Macroeconomics | First cut

CRISIL's Financial Conditions Index

January 2024

CRISIL launched the Financial Conditions Index (FCI) in October 2020 and since then three key features have stood out.

First, in addition to the Monetary Policy Committee's (MPC) rate actions, the Reserve Bank of India's (RBI) liquidity management measures are increasingly playing a key role in shaping financial conditions by enabling faster transmission of rate changes to market interest rates.

Second, external capital flows can either offset or reinforce the effect of monetary policy actions, in turn, impacting domestic financial conditions.

For instance, even before the MPC started raising the repo rate, removal of excess liquidity from the system nudged the FCI towards the tighter zone. Also, there have been instances when despite a repo rate hike and/or tighter liquidity conditions, the FCI eased, supported by large foreign capital inflows.

Third, existing economic conditions that influence demand for funds are also affecting financial conditions and sometimes even negating the two factors mentioned above.

For instance, despite the weighted average bank lending rate staying high at 8.75%, bank credit growth has remained fairly strong this year at 15-16% because of strong economic growth and banks' appetite to lend. Even in September and October, when the repo rate was at 6.5%, liquidity was in mild deficit and foreign capital saw an outflow, high bank credit growth kept the FCI within the comfort zone.

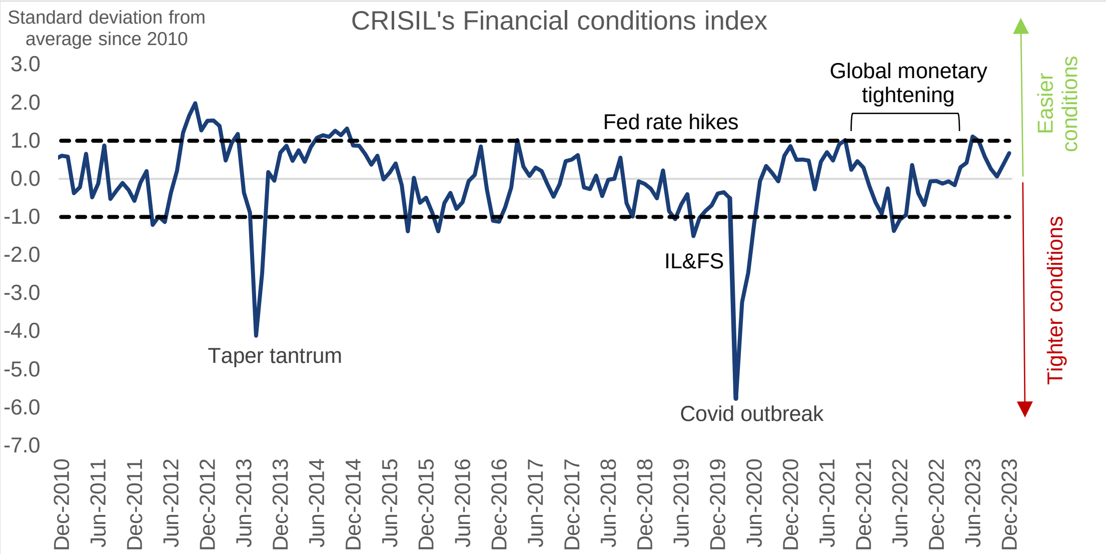
Therefore, tracking financial conditions involves much more than just monitoring the actions taken by the central bank. A monthly index, CRISIL's FCI puts together 15 key parameters across debt, equity, money and forex markets and overlays information on credit and policy conditions to gauge the overall impact. If the index moves up, it implies that domestic financial conditions are easing, and vice versa. If it stays within 1 standard deviation of its long-term average, the conditions are considered comfortable.

Financial conditions find support from FPI inflows in December

- CRISIL's FCI shows domestic financial conditions were easier in December than November. In December, the index rose to 0.7 from 0.4 previous month.
- The financial conditions were primarily boosted by foreign portfolio investor (FPI) inflows that reached a record high during the month. Domestic equities gained the most from the inflows though flows into the debt also remained steady ahead of India's inclusion in the JP Morgan Emerging Market Bond Index
- In the money market, there was some pressure on rates as domestic systemic liquidity was deeper in deficit. But in the banking system, lending rates remained stable and bank credit growth stayed strong.
- The RBI may keep liquidity sufficiently in deficit in the remainder of this fiscal to ensure transmission of its past rate hikes to bank lending and deposit rates. This, and regulatory measures to restrict risky credit could somewhat moderate credit growth in the coming months, entailing some de-facto tightening in domestic financial conditions.
- The upcoming budget could also sway market sentiments depending on how the government treads the road

to fiscal consolidation and what measures it takes to boost growth.

