Macroeconomics | First cut

Tight corner

July 2022

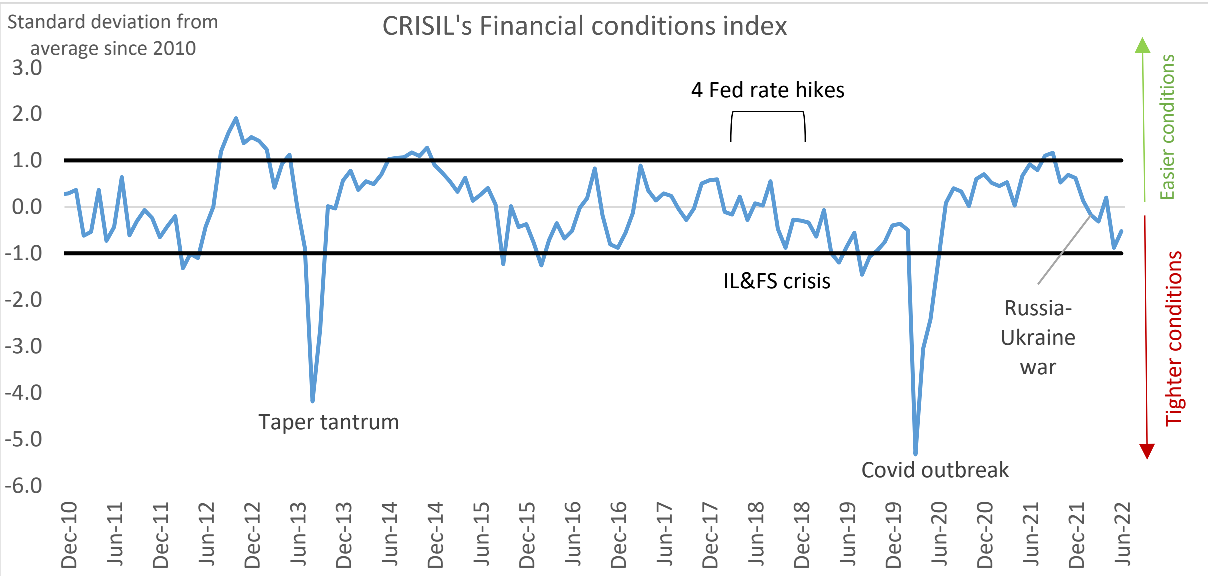
Domestic financial conditions tightening, but credit offtake improves

The increasingly tight domestic monetary policy and stronger external headwinds are holding domestic financial conditions in a bear hug. Some market segments are witnessing more stress than others. However, they remain in the comfort zone so far at the overall level, according to CRISIL's Financial Conditions Index (FCI). In June, the FCI, at a value of -0.5, was close to -0.9 in May, but tighter than 0.9 a year ago. For the June quarter, the FCI stood at -0.4 average, marginally lower than -0.1 in the March quarter.

CRISIL computes the index using key parameters across the equity, money, debt, and foreign exchange markets, coupled with indicators for policy and lending conditions. A lower index value indicates domestic financial conditions are approaching the tighter zone. A value below 0 indicates tighter conditions than the long-term average[1], with a value lower than 1 standard deviation indicating significant tightening.

Rate hikes by the Reserve Bank of India and a surge in foreign capital outflows, triggered by tighter monetary policy in the United States Federal Reserve have been tightening the financial conditions. However, credit offtake has continued to improve, with lending rates remaining lower than pre-pandemic levels and the economy's broadening recovery.

Domestic financial conditions tighter than a quarter ago, but not a cause for worry as yet



Note: Higher index value indicates easier financial conditions and vice versa; Source: CRISIL

[1] Average since April 2010

What put pressure on financial conditions?

- **The Reserve Bank of India's (RBI) accelerated policy-tightening:** The RBI increased policy rates by 50 basis points (bps) in June, faster than May's 40 bps hike. In addition, it continued to suck out excess liquidity, in line with its stated intent of 'withdrawal of accommodation'.

