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Signs of squeeze

Domestic financial conditions could tighten further as central banks aren’t done hiking rates and monetary transmission is picking up

CRISIL INSIGHT September 13, 2022

Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Ltd.
dharmakirti.joshi@crisil.com

Dipti Deshpande
Principal Economist, CRISIL Ltd
dipti.deshpande@crisil.com

Pankhuri Tandon
Economist, CRISIL Ltd.
pankhuri.tandon@crisil.com

Media contacts

Aveek Datta
Media Relations
CRISIL Limited
M: +91 99204 93912
B: +91 22 3342 3000
aveek.datta@crisil.com

Riddhi Savla
Media Relations
CRISIL Limited
M: +91 98199 57423
B: +91 22 3342 3000
riddhi.savla@ext-crisil.com

Key takeaways

- Financial conditions now are tighter than last decade's average, shows CRISIL's Financial Conditions Index
- These conditions are expected to tighten further as central banks continue to raise rates, the Reserve Bank of India (RBI) keeps the pedal on excess liquidity absorption and there is faster transmission of rate hikes to the broader market segments
- With the RBI aggressively tightening monetary policy this year, the repo rate has crossed the pre-pandemic level (February 2020), though it is lower than the five-year average before the pandemic. Systemic liquidity has reduced significantly, reaching close to the five-year average before the pandemic
- Monetary transmission has picked up across segments. Short-term rates are rising at a faster clip but remain below pre-pandemic average levels. In contrast, medium-term corporate bond yields and government bond yields have crossed those levels.
- Bank lending rates remain on the lower side, for now. This, combined with gradual economic recovery, has led to a sustained pick-up in credit growth
- The US Federal Reserve's (Fed) stance to continue with aggressive rate hikes, coupled with other volatile and uncertain global cues, could also keep domestic financial conditions on the edge
- Tighter financial conditions may not restrict growth for now, as policy rate hikes act with a lag. But their impact would largely be felt from the last quarter of this fiscal

Financial conditions getting tighter

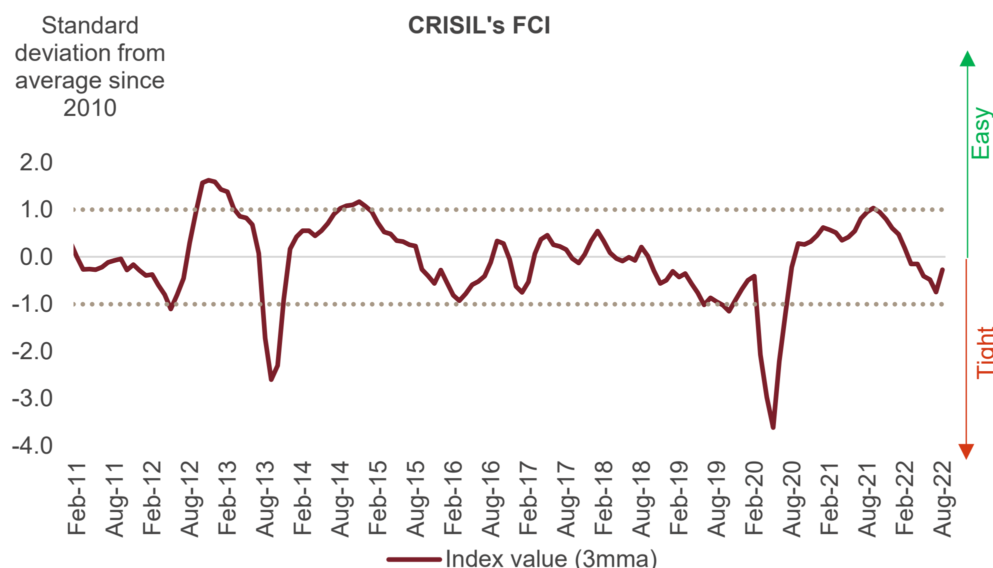
Financial markets have seen significant volatility this calendar year, driven mainly by war-induced shocks and monetary policy tightening by central banks.

CRISIL's Financial Conditions Index (FCI) is a summary indicator that combines 15 parameters reflecting domestic policy conditions, movements in money, debt, equity and foreign exchange markets, and credit conditions in the broader economy. A lower FCI value indicates tighter financial conditions, and vice versa.

