Macroeconomics | First cut

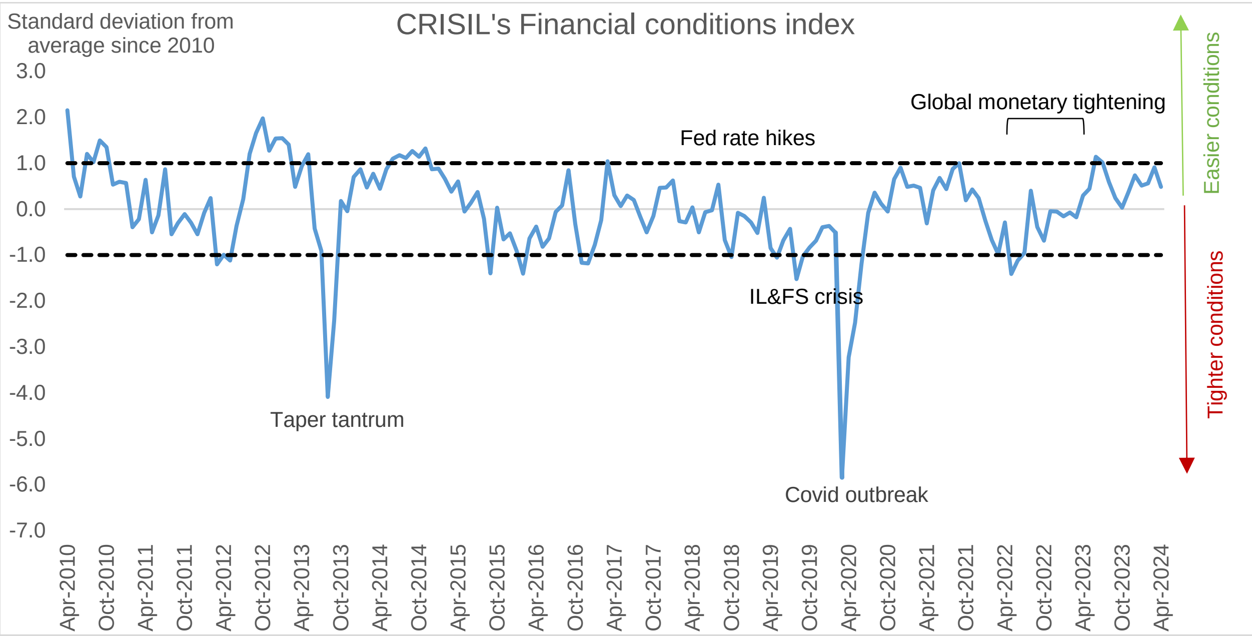
Financial conditions turn less supportive

May 2024

Geopolitical and rate-cut angst tilt FCI towards tightening

- CRISIL's Financial Conditions Index (FCI) tightened slightly in April but stayed within the comfort zone. The index value declined to 0.5 in April compared with 0.9 in March but was higher than 0.3 in April last year[1].
- Two global factors affected the Indian markets during the month. One, crude oil prices spiked after geopolitical tensions increased. Two, the markets baked in a delay in rate cuts by the US Federal Reserve (Fed), dimming global investor sentiment. As a result, foreign portfolio investors (FPIs) turned net sellers, which hit the rupee and domestic bond yields.
- Domestically, improving liquidity conditions provided relief. But the lagged impact of the Reserve Bank of India's (RBI) past monetary tightening has been affecting the credit growth with banks seeing a slowdown in credit offtake for the second consecutive month in April. Lending rates are also catching up in segments where transmission of the RBI's rate hikes had been slower so far in the cycle.
- The spectre of higher-for-longer policy on interest rates looms on financial conditions this year. S&P Global does not expect the Fed to cut rates before December, as US inflation stays stubbornly high. This can constrain space for monetary easing by the RBI as well, which will also factor in risks from weather that domestic inflation faces. Geopolitical tensions remain elevated and a risk for crude prices. All these mean little space for significant easing of financial conditions this fiscal.

