Macroeconomics | First cut

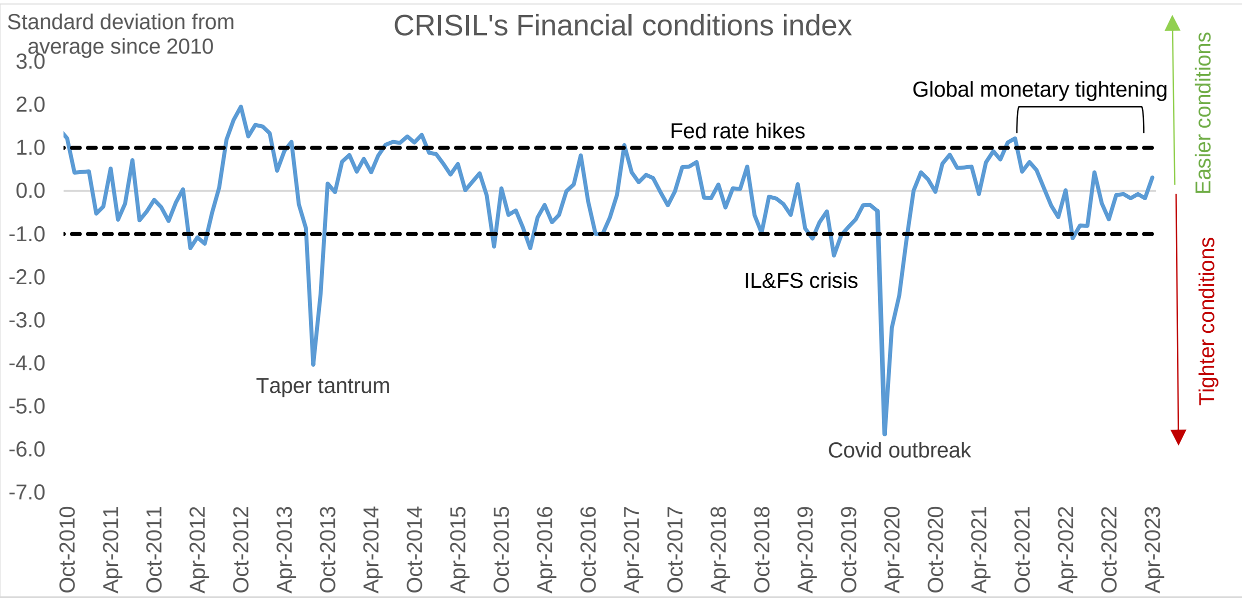
Mint Road non-move eases financial conditions

May 2023

Financial conditions eased after RBI's surprise pause in April

- Financial conditions in India eased in April after Reserve Bank of India (RBI) paused on rate hikes in its monetary policy.
- CRISIL's Financial Conditions Index (FCI) — a monthly tracker combining parameters across money, debt, equity and foreign exchange markets, policy, and lending conditions — increased to 0.3 in April from -0.2 in March. A higher value means easier financial conditions, and vice versa.
- The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) keeping policy rates unchanged in April came as a surprise to most market participants. While the MPC kept options open, inflation falling below its target threshold of 6% increased market bets of a pause during the monetary policy review in June. Market interest rates eased, and equities surged.
- Global market sentiments stabilised after a bout of volatility because of regional banking issues in the US. But worries reappeared towards the end of April as uncertainty around First Republic Bank intensified. In India, however, foreign portfolio investors (FPIs) increased their buying of shares.
- External risks remain high because of the possible impact of elevated interest rates in advanced economies on the leveraged market segments. However, India's macroeconomic fundamentals are expected to improve this fiscal, which should cushion its vulnerability to global shocks. This, coupled with a pause on rate hikes by the RBI and US Federal Reserve, should limit tightening of domestic financial conditions going ahead.

Financial conditions ease in April



Note: Index within dotted lines (1 standard deviation) represents conditions within comfort zone; Source: CRISIL

Why did financial conditions ease in April?