What the latest FCI tells us

- It indicates a tightening trend in domestic financial conditions since October 2021. Moreover, the FCI turned negative in 2022, implying financial conditions have become tighter than the long-term average observed since 2010
- But the FCI is still within one standard deviation of the decadal average (remaining within the dotted band in the chart below), beyond which it starts becoming a matter of concern
- The tightening which began in late 2021 can be explained by the RBI moving towards normalising monetary policy (by halting bond buying and withdrawing excess liquidity), along with the Fed's monetary tightening actions (which began with tapering its quantitative easing program in November).
- Tightening gained momentum with the Russia-Ukraine war in February. Risk-off sentiment spread, commodity prices and inflation surged globally, and central banks brought forward their rate hike cycle
- The impact of baby steps towards absorption of excess liquidity by the RBI were slow to show up in domestic financial conditions, though bond market yields had started firming up as early as October, indicating rising risk aversion. More recently, the impact of RBI's actions on financial conditions has become more pronounced
- Global headwinds softened a bit as commodity prices came off post-war highs. Yet, they continue to impart volatility to domestic conditions. Though growing concerns of recession in the US made markets expect that the Fed would go slow on monetary policy tightening, the Fed Chair has reaffirmed in August the need for aggressive rate hikes to fight elevated inflation

Financial conditions remain tight but comfortable



Note: A positive index value implies easier conditions and a negative index, tighter conditions relative to the long-term average since 2010; 3mma = 3-month moving average of the index

Source: CRISIL

A deep dive into the FCI sub-components reveals interesting results. Some market segments are still having it easy, while others have begun to experience stress:

- **Where conditions remain easy:** Policy rate, money market rates and bank lending rates remain lower than the pre-pandemic five-year average, even as they have been rising in the past few months. This reflects that liquidity in the system remains higher vis-à-vis demand. In this fiscal so far, bank credit growth has been higher than the pre-pandemic five-year average.
- **Where conditions have turned neutral**: Systemic liquidity has reduced significantly and moved closer to pre-pandemic five-year average, by August 2022. While the rupee has depreciated this year, the rate of depreciation has been range bound
- **Where there is stress**: Equity and debt markets have performed worse this fiscal so far, compared with the pre-pandemic average. Global factors such as movements in S&P 500, US Treasury yields and crude oil prices have been far more adversarial for Indian markets this fiscal vis-à-vis the average

Changes in financial conditions across segments

		Pre-pandemic trend	Covid years		Current fiscal year				
		FY16-20	FY21	FY22	Apr-22	May-22	Jun-22	Jul-22	Aug-22
Policy rate	Repo rate (%)	6.3	4.0	4.0	4	4.4	4.9	4.9	5.4
	Repo rate, inflation-adjusted (%)	2.0	-2.2	-1.5	-3.8	-2.6	-2.1	-1.8	-1.6
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
Money market	Call money rate (%)	6.2	3.4	3.3	3.5	4.0	4.4	4.8	5.0
	91 day T-bill (%)	6.5	3.3	3.5	3.9	4.8	5.0	5.3	5.5
	CP 6-month rate (%)	7.6	4.4	4.3	4.9	5.9	6.3	6.3	6.4
Debt market	10-year G-sec (%)	7.2	6.0	6.3	7.1	7.3	7.5	7.4	7.3
	Term premium (%)	1.0	1.9	2.3	3.1	3.0	2.7	2.5	2.0
	AAA bond spread' (%)	0.6	0.7	0.5	0.1	0.2	0.2	0.2	0.2
	AA bond spread'' (%)	2.0	3.6	2.0	3.0	3.0	3.1	3.3	3.1
Lending rates	MCLR (6 month) (%)	8.3	7.4	7.1	7.1	7.2	7.3	7.5	7.6
	Auto loan rate (%)	9.6	8.0	7.7	7.6	7.8	7.7	8.3	8.5
	Housing loan rate (%)	9.1	7.4	7.1	7.0	7.3	7.6	7.9	8.3
Credit availability	Bank credit growth (y-o-y,%)	9.7	5.9	7.0	10.1	11.1	12.1	14.5	15.5
Money supply	M3 growth (y-o-y %)	9.7	12.2	9.6	9.5	8.8	7.8	8.6	8.9
Equity market	Sensex (%*)	8.7	7.6	27.0	17.8	8.1	4.5	5.4	11.8
	NSE VIX	15.6	25.8	17.9	18.9	22.6	21.1	18.3	18.6
Forex market	Rs/$ (m-o-m, %)	0.2	-0.2	0.4	-0.1	1.5	1.0	2.0	-0.1
Foreign capital	Net FPI ($ bn)	0.6	3.0	-1.3	-3.0	-4.7	-6.6	0.2	7.1
Global conditions	S&P 500 (%*)	8.9	14.0	24.3	11.6	1.3	-3.2	-3.6	1.5
	10-year US Treasury yield (%)	2.3	0.9	1.6	2.7	2.9	3.1	2.9	2.9
	Brent ($/barrel)	57.4	44.8	80.0	105.8	112.4	120.1	108.9	98.6

