^ (%)	0.1	0.1	-0.1	0.4	0.5	0.6	0.6	0.8	0.8	0.9	1.5	1.4	1.4
	91 day T-bill (%)	3.4	3.3	3.3	3.4	3.5	3.6	3.6	3.8	3.8	3.9	4.8	5.0	5.3
Debt market	10-year G-Sec (%)	6.1	6.2	6.2	6.3	6.3	6.4	6.6	6.8	6.8	7.1	7.3	7.5	7.4
	Term premium (%)	2.1	2.2	2.2	2.3	2.3	2.4	2.6	2.8	2.8	3.1	3.0	2.7	2.5
	AAA bond spread' (%)	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.2	0.2	0.2
	AA bond spread" (%)	1.4	1.3	1.3	1.8	1.9	2.1	2.8	2.8	2.6	3.0	3.0	3.1	3.3
Lending rates	MCLR (6 month) (%)	7.2	7.2	7.2	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.2	7.3	7.5
	Housing loan rate (%)	7.2	7.2	7.2	7.1	7.0	7.0	7.0	7.0	7.0	7.0	7.30	7.57	7.88
	Auto loan rate (%)	7.8	7.8	7.8	7.7	7.6	7.6	7.6	7.6	7.6	7.6	7.84	7.70	8.3
Credit availability	Bank credit growth (y-o-y,%)	6.1	6.7	6.7	6.8	7.0	9.1	7.1	8.1	8.6	10.1	11.1	12.1	14.5
Money supply	M3 growth (y-o-y %)	9.9	9.5	9.3	9.7	9.5	9.9	8.4	8.7	8.7	9.5	8.8	7.8	8.6
Equity market	Sensex (%*)	26.2	29.9	35.5	36.4	31.8	26.0	28.0	22.1	16.9	17.8	8.1	4.5	5.4
	NSE VIX	12.6	13.2	15.7	16.9	16.9	17.2	18.4	22.1	25.1	18.9	22.6	21.1	18.3
Forex market	Rs/USD (m-o-m %)	1.3	-0.5	-0.8	1.8	-0.6	1.2	-1.2	0.8	1.7	-0.1	1.5	1.0	2.0
Foreign capital	Net FPI (USD bn)	-1.0	2.2	3.8	-1.7	-0.3	-3.9	-3.8	-5.1	-6.6	-3.0	-4.7	-6.6	0.2
Global conditions	S&P500 (%*)	28.0	28.4	25.9	24.3	27.6	25.7	21.1	16.1	13.6	11.6	1.3	-3.2	-3.6
	US 10Y Treasury yield (%)	1.3	1.3	1.4	1.6	1.6	1.5	1.8	1.9	2.1	2.7	2.9	3.1	2.9
	Brent ($/barrel)	74.4	70.0	74.6	83.7	80.8	74.3	85.5	95.8	115.6	105.8	112.4	120.1	108.9

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 5-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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