

Macroeconomics | **First cut**

Brief respite from global headwinds

September 2022

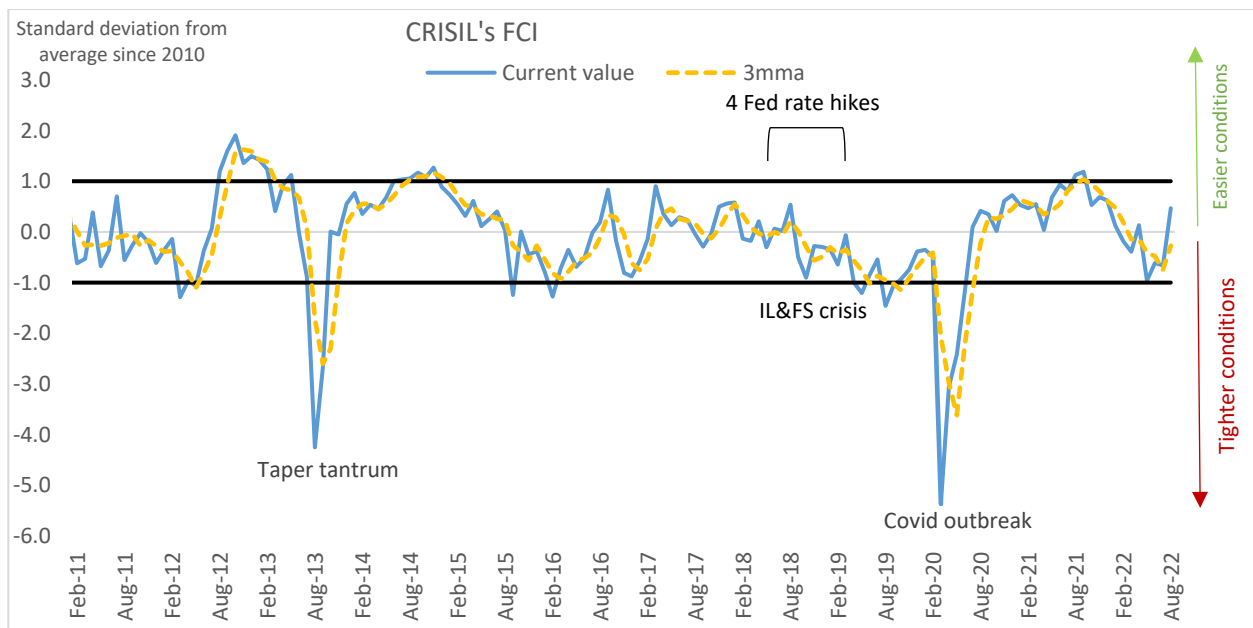
Financial conditions eased in August relative to previous month

Despite the Reserve Bank of India (RBI) hiking the repo rate by 50 basis points (bps) in August as well, financial conditions have remained within the comfort zone, CRISIL's Financial Conditions Index (FCI) shows. Easing global headwinds in the form of falling crude oil prices, weaker dollar, and higher foreign portfolio investor (FPI) inflows, supported the domestic markets.

The FCI – based on 15 parameters across money, debt, equity and foreign exchange markets, policy and lending conditions – came at 0.5 in August, compared with -0.7 previous month. A higher value indicates easier financial conditions, with a value above zero indicating easier conditions compared with the long-term average.¹ The 3-month moving average value remained negative at -0.3 in August.

Global factors such as falling crude oil prices and expectations of less-aggressive United States (US) Federal Reserve actions in the wake of a softer US inflation print for August, played a key role in boosting domestic markets in August. However, global markets remain volatile and could turn adverse as the Federal continues to hike rates aggressively. Meanwhile, the RBI has been steady on rate hikes and withdrawing excess liquidity, which will impart a mild tightening bias to financial conditions.

