Macroeconomics | First cut

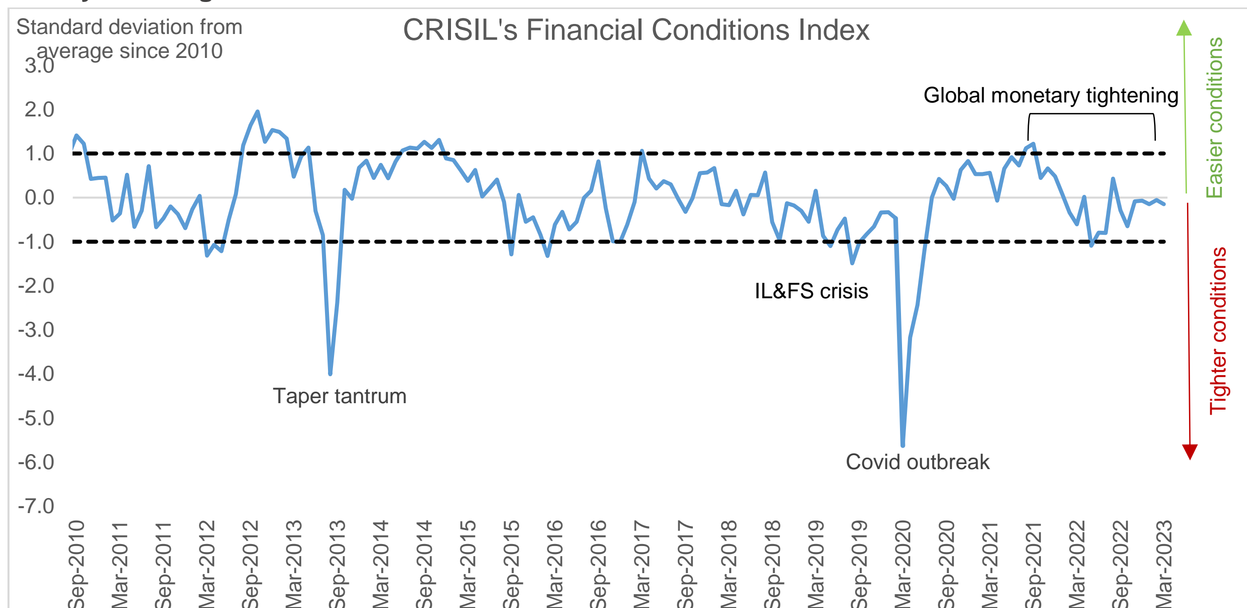
Steady amid global banking turmoil

April 2023

India's financial conditions broadly resilient to global banking disruptions

- The collapse of small banks in the United States (US) and a near-shutdown of a large global bank in Europe roiled global financial markets in March. But only a few market segments in India were affected, and hence the overall domestic financial conditions tightened only mildly in the month.
- CRISIL's Financial Conditions Index (FCI) — based on a comprehensive set of parameters across money, debt, equity and foreign exchange markets, policy, and lending conditions — tightened to -0.15 in March from -0.06 the previous month. However, the index value remained within 1 standard deviation of the long-term average, indicating overall conditions were within the comfort zone.
- The global banking turmoil had a brief impact on Indian markets, predominantly affecting equities. Yet, overall foreign portfolio investment (FPI) was net-positive in the month. A sharp fall in global crude oil prices augured well for Indian importers leading to a mild strengthening in the rupee.
- Monetary policy transmission in the economy continued to improve. While domestic interest rates rose at the short end due to tight domestic liquidity, long-term bond yields were range-bound on concerns of a slowdown in economic growth. Bank lending rates rose steadily, but caused only a slight moderation in credit growth.
- Central banks globally seem close to the end of the rate-hike cycle, but risks of financial disruptions remain high. External risks are higher as the rise in interest rates has been sharper in advanced economies. India's macros remain well positioned for now, but will need to be monitored for any major global spillovers to manoeuvre policy.

Steady in the tight zone



Note: A higher value indicates easier financial conditions, and vice versa. Index within dotted lines (1 standard deviation) represents conditions within comfort zone
Source: CRISIL

Which market segments saw tightening conditions?

- **Equity market:** The collapse of small banks in the US and the near-collapse of a large global bank in Europe within a few days in March hit investor sentiment globally, including in India. Equities suffered the most — US' S&P 500 fell by an average of 2.7% on-month, and India's S&P BSE Sensex followed with a 3.1% decline.
- **Money market:** Rates rose across the money market driven by a slight deficit in domestic liquidity. The interbank call money rate rose 10 basis points (bps) on-month to average 6.50%, staying close to the repo rate.