Financial conditions tighten slightly in April



Note: The index within dotted lines (1standard deviation) represents conditions within the comfort zone
Source: CRISIL

[1] A higher FCI value indicates easier financial conditions, and vice versa.

What led to tighter financial conditions

- **Upward swing in crude oil price continues:** Global crude oil prices continued to rise in April as geopolitical tensions escalated. Brent crude oil prices surged 5.4% on-month to an average of $90.1 per barrel.
- **Higher US treasury yields:** The yield on the 10-year US Treasury bond note rose sharply to 4.54% on average from 4.21% in March. Expectations that interest rates will remain higher for longer (due to higher-than-expected inflation and a strong job market) and the rise in global crude oil prices pushed up the US yields.
- **Net FPI outflows:** Foreign portfolio investors turned net sellers in April. India saw $1.9 billion of net foreign portfolio investment (FPI) outflows during the month compared with a strong inflow of $6.3 billion in March. Both the equity and debt markets saw net outflows. From equities, foreign investors withdrew $1 billion (vs net investment of $4.2 billion in March). After 12 straight months of net inflows, the debt segment saw $1.3 billion net outflows (vs an inflow of $1.6 billion in March). The outflows were driven by narrower spread between US treasury yields and Indian G-sec yields.
- **A weaker rupee:** The rupee depreciated against the dollar owing to the strengthening of the dollar index (105.4 from 103.6) and FPI outflows. The rupee averaged 83.4 per dollar, down from Rs 83 per dollar in March.
- **Higher domestic bond yields:** Indian G-sec yields moved up after softening for five consecutive months. The yield on the 10-year G-sec shot up 11 bps to an average of 7.17%. The domestic yields came under pressure because of external factors, such as higher US Treasury yields and rising crude oil prices, that resulted in net FPI outflows from Indian debt markets. On the flip side, domestic factors were supportive. A softer inflation print for March (data released in April) and a surplus in systemic liquidity prevented the yields from rising further.
- **Moderation of bank credit growth:** In April, bank credit growth was the slowest since October 2023 — 15.3%[2]. In March, the growth was higher at 16.3%.

  Sectoral data[3] for March indicates that credit growth in services (20.2% vs 21.2% in February) and personal loans (17.7% vs 18.1%) tempered during the month. A moderation in growth in credit cards (25.6% vs 31%) and the other personal loans category (18.7% vs 19.7%) slowed the growth in personal loans. Credit growth in the industry (8.5% vs 8.6%) and agriculture (20.1%) segments was broadly unchanged.
- **High bank lending rates:** Bank lending rates remained at their pre-pandemic average with some rates rising marginally in April. The rate on auto loans rose 1 bp to 9.78% and that on home loans 4 bps to 9.35%, while the one-year marginal cost of funds-based lending rate (MCLR) was steady at 8.8%.

  Compared with the 250-bps hike in the repo rate in the current cycle, transmission is almost complete in the housing loan segment (237 bps) while it lags for the one-year MCLR (155 bps) and auto loan rate (156 bps).

What factors limited the tightening

- **Surplus systemic liquidity:** After remaining in deficit for seven straight months, liquidity in the banking system entered the surplus zone in April. Hence, the RBI net absorbed on average Rs 0.2 lakh crore (0.1% of net demand and time liabilities, or NDTL) at its liquidity adjustment facility window. In comparison, the bank had net injected Rs 0.4 lakh crore (0.2% of NDTL) on average in March. Increased government spending and a softer credit-deposit ratio (0.79 vs 0.8 in March) were the factors that swung the liquidity into surplus. That said, liquidity conditions tightened as the month progressed with the last week seeing a deficit.
- **Softer money market rates:** The liquidity surplus led to a moderation in money market rates. The weighted average call money rate (WACR) eased 8 bps averaging 6.5%. Other money market rates also drifted lower with the six-month commercial paper (CP) rate falling 29 bps to 7.44% on average and the six-month certificate of deposit (CD) rate, 22 bps to 7.86% on average. The 91-day treasury bill averaged 6.87% compared with 6.91% in March.