Domestic financial conditions improved in August



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

¹ Average since April 2010

What supported financial markets in August

- **Falling crude oil prices:** Brent crude oil prices fell 9.5% on-month to \$98.6 per barrel in August, the lowest in six months. This improved investor sentiment towards oil importers like India.
- **Expectations of a less-aggressive Fed:** Inflation in the US showed signs of moderation in August. At the same time, incoming data showed the US gross domestic product decline for the second quarter in a row, fuelling concerns of a recession. This increased market expectations of the Fed slowing the pace of rate hikes. Further, the US dollar index weakened 0.5% on-month. This was a positive for emerging markets like India as it alleviated concerns of tight global financial conditions.
- **Robust FPI inflows:** FPI inflows were the highest in 20 months at \$7.1 billion (net) in August, compared with \$0.2 billion previous month. Most of the FPI inflows went to equity markets (\$6.4 billion versus \$0.6 billion in July). Also flows into the debt market turned positive for the first time in nine months (\$0.5 billion vs -\$0.3 billion).
- **Equity markets gained strength**, with the benchmark Sensex surging 7.9% on-month average in August. Besides positive external developments supporting risk sentiment, investors viewed India's macros to be relatively better placed in the world and domestic economic recovery to be on track
- **Bond yields softened** driven by falling crude oil prices, moderating domestic inflation, higher FPI inflows, along with growing expectations of India's inclusion in global bond indices. Yield on the 10-year government security (G-sec) fell 13 bps on-month to 7.26% average in August. Corporate bond yields eased as well, with higher rated bonds falling to a greater extent.
- **Rupee stabilised** at 76 per dollar on average in August, same as previous month. Weaker dollar index, stronger FPI inflows, along with moderation in India's trade deficit (\$28 billion in August vs \$30 billion previous month), supported the rupee.

What maintained pressure

- **RBI's third rate hike:** The RBI hiked policy rates by 50 bps in August, bringing the repo rate to 5.40%, standing deposit facility rate to 5.15%, and marginal standing facility to 5.65%. This led to a rise in interest rates across money markets and was passed on to bank lending rates to some extent.

Despite the rate hike, the 'real repo rate', i.e., repo rate adjusted for inflation, remains negative. Headline inflation based on the Consumer Price Index remained much higher at 7.0% in August.

- **Liquidity moving towards neutral:** Systemic liquidity, while remaining in surplus, reduced to a 3-year low. This is reflecting in the RBI net-absorbing Rs 1.2 lakh crore (0.7% of NDTL²) in August on average compared with Rs 1.9 lakh crore (1.1% of NDTL) previous month. The RBI's open market sales of G-secs, and rising bank credit growth drove the liquidity reduction.
- **Increasing transmission:** Money market rates rose for the sixth month in a row. The interbank call money rate rose 23 bps on-month to 5.0% average in August, but stayed below the repo rate. Rising demand for credit has also led to increased issuances of certificates of deposit (CDs) by banks. Interest rate on the 6-month CD increased 16 bps on-month average. Transmission of rate hikes to bank rates is improving as well, with the 6-month marginal cost-based lending rate (MCLR) rising 13 bps on-month in August.

Credit continues the upward march

² Net demand and time liabilities

Bank credit growth remains unhindered by rising lending rates. In August, bank credit grew 15.5% on-year, the highest since 2013. Sectoral data available until July indicates a broad-based revival across agriculture, industry, services and personal loans.

Tight domestic and global monetary policies to maintain pressure

While global factors provided relief in the past two months, risks of external shocks remain significant in the next few months. In particular, the Fed governor belied expectations of softening pace of rate hikes in the recent Jackson Hole meeting, stating their sole focus on bringing down inflation. S&P Global expects the Fed to front-load rate hikes in 2022, with a rate hike of 75 bps likely in September.

Minutes of the RBI's monetary policy meeting in August highlight that the members regard inflation as unacceptably high. Indeed, CPI inflation rose again to 7.0% in August, staying above RBI's target for the eighth month in a row. We expect a 25 bps hike in the repo rate by the RBI in September meeting.

Hence, interest rates could remain under pressure in the remainder of this fiscal because of rate hikes by the RBI and the US Fed. Rupee also faces risks from a possible tightening in global liquidity amid elevated current account deficit.