  Domestic liquidity, which was in large surplus during the pandemic years, reduced gradually in the past 12 months. Since February, it has turned into mild deficit — as indicated by the Reserve Bank of India (RBI) net-injecting funds under the liquidity adjustment facility (details in table below). This has caused the sharpest change in money market rates, which fell the most during the liquidity glut of the pandemic.
- **Banking sector:** Deficit-liquidity conditions are facilitating the transmission of the RBI's rate hikes to bank lending rates and deposit rates. In March, bank deposit rates (1-3 years) rose by an average of 8 bps on-month, 1-year marginal cost-based lending rate (MCLR) by 10 bps, and auto loan rates by 4 bps.

  Compared with the 250 bps hike in the repo rate last fiscal, the transmission is almost complete for home loan rates (243 bps rise so far) but is pending for auto loan rates (190 bps), 1-year MCLR (130 bps), and deposit rates (168 bps).

  Home loan rates stand at 2016 levels, while the other lending rates are at 2019 levels. This suggests borrowing costs have turned slightly restrictive for the domestic economy.

  There are some signs that rising costs may be affecting credit offtake. Bank credit growth moderated to 15% on-year in March from 15.5% the previous month. The sectoral decomposition[1] indicates industrial credit slowed the most, while services were hit to a smaller extent. Retail credit has remained robust and stable so far.
- **Rising real interest rates:** Interest rates are rising in real terms as well, as inflation is declining. The real policy rate (i.e., the repo rate adjusted for inflation) increased to 0.8% in March from 0.1% the previous month, as headline inflation[2] reduced to 5.7% from 6.4%. It remains lower than levels seen before September 2019.

Factors that supported financial conditions

- **Crude oil prices**: International crude oil prices fell sharply as the global banking turmoil made investors factor in a sharper slowdown than anticipated. Brent crude oil prices fell 5.1% on-month to $78 per barrel, the lowest in 15 months. This boded well for net importers such as India and limited the capital outflows amid the global banking disruptions.
- **Foreign capital inflows**: Despite negative global-market sentiment, FPIs were net-buyers in India, investing $711 million in March — in contrast, they net-sold $501 million the previous month.
- **Rupee**: The rupee appreciated a mild 0.4% on-month to average 82.3 against the US dollar, supported by FPI inflows and falling crude prices.
- **Bond market**: The rise in domestic bond yields was limited by expectations of a sharper global slowdown, falling US Treasury yields, and a slide in crude oil prices. The yield on India's 10-year benchmark government security (G-sec) was stable at an average of 7.37% in March, compared with 7.36% the previous month.

[1] Available until February 2023
[2] Consumer Price Index-based inflation

The growth in rates for long-term securities has been lower due to concerns of an impending global slowdown. The term premium of the 10-year G-sec yield over the repo rate fell considerably to 87 bps in March from 283 bps in the year-ago period.

Risk of market disruptions could keep financial conditions volatile

After a year of aggressive rate hikes, major central banks are slowing the pace of monetary tightening. Though this will limit the tightening of financial conditions, the impact of elevated interest rates on various market segments needs monitoring.

The current US federal funds rate at 4.75%-5.00% is the highest since 2007. S&P Global expects it to peak at 5.00%-5.15% by May, and stay there for the rest of 2023.

Such a sharp rise in rates has already caused significant damages to interest-sensitive and leveraged sectors. According to S&P Global's Financial Fragility Indicator for the US, financial fragilities of the private sector are the worst since the 2008 financial crisis. The risk of financial-sector stress amplifying and spilling to the real economy is high, according to the International Monetary Fund's April World Economic Outlook. Such incidents could affect India primarily through volatile FPI flows.

Given the interest-rate risk, the RBI decided to pause the repo rate hike in the April monetary policy and monitor the impact of the 250 bps rate hike implemented over the past year. We believe, unless inflation rises above than RBI's forecast, the RBI would pause and watch the impact of past rate hikes on growth and inflation.

With the ongoing transmission of the RBI's rate hikes, nominal interest rates moved well above the pandemic levels across different market segments. This is expected to slow gross domestic product (GDP) growth this fiscal. We expect the RBI to remain on pause unless inflation deviates significantly from its expectations.

While the phase of aggressive rate hikes may be behind us, the aftereffects on financial conditions, along with any upside to inflation, could pressure financial conditions this fiscal.

Meanwhile, the RBI will need to closely monitor any spillovers from global market volatility, even as a slowdown in rate hikes by major central banks offers partial relief. As growth slowdown seeps in and inflation moderates, we expect the RBI to cut rates by the end of this fiscal.