Financial conditions eased in December



Note: Higher value indicates easier financial conditions, and vice versa. The index within dotted lines (1 standard deviation) represents conditions within the comfort zone.
Source: CRISIL

Factors that supported easier financial conditions

- **Surging FPI inflows:** In December, not only did FPIs remain net buyers, they also invested a decadal high amount of $10.1 billion in the domestic financial markets. Net FPI buying in the equity segment rose to $7.9 billion from $1.1 billion in November, the highest since December 2020. Debt market inflows rose to $2.2 billion from $1.8 billion, possibly because of pre-positioning by foreign investors as domestic bonds will be included in JP Morgan Emerging Market Bond Index from mid-2024. FPI inflows into debt were at their highest since 2017.
- **Easing domestic yields:** Yield on the benchmark 10-year G-sec eased for the second straight month to 7.21% on average from 7.27% in November and 7.33% in October. The decline in bond yields over the last two months can be attributed to softening of US Treasury yields, strong foreign investment into the Indian debt market and decline in crude oil prices. On the other hand, the widening deficit in domestic liquidity limited the decline in yields.
- **US treasury yield** cooled for the second consecutive month. The yield on the 10-year Treasury bond eased sharply, averaging 4.02% in December from 4.5% in November and 4.8% in October. During December, the yield fell below 4% for the first time since August. The Fed holding interest rates steady for the third time in a row and signalling the possibility of cumulative rate cut of 75 bps in 2024 led to a sharp drop in yields. The decline in global oil prices was also an important factor behind the fall in yields.
- **Indian equities** continued to see strong gains in December with the market seeing the highest monthly returns of calendar 2023. Both, domestic and global factors were supportive of foreign capital inflows. The S&P BSE Sensex rose 7.7% on average and the Nifty 50, 8%. The stronger-than-expected gross domestic product (GDP) growth of 7.6% for the second quarter, released on the last day of November, buoyed the market at the beginning of the month. The Fed's decision to hold rates steady and its dovish stance on rate cuts boosted foreign capital inflows. Other major central banks maintaining status quo on rates also supported the equities.
- **Crude oil prices eased** to an average of $77.9 per barrel in December from an average of $82.3 per barrel in November, a 6.4% decline on-month. However, shipping disruptions along the Red Sea route capped the decline in prices.

- **Bank lending rates were largely unchanged** in December. Deposit rates averaged 6.8% while housing loan rates averaged 9.3%, unchanged from the previous month. Auto loan rates rose 1 bp to an average of 9.7%. The six-month marginal cost of the fund-based lending rate (MCLR) rose 3 bps averaging 8.8%.

  The RBI's rate hikes have not fully transmitted to lending rates yet. While the repo rate has risen 250 bps since April 2022, the auto loan rate has risen 151 bps, six-month MCLR 163 bps and deposit rates 170 bps. However, in the housing loan segment, the transmission is almost complete as the rate has risen 231 bps during the period.
- **The rupee was stable against the dollar** in December, averaging 83.3 owing to weaker dollar (the US Dollar index declined to an average of 102.7 from 104.5 in November) and the increase in FPI inflows into India.

Factors that were a drag

- **Domestic systemic liquidity** was in deficit for the fourth consecutive month. In fact, the deficit widened as the RBI net injected Rs 1.14 lakh crore (0.5% of NDTL[1]) under the liquidity adjusted facility (LAF), up from Rs 0.6 lakh crore (0.3% of NDTL) in November. The factors that contributed to the worsening of the deficit are faster growth in credit than deposit, increased spending during the festival season, tax outflows and a lower government spending.
- **Money market rates remained under pressure** as the domestic liquidity remained in the deficit zone. The interbank call money rate remained above the repo rate, averaging 6.8% in December. The six-month commercial paper (CP) rate rose 15 bps averaging 8% while the six-month certificates of deposit (CD) rate rose 12 bps averaging 7.7%. The 91-day T-bill rate averaged 7%, 2 bps higher on-month.
- **Bank credit growth mildly slowed** to 15.8%[2] after accelerating to 16.2% in November. Sectoral data[3] for November showed that the pickup in bank credit during the month was because of faster credit growth in agriculture (18.2% vs 17.5%), industry (6.1 vs 5.4%), services (21.9% vs 20.1%) and personal loans (18.6% vs 18%).