- **Pause on rate hikes**: The MPC kept policy rates unchanged in April, keeping the repo rate at 6.5%. This was against wide market expectations of one 'last rate hike of the current cycle'. While the RBI indicated its readiness to move if inflation surprised on the upside, incoming headline inflation print, based on the consumer price index (CPI), eased to 5.7% in March – below MPC's upper threshold of 6%. This increased market expectations of policy rates having peaked, and another pause during the June review meeting.

  It is notable that even with unchanged repo rate, the 'real' repo rate i.e., repo rate adjusted for inflation, is increasing with falling inflation. The real repo rate (ex-post) stood at 1.8% in April, the highest since August 2019. It is expected to continue increasing with further fall in inflation in the coming months.

- **Improving liquidity conditions**: Systemic liquidity turned surplus after two months. This was reflected in the RBI net-absorbing Rs 1.5 trillion (0.8% of NDTL) under liquidity adjustment facility (LAF) in April, in contrast to the RBI needing to inject Rs 12.7 billion (0.01% of NDTL) in March. Increase in government spending and FPI inflows contributed to improving liquidity in April.

- **Easing money market rates**: MPC's pause and improving liquidity eased interest rates across money market instruments, with the interbank call money rate falling 3 basis points (bps) on-month, 91-day treasury bill yield falling 11 bps, and 6-month commercial paper (CP) easing 37 bps in April.

- **Fall in long-term bond yields**: Bond yields eased significantly as investors factored in a pause in rate hikes. Yield on the benchmark 10-year government security (G-Sec) fell 16 bps to 7.21% average in April. Its term premium over repo rate averaged 71 bps, going below pre-pandemic decadal average of 86 bps. Corporate bond yields also eased in tandem.

- **Rising FPIs**: FPIs increased their investment in the Indian markets as global risk sentiment revived with the US banking turmoil staying largely under control. Net FPI buying increased to $1.7 billion from $0.7 billion previous month. Most of the inflows went to equity markets ($1.4 billion in April). The rupee saw a mild appreciation of 0.3% on-month.

- **Improving equities**: Equity markets gained amid the pause in rate hike and rising FPI inflows. The benchmark S&P BSE Sensex gained 2.6% on-month, and market volatility reduced, as per the National Stock Exchange's India VIX index.

Transmission of previous rate hikes continued to increase lending rates

Even monetary policy was hit status quo, certain bank lending rates continued to rise — they hadn't increased to the extent of repo rates so far. In April, the 6-month marginal cost of funds-based lending rate, or MCLR, rose 4 bps on-month, auto loan rates rose 9 bps, while housing loan rates remained unchanged. The 250 bps cumulative hike in repo rate since 2022 has mostly been transmitted to housing loan rates (242 bps cumulative hike), but to a lesser extent to auto loan rates (199 bps).

Overall bank credit growth remains at decadal highs, and even rose to 15.9% in April from 15.0% previous month. However, as per sectoral data available until March, robust credit offtake is mostly driven by retail loans, while it has begun showing slowdown for industry and services.

Peaking of policy rates could offer relief to financial conditions

With inflation on a downtrend, we expect the MPC to keep policy rates unchanged during its review meeting in June. Since March, headline inflation has fallen below 6%, and we expect further easing for another month or two due to high-base effect. Meanwhile, real policy rates will continue to rise. As inflation moderates and growth slowdown seeps in, we expect the MPC to cut rates by the end of this fiscal.

The Fed is also expected to hit a pause after 15 months of aggressive rate hikes. At 5.00-5.25%, the federal funds rate is the highest since 2007. S&P Global expects it to stay at this level for the rest of 2023.

Elevated interest rates remain a risk for financial conditions. Risks are higher in advanced economies since they saw a sharper rise in interest rates from pandemic lows. Capital flows to India could be hit from low interest rate differential with advanced economies, and possible market accidents emanating from US banking sector and other leveraged global market segments.

Yet, India's dependence on external financing is expected to reduce this fiscal. India's key external liability — current account deficit — will likely be pared this fiscal on lower crude oil prices. This, coupled with the Reserve Bank of India's adequate forex reserves and India's good growth prospects, should cushion the impact of a global spillover on overall macros.