  Systemic liquidity in the banking system, while remaining in surplus, reduced sharply in June, reaching below pre-Covid levels. Average funds absorbed under the liquidity adjustment facility (LAF) fell steeply to Rs 2.9 trillion (1.7% of NDTL[2]) in June from Rs 4.4 trillion (2.5% of NDTL) in May and Rs 3.1 trillion (2.2% of NDTL) in pre-Covid months of January and February 2020.

  This put pressure on money and debt market yields, with the rise being sharper for shorter-tenure debt instruments. The interbank call money rate stayed below the repo rate but rose 38 bps on-month average in June, while the 91-day Treasury bill yield rose 30 bps, and the 10-year government security (G-sec) yield by 14 bps.

- **Stronger external headwinds:** The United States (US) Federal Reserve (Fed) stepped on the rate-hike accelerator, increasing the policy rate by 75 bps in June compared with 50 bps in the previous month. This led to the US dollar index rising to a two-year high, and 10-year US Treasury yield crossing 3% for the first time since November 2018. Brent crude prices averaged $120 per barrel, the highest since April 2012.

  Increased uncertainty due to firmer oil prices, talk of an ensuing global slowdown and higher interest rates in the US drove foreign portfolio investment (FPI) outflows to $6.6 billion in June from $4.7 billion in the previous month. The rupee reached an all-time low of 78 per US dollar on average in June, 1% weaker on-month.

  Primarily, it was the equity market that bore the brunt, with FPI outflows at $6.4 billion in June. Equity indices continued to decline, with the benchmark Sensex falling 1.8% on-month on average. Rising crude prices and the Fed rates added pressure on domestic bond yields as well.

What offered comfort?

- **Real policy rate remains negative:** Even as the 50 bps hike by the RBI brought the repo rate to 4.90%, it is below the prevailing inflation at 7%. Thus, policy rate adjusted for inflation remains negative and supportive of credit.

- **Benign lending rates**: While lending rates rose in June, on average they remain below pre-pandemic levels and at decadal lows.

- **Improving credit growth**: Amid supportive credit conditions, bank credit growth rose for the fifth consecutive month to 13.2% in June, the highest since 2019. The rise has been broad-based across agriculture, industry, services, and retail.

- **Controlled rupee depreciation**: Even though external headwinds pushed the rupee to an all-time low, its pace of depreciation remains lower than similar periods in the past. During the taper tantrum, the peak monthly depreciation was 6.3% in June 2013, and when the Fed hiked rates successively in 2018, the peak depreciation was 3.8%, in September 2018. So far in 2022, the peak monthly depreciation has been 1.7% in March, while it was 1% in June. The RBI's interventions in forex markets have arrested a disorderly depreciation in the rupee.

[2] Net demand and time liabilities

Conditions to tighten, but unlikely to be a significant drag on growth

Going ahead, we expect domestic financial conditions to move further towards the 'tighter zone', driven by three key factors.

1. We forecast the RBI will raise rates by at least 75 bps more this year and these will be front-loaded given high inflation. The central bank is also committed to reduce the excess liquidity prevailing in the market, the pace of which has already increased in recent months. Both these actions are expected to push up yields in the money and debt market.

2. The Fed is expected to raise rates by another 150 bps this year and 50 bps next year, according to S&P Global.

3. The talk of a global growth slowdown, in addition to high inflation is making markets jittery and driving foreign capital away from emerging economies such as India, and towards safe-haven securities in advanced economies. This could increase in coming months, putting pressure on domestic financial conditions.

Even as interest rates rise, we believe it will not create a significant drag on growth this fiscal. The repo rate in real terms is expected to turn mildly positive by this fiscal-end and remain lower than pre-pandemic levels (0.60% in fiscal 2020 and 2.92% in fiscal 2019). Monetary tightening typically impacts growth with a lag of at least 3-4 quarters; hence, the peak impact of rate hikes will be felt towards the last quarter of this fiscal and the first quarter of the next. Lending rates will further take time to move from decadal lows.

In the months to come, downside risks to US risks remain a monitorable. An increased pace of hikes by the RBI will depend on the inflation trajectory in the second half and whether the Fed slows its pace of rate hikes in event of a US recession. Hikes by other major central banks, including the European Central Bank, will keep global financial conditions tight and maintain pressure on capital flows into emerging markets, including India.