Easier than pre-pandemic 5-year average
Close to pre-pandemic 5-year average
Worse than pre-pandemic 5 year average

*Notes: LAF - liquidity adjustment facility; Term premium – Spread of 10 year G-sec yield over repo rate; ' Spread over 10-year G-sec yield; '' Spread over 5-year G-sec yield; * % change with respect to 2-year moving average; A positive percentage rupee change implies depreciation against the dollar and vice-versa*

Source: RBI, National Securities Depository Ltd (NSDL), US Treasury department, CEIC, CRISIL

Role of domestic and global factors in tightening India's financial conditions

The increasingly tight domestic monetary policy and stronger external headwinds are holding domestic financial conditions in a bear hug. While the initial set of shocks came in from stronger global headwinds, recent months have seen some of these stabilize. Domestic monetary tightening actions in fact, have been nudging financial conditions deeper towards the tighter zone. The months to come however may see global factors again take precedence as headwinds rise with aggressive monetary policy actions expected to be taken by systemically important central banks such as the US Fed and the European Central Bank to combat inflation.

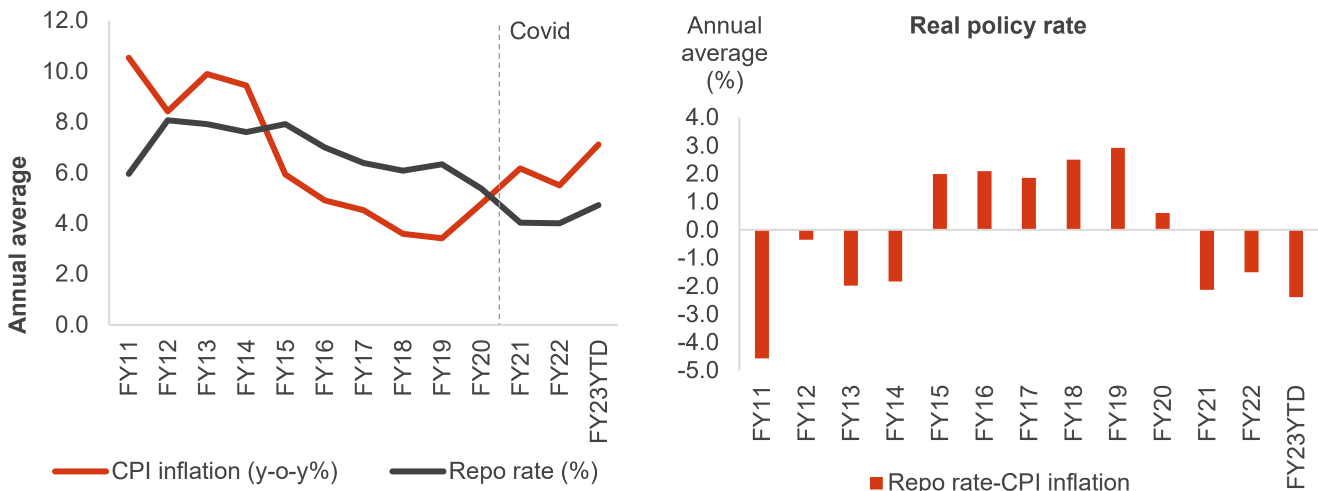
Domestic factors that have played a role in recent months

- The RBI has been on a rate hiking spree and reducing excess liquidity it injected in the past two years
- It began raising the repo rate in May 2022 and has cumulatively hiked it by 140 bps until August. The repo rate stands at 5.40% currently, 25 bps above the pre-pandemic level of 5.15% in February 2020