Monetary policy transmission may rein in financial conditions

Global market developments remain a source of volatility. While the US Fed tilting towards rate cuts provided relief to markets in December, disruptions in the Red Sea trade route in January have revived tensions in some market segments. Especially, crude oil prices have begun rising around mid-January. Any increase in volatility could affect short-term capital flows into the Indian markets.

That said, the country's healthy domestic growth prospects, low vulnerability of the external sector and the inclusion in the JP Morgan Emerging Market Bond Index augur well for foreign capital flows.

The RBI has stayed steady on policy rates and its stance of 'withdrawal of accommodation'. We believe it will continue to use liquidity and regulatory tools to facilitate a rise in lending rates and to curb credit in risky segments. All these can contribute to some tightening in financial conditions even as the repo rate remains unchanged this fiscal.

The upcoming Budget can also affect market sentiments, as it would indicate the path the government is likely to take to reduce fiscal deficit. Any growth boosting measures, such as a fresh push to capital expenditure, can lift the investor sentiments.

[1] Net demand and time liabilities
[2] As on December 15, excluding the impact of the HDFC merger
[3] Excluding impact of HDFC merger

How financial conditions moved across various market segments

		Past 3 years' annual average			Current fiscal							
		FY21	FY22	FY23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23
Policy rate	Repo rate (%)	4.0	4.0	5.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	-2.2	-1.5	-1.1	2.2	1.7	-0.9	-0.3	1.5	1.6	0.9	0.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	-3.0	-3.9	-0.9	-0.4	-0.6	-0.8	-0.6	0.1	0.2	0.3	0.5
Money market	Call money rate (%)	3.4	3.3	5.4	6.6	6.5	6.5	6.6	6.7	6.7	6.8	6.8
	91 day T-bill (%)	3.3	3.5	5.8	6.8	6.7	6.7	6.8	6.8	6.9	6.9	7.0
	CP 6-month rate (%)	4.4	4.3	6.9	7.6	7.5	7.4	7.5	7.6	7.8	7.9	8.0
Debt market	10-year G-sec (%)	6.0	6.3	7.3	7.0	7.0	7.1	7.2	7.2	7.3	7.3	7.2
	Term premium (%)	1.9	2.3	1.8	0.5	0.5	0.6	0.7	0.7	0.8	0.8	0.7
	AAA bond spread' (%)	0.7	0.5	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.4
	AA bond spread" (%)	3.6	2.0	3.5	2.9	3.0	2.9	2.6	2.7	3.2	3.3	3.3
Lending rates	MCLR (6 month) (%)	7.4	7.1	7.8	8.6	8.6	8.6	8.7	8.7	8.7	8.7	8.8
	Auto loan rate (%)	8.0	7.7	9.0	9.7	9.7	9.8	9.8	9.8	9.8	9.8	9.7
	Housing loan rate (%)	7.4	7.1	8.4	9.4	9.5	9.5	9.5	9.5	9.5	9.5	9.3
Credit availability	Bank credit growth (y-o-y,%)	5.9	7.0	14.2	15.4	16.0	14.7	14.9	15.3	15.2	16.2	15.8
Money supply	M3 growth (y-o-y %)	12.2	9.6	8.9	10.1	13.4	10.6	10.8	10.9	10.8	11.2	10.9
Equity market	Sensex (%*)	7.6	27.0	8.7	6.8	8.0	12.0	10.1	11.2	8.9	8.7	16.0
	NSE VIX	25.8	17.9	17.5	12.5	11.2	11.2	11.6	11.2	11.1	11.6	13.5
Forex market	Rs/$ (m-o-m, %)	-0.2	0.4	0.6	0.4	-0.1	-0.1	0.8	0.3	0.2	0.1	0.0
Foreign capital	Net FPI ($ bn)	3.0	-1.3	-0.5	5.9	6.8	5.8	2.2	-1.7	-2.1	2.9	10.1
Global conditions	S&P 500 (%*)	14.0	24.3	-2.8	-1.2	3.3	6.9	5.6	4.5	1.4	5.9	11.2
	10-year US Treasury yield (%)	0.9	1.6	3.4	3.6	3.7	3.9	4.2	4.4	4.8	4.5	4.0
	Brent ($/barrel)	44.8	80.0	95.4	75.7	74.9	80.1	86.2	94.0	91.1	83.2	77.9

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

*Notes: Q3YTD refers to October-November 2023. ^Spread over the repo rate; term premium is the 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; credit and money supply data excludes the impact of a bank with non-bank*

Source: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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