Resilience to global spillovers, coupled with peaking domestic interest rates could halt further tightening in financial conditions going ahead.

How financial conditions moved across various market segments

		Pre-pandemic average FY16-20	May-2022	Jun-2022	Jul-2022	Aug-2022	Sep-2022	Oct-2022	Nov-2022	Dec-2022	Jan-2023	Feb-2023	Mar-2023	Apr-2023
Policy rate	Repo rate (%)	6.3	4.4	4.9	4.9	5.4	5.4	5.9	5.9	6.25	6.25	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	2.0	-2.6	-2.1	-1.8	-1.6	-2.0	-0.9	0.0	0.5	-0.3	0.1	0.8	1.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	-0.5	-2.5	-1.7	-1.1	-0.7	-0.4	0.0	-0.3	-0.3	-0.3	0.0	0.0	-0.8
Money market	Call money rate (%)	6.2	4.0	4.4	4.8	5.0	5.3	6.0	6.0	6.2	6.2	6.4	6.5	6.5
	91 day T-bill (%)	6.5	4.8	5.0	5.3	5.5	5.8	6.2	6.4	6.4	6.4	6.7	6.9	6.8
	CP 6-month rate (%)	7.6	5.9	6.3	6.3	6.4	6.7	7.5	7.6	7.6	7.7	7.9	7.9	7.6
Debt market	10-year G-sec (%)	7.2	7.3	7.5	7.4	7.3	7.3	7.4	7.3	7.3	7.3	7.4	7.4	7.2
	Term premium (%)	1.0	3.0	2.7	2.5	2.0	1.8	1.5	1.4	1.1	1.1	0.9	0.9	0.7
	AAA bond spread' (%)	0.6	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2
	AA bond spread" (%)	2.0	3.0	3.1	3.3	3.1	2.9	3.7	4.0	4.0	4.4	3.8	3.5	2.9
Lending rates	MCLR (6 month) (%)	8.3	7.2	7.3	7.5	7.6	7.7	7.8	7.9	8.1	8.3	8.4	8.5	8.6
	Auto loan rate (%)	9.6	7.8	7.7	8.3	8.6	8.6	9.1	9.0	9.2	9.3	9.5	9.5	9.6
	Housing loan rate (%)	9.1	7.3	7.6	7.9	8.3	8.4	8.8	8.9	9.2	9.2	9.4	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	9.7	11.1	12.1	13.4	14.3	15.3	16.6	16.0	14.9	16.3	15.5	15.0	15.9
Money supply	M3 growth (y-o-y %)	9.7	8.8	7.8	8.6	8.9	8.6	9.1	8.9	8.7	9.8	9.5	9.0	9.5
Equity market	Sensex (%*)	8.7	8.1	4.5	5.4	11.8	9.8	7.8	11.8	10.7	7.3	6.5	2.6	4.4
	NSE VIX	15.6	22.6	21.1	18.3	18.6	19.6	18.3	14.6	14.2	15.0	14.1	14.4	11.9
Forex market	Rs/$ (m-o-m, %)	0.2	1.5	1.0	2.0	-0.1	0.9	2.6	-0.6	0.8	-0.7	0.9	-0.4	-0.3
Foreign capital	Net FPI ($ bn)	0.6	-4.7	-6.6	0.2	7.1	-0.4	-0.4	4.1	1.1	-3.2	-0.5	0.7	1.7
Global conditions	S&P 500 (%*)	8.9	1.3	-3.2	-3.6	1.5	-6.4	-9.8	-5.6	-6.0	-5.1	-2.5	-5.3	-1.8
	10-year US Treasury yield (%)	2.3	2.9	3.1	2.9	2.9	3.5	4.0	3.9	3.6	3.5	3.7	3.7	3.5
	Brent ($/barrel)	57.4	112.4	120.1	108.9	98.6	90.2	93.1	91.1	80.9	83.1	82.7	78.5	84.1

Easier than pre-pandemic five-year average

Close to pre-pandemic five-year average

Worse than pre-pandemic five-year average

*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 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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