- Yet, in real terms, the policy rate remains negative, as inflation is trending higher than the repo rate. In the first four months of this fiscal, nominal repo rate averaged 4.6%, CPI inflation 7.1%, implying a real repo rate of -2.6%[1]. Not only is this lower than the pre-pandemic level, but the lowest since fiscal 2011. That said, the gap is narrowing with successive rate hikes and moderating inflation
- Even before the rate hikes, the RBI has been reducing excess liquidity since 2021. It began increasing absorption of liquidity under variable rate reverse repo operations (VRRRs) since August 2021, followed by open market sales of G-secs from November. In April, the floor of the policy corridor was raised by replacing reverse repo rate with the standing deposit facility (SDF)
- The RBI's dollar sales to prevent excess rupee depreciation further led to reduction in rupee liquidity
- Other economic factors such as falling credit-deposit ratio further reduced banking liquidity

The RBI's deliberate monetary tightening, along with other factors mentioned above, has led to significant liquidity reduction. Systemic liquidity, while remaining in surplus, was the lowest in July 2022 since October 2019. Rate hikes and liquidity reduction have led to a rise in interest rates to varying degrees across different market segments.

Repo rate on the rise but negative in real terms so far

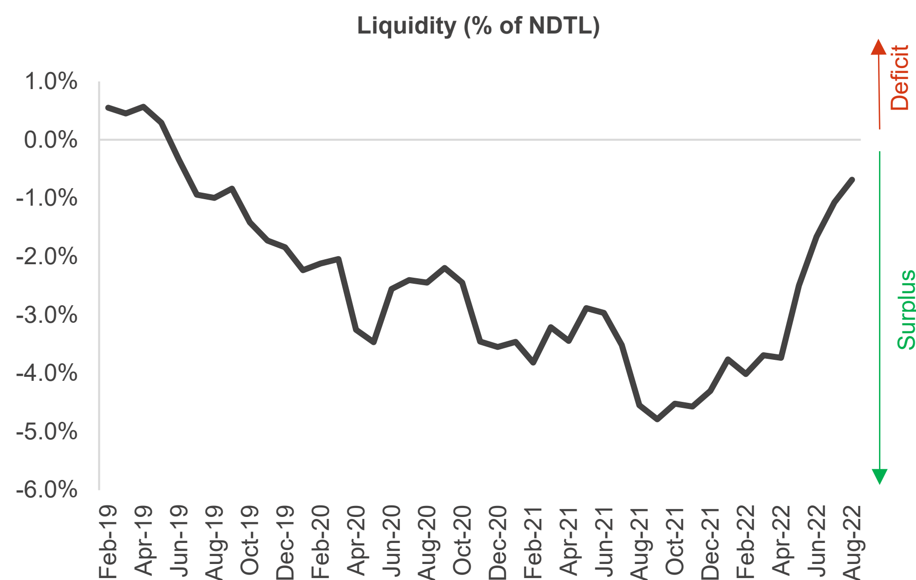


Note: FY23YTD refers to April-August 2022 average; Real policy rate refers to ex-post rate based on contemporaneous CPI inflation

Source: RBI, National Statistics Office, CEIC, CRISIL

[1] This is the ex-post real rate based on contemporaneous inflation

Systemic liquidity has fallen to 2019 levels



Note: Liquidity refers to net injection/absorption by the RBI under liquidity adjustment facility (LAF). A positive value indicates injection of funds by the RBI (and hence a liquidity deficit); a negative value shows net absorption by the RBI (and hence a liquidity surplus); NDTL refers to net demand and time liabilities