That said, crude oil prices remain lower than post-war highs, which will support investor sentiment. The impact of idiosyncratic factors such as India's possible inclusion in global bond indices and its improved positioning vis-à-vis other economies amid the current geopolitical environment, will also be a monitorable. In September so far, some of these factors have helped buoy Indian bonds and equities, despite growing worries of an aggressive Fed.

How financial conditions moved across various market segments

		Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22
Policy rate	Repo rate (%)	4	4	4	4	4	4	4	4	4	4.4	4.9	4.9	5.4
	Repo rate, inflation-adjusted (%)	-1.3	-0.3	-0.5	-0.9	-1.7	-2.0	-2.1	-3.0	-3.8	-2.6	-2.1	-1.8	-1.6
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	-4.5	-4.8	-4.5	-4.6	-4.3	-3.8	-4.0	-3.7	-3.7	-2.5	-1.7	-1.1	-0.7
	Call money rate (%)	3.2	3.2	3.3	3.3	3.3	3.5	3.3	3.3	3.5	4.0	4.4	4.8	5.0
Money market	91 day T-bill (%)	3.3	3.3	3.4	3.5	3.6	3.6	3.8	3.8	3.9	4.8	5.0	5.3	5.5
	CP 6-month rate (%)	4.1	3.9	4.4	4.5	4.6	4.6	4.8	4.8	4.9	5.9	6.3	6.3	6.4
Debt market	10-year G-Sec (%)	6.2	6.2	6.3	6.3	6.4	6.6	6.8	6.8	7.1	7.3	7.5	7.4	7.3
	Term premium (%)	2.2	2.2	2.3	2.3	2.4	2.6	2.8	2.8	3.1	3.0	2.7	2.5	2.0
	AAA bond spread' (%)	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.2	0.2	0.2	0.2
	AA bond spread" (%)	1.3	1.3	1.8	1.9	2.1	2.8	2.8	2.6	3.0	3.0	3.1	3.3	3.1
Lending rates	MCLR (6 month) (%)	7.2	7.2	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.2	7.3	7.5	7.6
	Auto loan rate (%)	7.8	7.8	7.7	7.6	7.6	7.6	7.6	7.6	7.6	7.84	7.70	8.3	8.5
	Housing loan rate (%)	7.2	7.2	7.1	7.0	7.0	7.0	7.0	7.0	7.0	7.30	7.57	7.88	8.3
Credit availability	Bank credit growth (y-o-y,%)	6.7	6.7	6.8	7.0	9.1	7.1	8.1	8.6	10.1	11.1	12.1	14.5	15.5
Money supply	M3 growth (y-o-y %)	9.5	9.3	9.7	9.5	9.9	8.4	8.7	8.7	9.5	8.8	7.8	8.6	8.9
Equity market	Sensex (%*)	29.9	35.5	36.4	31.8	26.0	28.0	22.1	16.9	17.8	8.1	4.5	5.4	11.8
	NSE VIX	13.2	15.7	16.9	16.9	17.2	18.4	22.1	25.1	18.9	22.6	21.1	18.3	18.6
Forex market	Rs/USD (m-o-m %)	-0.5	-0.8	1.8	-0.6	1.2	-1.2	0.8	1.7	-0.1	1.5	1.0	2.0	-0.1
Foreign capital	Net FPI (USD bn)	2.2	3.8	-1.7	-0.3	-3.9	-3.8	-5.1	-6.6	-3.0	-4.7	-6.6	0.2	7.1
Global conditions	S&P500 (%*)	28.4	25.9	24.3	27.6	25.7	21.1	16.1	13.6	11.6	1.3	-3.2	-3.6	1.5
	US 10Y Treasury yield (%)	1.3	1.4	1.6	1.6	1.5	1.8	1.9	2.1	2.7	2.9	3.1	2.9	2.9
	Brent (\$/barrel)	70.0	74.6	83.7	80.8	74.3	85.5	95.8	115.6	105.8	112.4	120.1	108.9	98.6

Legend: ■ 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 dollar, and vice versa
 Source: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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