Macroeconomics | First cut

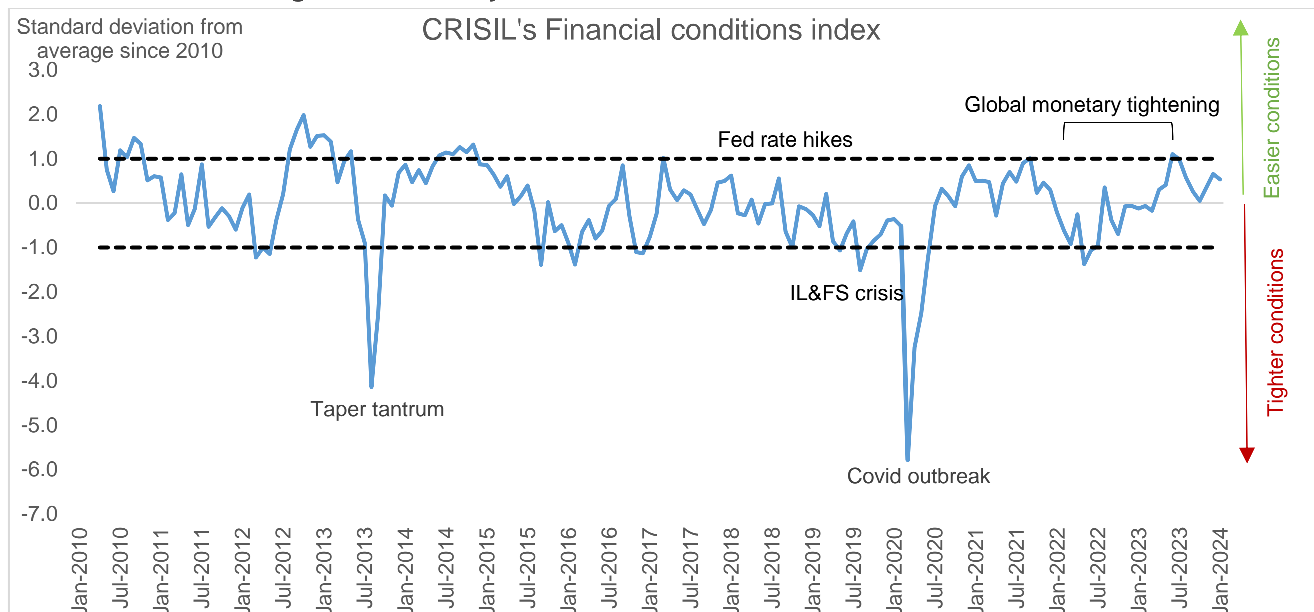
Liquidity pressure

February 2024

Financial conditions constrained by liquidity and capital outflows

- CRISIL's Financial Conditions Index (FCI) shows India's overall financial conditions tightened in January compared with December
- The FCI fell to 0.5 in January from 0.7 in December. A lower FCI value indicates tighter financial conditions, and vice versa
- Liquidity went into deeper deficit, putting upward pressure on short-term rates. Financial conditions were also affected by foreign portfolio investors (FPIs) turning net-sellers
- But as liquidity tightened, the transmission of interest rate hikes improved across lending and deposit rates in January. However, the cumulative rise in most lending and deposit rates remains lower than the Reserve Bank of India's (RBI's) 250 basis point hikes since May 2022. Overall bank credit growth has been largely unaffected by the rise in lending and deposit rates so far
- Incomplete transmission of monetary policy prompted the RBI to keep interest rates unchanged and continue its withdrawal of accommodation stance. We believe the central bank will be active in liquidity management and regulatory measures to prevent excesses in credit growth. We expect this to moderate gross domestic product (GDP) growth by next fiscal year. We foresee the RBI cutting rates from June 2024

Financial conditions tighten in January



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

Why financial conditions tightened in January

- **The deficit in domestic systemic liquidity** almost doubled in January compared with December**.** This led to a net infusion of Rs 2.07 lakh crore (1.0% of NDTL) by the RBI under the liquidity adjustment facility (LAF),

compared with Rs 1.14 lakh crore (0.5% of NDTL) in December. Liquidity has been in deficit since September, and the gap has been widening since then *(refer to the table below for trends)*

The tightening follows the central government cutting spending and parking more funds with the RBI. Separately, bank credit growth (16% on-year in January) continues to outpace deposit growth (13.2%), leading to reduction in banking system liquidity. In addition, rising currency in circulation due to festive spending increased leakage of funds from the banking system.