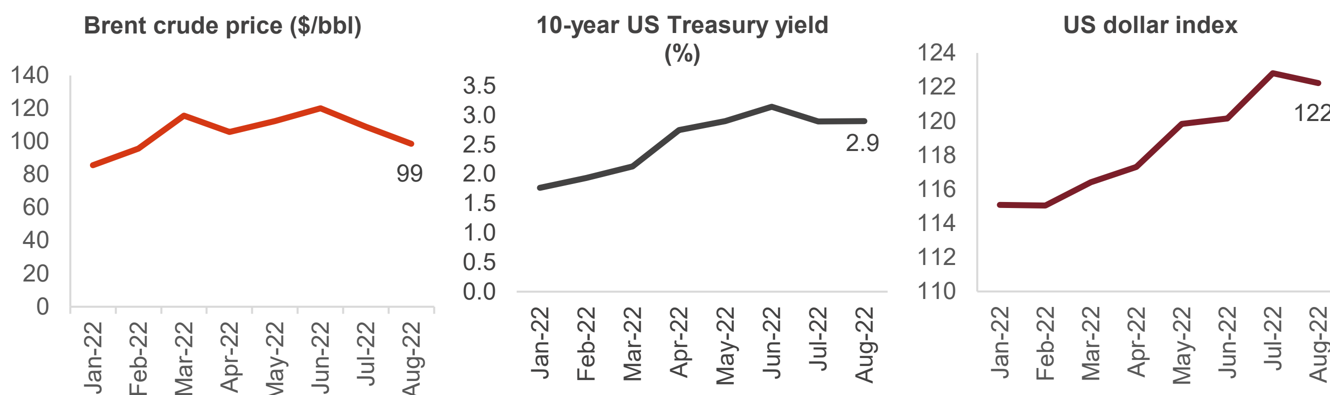
Source: RBI, CEIC, CRISIL

How global factors influenced India's financial conditions

- Global factors played a much bigger role in tightening financial conditions initially.
- The outbreak of the Russia-Ukraine war in February triggered a sharp rise in commodity prices and increased the risk-off sentiment globally. The resultant high inflation globally made central banks tighten monetary policy and frontload rate hikes
- The US Fed started the tightening cycle with a 25 basis points (bps) rate hike in March and progressively increased the quantum of hikes to 50 bps in May, and 75 bps each in June and July
- This led to a sharp tightening in global financial conditions. The peak period of stress was between January-June 2022, when the 10-year US Treasury yield increased 138 bps, S&P 500 declined 14.8%, and dollar index appreciated 4.4%. A 40.4% rise in crude prices during this period further soured sentiment for oil importers like India
- Foreign portfolio investors (FPIs) net-withdrew $29.7 billion from India between January-June, more than $7.1 billion net investment in the whole of 2021. Coupled with widening current account deficit and strengthening dollar, this led the rupee to depreciate 6.9% during this period
- Since July, growing concerns of growth slowdown in major economies such as the US and China have brought down commodity prices from post-war highs. This has helped ease FPI outflows and rupee depreciation to some extent. Yet some headwinds have emerged again, with Fed Chair Jerome Powell re-emphasising the

need for aggressive monetary tightening at the Jackson Hole summit. Global factors are hence extremely volatile and uncertain at this stage, which could keep domestic financial conditions on the edge.

Key external drivers of tightening financial conditions this year



Note: Data is for monthly averages

Source: World Bank, US Department of Treasury, US Federal Reserve Bank of St. Louis, CRISIL

To what extent have the RBI's rate hikes transmitted to the economy?

Interest rates are increasing, but are not high enough that they will stifle growth this fiscal

To gauge the transmission of rate hikes, we looked at how rates have moved across various market segments (money markets, corporate and government bond markets, lending, and deposit rates).

Here are three key findings:

1. **Rates in the short term (overnight to six months) have risen rapidly in the past 10 months, but remain below the pre-pandemic (pp) average levels**

This is because rate cuts, coupled with extraordinary liquidity infusion by the RBI during the pandemic years, forced short-term rates downwards. While repo rate was cut by 115 bps, overnight call rate in the banking system fell more than 170 bps during the period. Commercial paper rate dropped over 170 bps and was also influenced by lower borrowing by corporates in the wake of uncertainty. From these lows, the rise so far has not taken the rates significantly above their pre-pandemic levels. In contrast, yields on medium-term corporate paper have reached pp average level, with lower-rated bonds like the AA benchmark crossing those rates. In recent months, the impact of geopolitical tensions and associated risks, in addition to tighter monetary policy, have pushed up yields for AA corporates.