How financial conditions moved across various market segments

		Pre-pandemic average	Covid years		Fiscal 2023											
		FY16-20	FY21	FY22	Apr-2022	May-2022	Jun-2022	Jul-2022	Aug-2022	Sep-2022	Oct-2022	Nov-2022	Dec-2022	Jan-2023	Feb-2023	Mar-2023
Policy rate	Repo rate (%)	**6.3**	*4.0*	*4.0*	4	4.4	4.9	4.9	5.4	5.4	5.9	5.9	6.25	6.25	6.5	6.5
	Repo rate, inflation-adjusted (%)	**2.0**	*-2.2*	*-1.5*	-3.8	-2.6	-2.1	-1.8	-1.6	-2.0	-0.9	0.0	0.5	-0.3	0.1	0.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	**-0.5**	*-3.0*	*-3.9*	-3.7	-2.5	-1.7	-1.1	-0.7	-0.4	0.0	-0.3	-0.3	-0.3	0.0	0.0
Money market	Call money rate (%)	**6.2**	*3.4*	*3.3*	3.5	4.0	4.4	4.8	5.0	5.3	6.0	6.0	6.2	6.2	6.4	6.5
	91 day T-bill (%)	**6.5**	*3.3*	*3.5*	3.9	4.8	5.0	5.3	5.5	5.8	6.2	6.4	6.4	6.4	6.7	6.9
	CP 6-month rate (%)	**7.6**	*4.4*	*4.3*	4.9	5.9	6.3	6.3	6.4	6.7	7.5	7.6	7.6	7.7	7.9	7.9
Debt market	10-year G-sec (%)	**7.2**	*6.0*	*6.3*	7.1	7.3	7.5	7.4	7.3	7.3	7.4	7.3	7.3	7.3	7.4	7.4
	Term premium (%)	**1.0**	*1.9*	*2.3*	3.1	3.0	2.7	2.5	2.0	1.8	1.5	1.4	1.1	1.1	0.9	0.9
	AAA bond spread' (%)	**0.6**	*0.7*	*0.5*	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2
	AA bond spread" (%)	**2.0**	*3.6*	*2.0*	3.0	3.0	3.1	3.3	3.1	2.9	3.7	4.0	4.0	4.4	3.8	3.5
Lending rates	MCLR (6 month) (%)	**8.3**	*7.4*	*7.1*	7.1	7.2	7.3	7.5	7.6	7.7	7.8	7.9	8.1	8.3	8.4	8.5
	Auto loan rate (%)	**9.6**	*8.0*	*7.7*	7.6	7.8	7.7	8.3	8.6	8.6	9.0	8.9	9.1	9.2	9.4	9.5
	Housing loan rate (%)	**9.1**	*7.4*	*7.1*	7.0	7.3	7.6	7.9	8.3	8.4	8.8	8.9	9.2	9.2	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	*5.9*	*7.0*	10.1	11.1	12.1	13.4	14.3	15.3	16.6	16.0	14.9	16.3	15.5	15.0
Money supply	M3 growth (y-o-y %)	**9.7**	*12.2*	*9.6*	9.5	8.8	7.8	8.6	8.9	8.6	9.1	8.9	8.7	9.8	9.5	9.0
Equity market	Sensex (%*)	**8.7**	*7.6*	*27.0*	17.8	8.1	4.5	5.4	11.8	9.8	7.8	11.8	10.7	7.3	6.5	2.6
	NSE VIX	**15.6**	*25.8*	*17.9*	18.9	22.6	21.1	18.3	18.6	19.6	18.3	14.6	14.2	15.0	14.1	14.4
Forex market	Rs/$ (m-o-m, %)	**0.2**	*-0.2*	*0.4*	-0.1	1.5	1.0	2.0	-0.1	0.9	2.6	-0.6	0.8	-0.7	0.9	-0.4
Foreign capital	Net FPI ($ bn)	**0.6**	*3.0*	*-1.3*	-3.0	-4.7	-6.6	0.2	7.1	-0.4	-0.4	4.1	1.1	-3.2	-0.5	0.7
Global conditions	S&P 500 (%*)	**8.9**	*14.0*	*24.3*	11.6	1.3	-3.2	-3.6	1.5	-6.4	-9.8	-5.6	-6.0	-5.1	-2.5	-5.3
	10-year US Treasury yield (%)	**2.3**	*0.9*	*1.6*	2.7	2.9	3.1	2.9	2.9	3.5	4.0	3.9	3.6	3.5	3.7	3.7
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	105.8	112.4	120.1	108.9	98.6	90.2	93.1	91.1	80.9	83.1	82.7	78.5

Easier than pre-pandemic five-year average
Close to pre-pandemic five-year average
Worse than pre-pandemic five-year average

*Note: #The RBI hiked the repo rate to 5.90% at September-end; ^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 two-year moving average; a positive % rupee change implies depreciation against the US dollar and vice versa*
Source: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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