[2] As on April 19, excluding the impact of the HDFC merger
[3] Excluding impact of HDFC merger

- **Moderate rise in equities:** The benchmark indices S&P BSE Sensex and Nifty 50 gained ~1% on-month each driven by healthy corporate earnings and a global rally towards the end of the month. However, FPI outflows and uncertainty owing to geopolitical tensions weighed on sentiments and limited the rise in equities.

Higher-for-longer rates can delay easing of financial conditions

Major central banks are awaiting decisive signals of inflation easing and growth softening to cut rates.

The US — a crucial player that drives the global financial conditions — is not likely to see the first rate cut before December, according to S&P Global. While US inflation showed signs of moderation in April, it remained above the Fed's 2% target. Robust growth momentum and resilient labour markets remain an upside risk to US inflation.

In contrast, headline inflation in India has been within the RBI's target range of 2-6% for the past eight months. However, food inflation remains stubbornly high. Though in April the headline inflation moderated to 4.8% from 4.9% in March, food inflation rose to 8.7% from 8.5%. The RBI will wait for the risks to food inflation to ebb before cutting rates. The initial forecast of an above-normal monsoon this year offers hope. However, the heatwave and other extreme weather events remain a risk.

We expect the RBI to cut rates twice in the second half of this fiscal. Meanwhile, the impact of the past monetary tightening is expected to be seen across sectors. As evident in April, bank lending rates are still rising and credit growth moderating. The RBI's regulatory measures to clamp down on risky bank lending in certain segments are also expected to contribute to the moderation in credit growth and overall growth this year.

Nevertheless, India's inclusion in the global bond indices this year and low external vulnerability are expected to support the country's financial markets.

Table: How financial conditions are evolving across market segments

		Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-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	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	1.4	1.6	1.7
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	0.9	0.8	0.2	-0.1
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	6.7	6.6	6.5
	91 day T-bill (%)	6.8	6.8	6.7	6.7	6.8	6.8	6.9	6.9	7.0	7.0	7.0	6.9	6.9
	CP 6-month rate (%)	7.6	7.6	7.5	7.4	7.5	7.6	7.8	7.9	8.0	8.2	8.5	8.1	7.9
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	7.1	7.1	7.2
	Term premium (%)	0.7	0.5	0.5	0.6	0.7	0.7	0.8	0.8	0.7	0.7	0.6	0.6	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	0.3	0.3	0.2
	AA bond spread" (%)	2.9	2.9	3.0	2.9	2.6	2.7	3.2	3.3	3.3	0.9	1.8	1.8	2.0
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	8.8	8.8	8.9
	Auto loan rate (%)	9.8	9.8	9.8	9.8	9.8	9.8	9.7	9.7	9.7	9.7	9.8	9.8	9.8
	Housing loan rate (%)	9.4	9.4	9.4	9.4	9.4	9.4	9.3	9.3	9.3	9.3	9.3	9.3	9.4
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	16.1	16.5	16.3	15.3
Money supply	M3 growth (y-o-y %)	9.5	10.1	13.4	10.6	10.8	10.9	10.8	11.2	11.0	11.0	10.9	11.2	10.9
Equity market	Sensex (%*)	4.4	6.8	8.0	12.0	10.1	11.2	8.9	8.7	16.0	17.1	16.8	17.0	17.0
	NSE VIX	11.9	12.5	11.2	11.2	11.6	11.2	11.1	11.6	13.5	14.1	15.5	13.8	11.7
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	-0.2	0.0	0.5
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	3.8	6.3	-1.9
Global conditions	S&P500 (%*)	-1.8	-1.2	3.3	6.9	5.6	4.5	1.4	5.9	11.2	13.9	18.4	21.3	19.1
	US 10Y Treasury yield (%)	3.5	3.6	3.7	3.9	4.2	4.4	4.8	4.5	4.0	4.1	4.2	4.2	4.5
	Brent ($/barrel)	84.1	75.7	74.9	80.1	86.2	94.0	91.1	83.2	77.9	80.2	83.8	85.4	90.1

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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