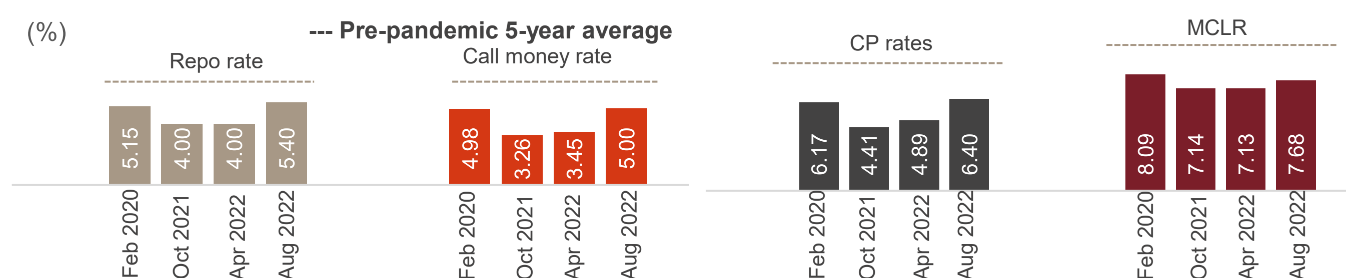
2. **Banking system liquidity remains robust, keeping lending and deposit rates low so far**

Since the transmission channel of repo rate cuts and liquidity injection is routed through the banking system, both short-term (MCLR) and medium term (deposits) rates fell considerably during the pandemic years. Despite RBI's back-to-back rate hikes, ample liquidity with banks has kept these rates low. This also applies to lending rates extended by banks to consumers, such as auto and housing loans. Banks' cost of borrowing (via deposits) is the slowest to rise, which also explains why lending rates have stayed sticky. In a scenario of rising credit demand, this supports economic recovery, though there could be some impact on certain segments especially in the next fiscal, as lending rates inevitably rise. In recent weeks, banks have started raising deposit and lending rates, as demand for credit has begun improving. However, we do not believe that lending rates will rise so much as to stifle growth. Under the rough assumption that the cumulative repo rate hikes this fiscal would be 180-200 bps (including another 25-50 bps hike from here), and the entire increase is passed on to consumers, housing or auto loan rates would still be lower than their pre-pandemic five-year averages.

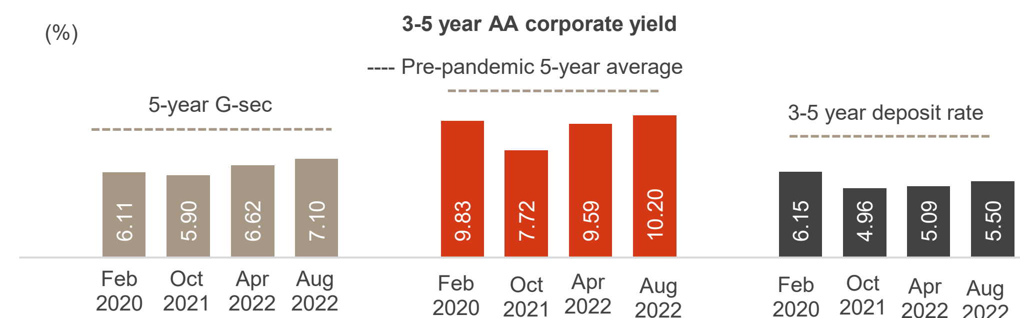
3. **Despite monetary easing during the pandemic, government bond yields benefitted less, given the large borrowing programme and risk-on sentiment in the economy**

Government securities (G-Secs) bonds have either touched (e.g., G-secs with five-year maturity) or crossed (G-secs with 10-year maturity) pp average levels. During the pandemic years, the five-year G-sec fell about 100 bps up to July 2020 and has climbed 230 bps since then. Interestingly, the 10-year G-sec fell only 60 bps and has already climbed 160 bps since then. Therefore, for G-secs, fiscal woes, and global headwinds have pushed up yields in addition to tighter monetary policy.

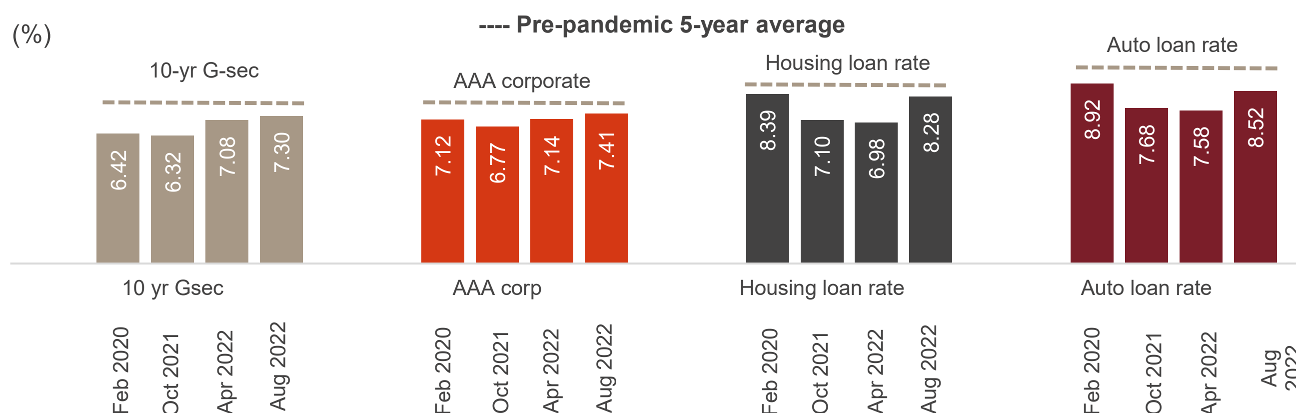
Most short-term rates have stayed below the pre-pandemic level and pre-pandemic five-year average