- **Money market rates were under pressure** due to the crunch in systemic liquidity. The call money rate has remained above 6.75% — the marginal standing facility and the upper limit of the RBI's policy corridor — for the past three months, indicating a liquidity crunch in the banking system.

  Other money market rates saw a sharper rise in January, with the six-month commercial paper (CP) and the six-month certificate of deposit (CD) rates rising sharply on-month by 18 bps and 10 bps, respectively. The CP rate averaged 8.2%, while the CD rate averaged 7.8%

- **Bank lending rates rose** in January. Deposit rates, which were steady for the past three months, rose 5 bps averaging 6.85% in January. The auto loan rate was up 2 bps averaging 9.75%, while the 1-year MCLR was up 5 bps to 8.8%. In contrast, home loan rates remained steady as the transmission of the RBI's rate hikes to mortgage rates is almost complete.

  In the current interest rate cycle, while the repo rate has risen 250 bps, home loan rates are up 231 bps on average. However, the transmission to other lending rates has been lesser. The auto loan rate and the 1-year MCLR have risen only 153 bps and 155 bps, respectively. The weighted average lending rate (WALR) increased181 basis points till December and deposit rates have risen 176 bps.

- **Net FPI outflows:** FPIs turned net sellers in January after two months of inflows. They withdrew $0.8 billion from the Indian markets, in contrast to a decadal high inflow of $10.1 billion in December. Rising crude oil prices and US Treasury yields affected global investor sentiment.

  FPI outflows were mainly seen in equities, where foreign investors withdrew $3.1 billion (against an inflow of $7.9 billion in December). Inflows into the debt segment continued, rising to $2.4 billion from $2.2 billion. The announcement of inclusion of Indian government bonds in the JP Morgan Emerging Markets Index from June 2024, has spurred foreign investment in the Indian debt market.

- **Rise in crude oil prices:** Brent crude oil prices rose by 3% in January to $80.2 per barrel. Attacks on the critical Red Sea trade route and expectations of an economic recovery in China led to the price rise.

- **US treasury yield** hardened marginally after two consecutive months of decline. The 10-year yield rose to 4.06% on average in January from 4.02% in December as economic data released during the month fuelled fears that the Fed may keep rates elevated for longer than previously expected. CPI inflation data released in January showed that inflation hardened to 3.4% in December from 3.1% in November.

Factors that lent support

- **Declining domestic yields:** The yield on the benchmark 10-year G-sec eased for the third consecutive month in January, though the decline was muted compared with December. The yield averaged 7.18% in January down from 7.21% in December and 7.27% in November. Softer domestic core inflation, surging FPI inflows in the debt segment and the proposed inclusion of India in one of Bloomberg's bond indices pulled down yields. A further decline in domestic yields was capped by rising global crude oil prices, hardening US treasury yields, and the deficit in domestic liquidity.

- **Bank credit growth surged** to 16%[1] from 15.6% in December. Sectoral data[2] (available with a lag of one month) indicates credit growth accelerated in agriculture (19.5% vs 18.2%) and industry (8.1%vs 6.1%).

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[1] As on January 12, excluding the impact of the HDFC merger
[2] Excluding impact of HDFC merger

However, it slowed in services (19.6% vs 21.9%) and personal loans (17.7% vs 18.2%), possibly reflecting some impact of RBI increasing risk weights for bank credit to NBFCs and risky consumer segments.

- **Indian equities** rose on-month in January, although the rise was mild compared to the previous month. S&P BSE Sensex and Nifty 50 rose 1.8% (vs 7.7% in December) and 2.2 (vs 8% in December) on-average, respectively. Market volatility was higher in January, as reflected in the NSE's India VIX index (see table below). FPI outflows in equities affected market sentiment in January.