India's vulnerability to external shocks hinges on crude oil prices, since it significantly impacts a host of key macros such as current account deficit, rupee, inflation, growth, and fiscal health. In this regard, the recent softening of crude oil prices to ~$100/barrel in the first two weeks of July offers relief.

How financial conditions moved across various market segments

		Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22
Policy rate	Repo rate (%)	4	4	4	4	4	4	4	4	4	4	4	4.4	4.9
	Repo rate, inflation-adjusted (%)	-2.3	-1.6	-1.3	-0.3	-0.5	-0.9	-1.7	-2.0	-2.1	-3.0	-3.8	-2.6	-2.1
Liquidity conditions	Net absorption(-)/injection(+) under LAF (Rs bn)	-4794	-5774	-7438	-7876	-7485	-7618	-7388	-6372	-6881	-6422	-6545	-4390	-2921
Money market	Call money rate (%)	3.1	3.2	3.2	3.2	3.3	3.3	3.3	3.5	3.3	3.3	3.5	4.0	4.4
	CP 6-month spread^ (%)	0.0	0.1	0.1	-0.1	0.4	0.5	0.6	0.6	0.8	0.8	0.9	1.5	1.4
	91 day T-bill (%)	3.4	3.4	3.3	3.3	3.4	3.5	3.6	3.6	3.8	3.8	3.9	4.8	5.0
Debt market	10-year G-Sec (%)	6.0	6.1	6.2	6.2	6.3	6.3	6.4	6.6	6.8	6.8	7.1	7.3	7.5
	Term premium (%)	2.0	2.1	2.2	2.2	2.3	2.3	2.4	2.6	2.8	2.8	3.1	3.0	2.7
	AAA bond spread' (%)	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.2	0.2
	AA bond spread" (%)	1.9	1.4	1.3	1.3	1.8	1.9	2.1	2.8	2.8	2.6	3.0	3.0	3.1
Lending rates	MCLR (6 month) (%)	7.2	7.2	7.2	7.2	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.2	7.3
	Housing loan rate (%)	7.2	7.2	7.2	7.2	7.1	7.0	7.0	7.0	7.0	7.0	7.0	7.3	7.6
	Auto loan rate (%)	7.8	7.8	7.8	7.8	7.7	7.6	7.6	7.6	7.6	7.6	7.6	7.8	7.7
Credit availability	Bank credit growth (y-o-y,%)	5.8	6.1	6.7	6.7	6.8	7.0	9.1	7.1	7.9	9.6	11.1	12.1	13.2
Money supply	M3 growth (y-o-y %)	10.7	9.9	9.5	9.3	9.7	9.5	9.9	8.4	8.7	8.7	9.5	8.8	7.8
Equity market	Sensex (%*)	27.3	26.2	29.9	35.5	36.4	31.8	26.0	28.0	22.1	16.9	17.8	8.1	4.5
	NSE VIX	14.9	12.6	13.2	15.7	16.9	16.9	17.2	18.4	22.1	25.1	18.9	22.6	21.1
Forex market	Rs/USD (m-o-m %)	0.4	1.3	-0.5	-0.8	1.8	-0.6	1.2	-1.2	0.8	1.7	-0.1	1.5	1.0
Foreign capital	Net FPI (USD bn)	1.8	-1.0	2.2	3.8	-1.7	-0.3	-3.9	-3.8	-5.1	-6.6	-3.0	-4.7	-6.6
Global conditions	S&P500 (%*)	26.5	28.0	28.4	25.9	24.3	27.6	25.7	21.1	16.1	13.6	11.6	1.3	-3.2
	US 10Y Treasury yield (%)	1.5	1.3	1.3	1.4	1.6	1.6	1.5	1.8	1.9	2.1	2.7	2.9	3.1
	Brent ($/barrel)	73.1	74.4	70.0	74.6	83.7	80.8	74.3	85.5	95.8	115.6	105.8	112.4	120.1

Favourable Adverse Neutral

*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 2-year moving average; a positive % rupee change implies depreciation against the US dollar and vice-versa*
Source: RBI, National Securities Depository Ltd, US Treasury department, CEIC, CRISIL

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