Medium-term yields on G-secs and AA-rated corporates have climbed to or above pre-pandemic levels



Long-term yields on G-secs have crossed pre-pandemic levels, for others, they remain benign



Source: RBI, CRISIL

Is the pace of monetary policy transmission changing?

Yes, and it is expected to pick up for two reasons:

Growing adoption of EBLR-based lending: In October 2019, the RBI introduced the external benchmark-based lending (EBLR) regime. Under this, banks were mandated to link lending rates to external benchmarks (e.g., repo rate and T-bill yields) for fresh floating rate retail and MSME loans. Interest rates under EBLR must be reset at least once in three months.

Linking to external benchmark rates should ensure faster transmission of any policy rate changes, compared with the previous MCLR and base rate regimes, where lending rates were derived internally by banks based on their cost of funding.

A growing proportion of EBLR-linked loans is improving monetary policy transmission. According to an RBI study[2], the proportion of EBLR-based loans by scheduled commercial banks increased from 2.9% in September 2019 to 39.2% in December 2021. This contributed to faster transmission of monetary policy easing between October 2019 and March 2022, the study shows.

With a pickup in credit demand in current fiscal year, the proportion of EBLR-based loans would have increased further. RBI's rate hikes are hence expected to reach lending rates faster this year.

Reduction in liquidity: Surplus liquidity was hindering the transmission of rate hikes to some extent. However, the RBI has been absorbing this surplus liquidity at a much faster pace in recent months. For instance, compared to an average daily liquidity absorption of Rs 4618.6 billion in the March quarter, the current quarter so far (July-August) has seen an average daily absorption of Rs 1559.4 billion. This trend which is expected to continue given RBI's stance of withdrawal of accommodation and pickup in credit growth. That will again hasten the transmission of rate hikes.

[2] RBI Bulletin (April 2022). Monetary Transmission to Banks' Interest Rates: Implications of External Benchmark Regime

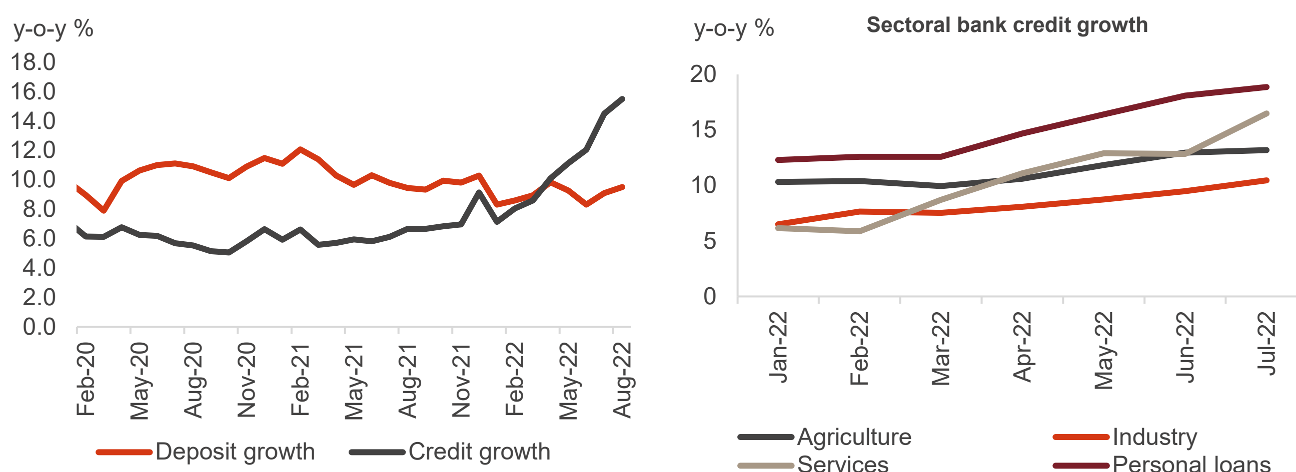
Financial conditions for the broader economy