With central banks wary of premature rate cuts, transmission of past hikes may continue

Amid resilient growth prints, major central banks are not yet declaring victory over inflation. In their latest policy meetings in February, the RBI joined the US Federal Reserve in scaling back expectations of an early rate cut.

Headline inflation in India has been within the RBI's target range for the past four months. Yet, the central bank aims to increase transmission of past rate hikes amid sustained strength in credit growth and overall GDP growth. We expect the RBI to keep liquidity tight this fiscal to facilitate transmission.

This will lead to some de facto tightening in domestic financial conditions. CRISIL MI&A expects bank credit growth to moderate 13.5-14.5% in fiscal 2025 from an estimated 14.5-15.5% this fiscal. Non-banking credit is expected to see a sharper slowdown of 15-16% next fiscal from 17-18% in the current one, driven by RBI's regulatory measures to clamp down excessive lending in this segment.

This would have a bearing on the pace economic growth next fiscal as well. GDP growth is expected to reduce from the second half of the current fiscal until the next fiscal. In this context, we expect the RBI to start cutting rates from June 2024. Such volatility could affect short-term capital flows into Indian markets.

India's sound macroeconomic fundamentals will keep financial markets resilient to external shocks. The push towards fiscal consolidation in the recent interim budget will further boost investor confidence in Indian markets.

Table: How financial conditions evolved across market segments this fiscal

		Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24
Policy rate	Repo rate (%)	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	1.8	2.2	1.7	-0.9	-0.3	1.5	1.6	0.9	0.8	1.4
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	-0.8	-0.4	-0.6	-0.8	-0.6	0.1	0.2	0.3	0.5	1.0
Money market	Call money rate (%)	6.5	6.6	6.5	6.5	6.6	6.7	6.7	6.8	6.8	6.8
	91 day T-bill (%)	6.8	6.8	6.7	6.7	6.8	6.8	6.9	6.9	7.0	7.0
	CP 6-month rate (%)	7.6	7.6	7.5	7.4	7.5	7.6	7.8	7.9	8.0	8.2
Debt market	10-year G-Sec (%)	7.2	7.0	7.0	7.1	7.2	7.2	7.3	7.3	7.2	7.2
	Term premium (%)	0.7	0.5	0.5	0.6	0.7	0.7	0.8	0.8	0.7	0.7
	AAA bond spread' (%)	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.4	0.4
	AA bond spread" (%)	2.9	2.9	3.0	2.9	2.6	2.68	3.2	3.3	3.3	0.9
Lending rates	MCLR (1 year) (%)	8.6	8.6	8.7	8.7	8.6	8.7	8.7	8.7	8.8	8.8
	Auto loan rate (%)	9.8	9.8	9.8	9.8	9.8	9.8	9.7	9.7	9.7	9.7
	Housing loan rate (%)	9.40	9.4	9.4	9.4	9.4	9.4	9.4	9.3	9.3	9.3
Credit availability	Bank credit growth (y-o-y,%)	15.9	15.4	16.2	14.7	14.9	15.3	15.2	16.2	15.6	16.0
Money supply	M3 growth (y-o-y %)	9.5	10.1	13.4	10.6	10.8	10.9	10.8	11.2	10.9	11.0
Equity market	Sensex (%*)	4.4	6.8	8.0	12.0	10.1	11.2	8.9	8.7	16.0	17.1
	NSE VIX	11.9	12.5	11.2	11.2	11.6	11.2	11.1	11.6	13.5	14.1
Forex market	Rs/USD (m-o-m %)	-0.3	0.4	-0.1	-0.1	0.8	0.3	0.2	0.1	0.0	-0.2
Foreign capital	Net FPI (USD bn)	1.7	5.9	6.8	5.8	2.2	-1.7	-2.1	2.9	10.1	-0.8
Global conditions	S&P500 (%*)	-1.8	-1.2	3.3	6.9	5.6	4.5	1.4	5.9	11.2	13.9
	US 10Y Treasury yield (%)	3.5	3.6	3.7	3.9	4.2	4.4	4.8	4.5	4.0	4.1
	Brent ($/barrel)	84.1	75.7	74.9	80.1	86.2	94.0	91.1	83.2	77.9	80.2

Favourable
Neutral
Adverse

*Note: ^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 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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