Rising interest rates have not impacted credit growth so far

Despite rising rates, bank credit growth has consistently gone up since February 2022, reaching 14.5% on-year in July, the highest since March 2019. It has also been higher than deposit growth since April 2022, a trend that was last seen before August 2019.

The rise in credit growth has been broad-based across agriculture, industry, services, and personal loans.

Bank credit growth has surged ahead of deposits, with the rise being broad-based



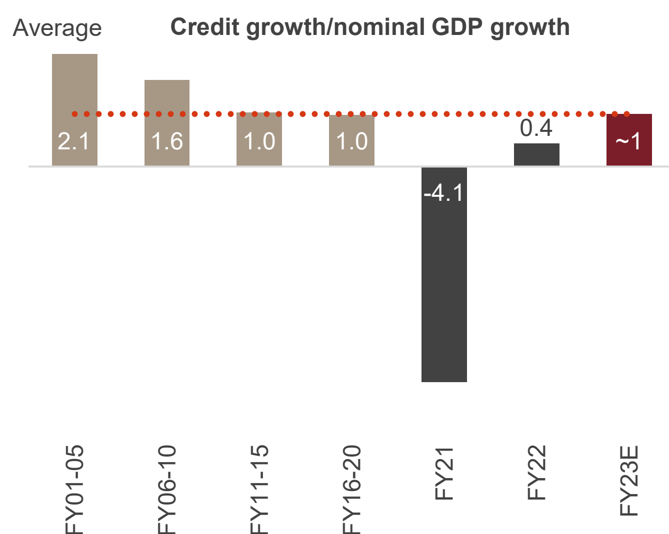
Source: RBI, CEIC, CRISIL

Why is credit growth picking up?

- Economic recovery
  - Subsequent variants of Covid-19 have been mild so far and not caused any functional disruption to economic activity in 2022, even as people have learnt to live with the virus
  - The RBI's survey indicates consistent improvement in capacity utilisation of the manufacturing sector for three consecutive quarters, which augurs well for investment demand. After two years of the pandemic, services are also contributing more to overall growth and credit growth this year
- High inflation
  - Rising inflation in crude, commodities, chemicals, and other inputs has increased working capital requirements, particularly for small businesses, leading to increased demand for credit
- Substitution

– Part of the rise in credit growth is also a result of firms moving away from money and debt markets, as these markets have seen a sharper rise in interest costs relative to bank lending rates

Credit-GDP growth ratio expected to inch closer to 1 this fiscal



Source: RBI, National Statistics Office, CEIC, CRISIL

Is monetary tightening reaching a peak?

Domestic monetary policy is at crossroads after frontloading rate hikes

The minutes of the last Monetary Policy Committee (MPC) meeting highlight that the members regard inflation as unacceptably high. And though inflation has softened a bit since then, it would be premature to lower the guard.

While the inflation trajectory and global financial conditions still appear cloudy, we expect the RBI to raise the repo rate by another 25 bps in its September meeting, and thereafter be guided by inflation dynamics and the Fed's actions in the second half of the year.

Reiterating the Fed's sole focus on fighting inflation, which remains at decadal highs, Fed Chair Jerome Powell in his recent Jackson Hole speech said, "The historical record cautions strongly against prematurely loosening policy…in current circumstances, with inflation running far above 2% and labor market extremely tight, estimates of longer-run neutral (interest rate) are not a place for stop or pause."

The US Fed's aggressive stance, along with RBI's rate hike, liquidity reduction and increasing transmission will continue to lend a tightening bias to domestic financial conditions.

However, the repo rate is expected to remain below the May 2019 level of 6.0% this fiscal. Even as inflation moderates, we expect the real repo rate to move into positive territory only by the fourth quarter of this fiscal. And as monetary actions impact the real economy with a lag, its effects will be felt towards the end of this fiscal and in the next one.

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CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India

Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com

/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited /lifeatcrisil

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