Macroeconomics | First cut

Financial conditions stabilise, foreign investor inflows lend a leg-up

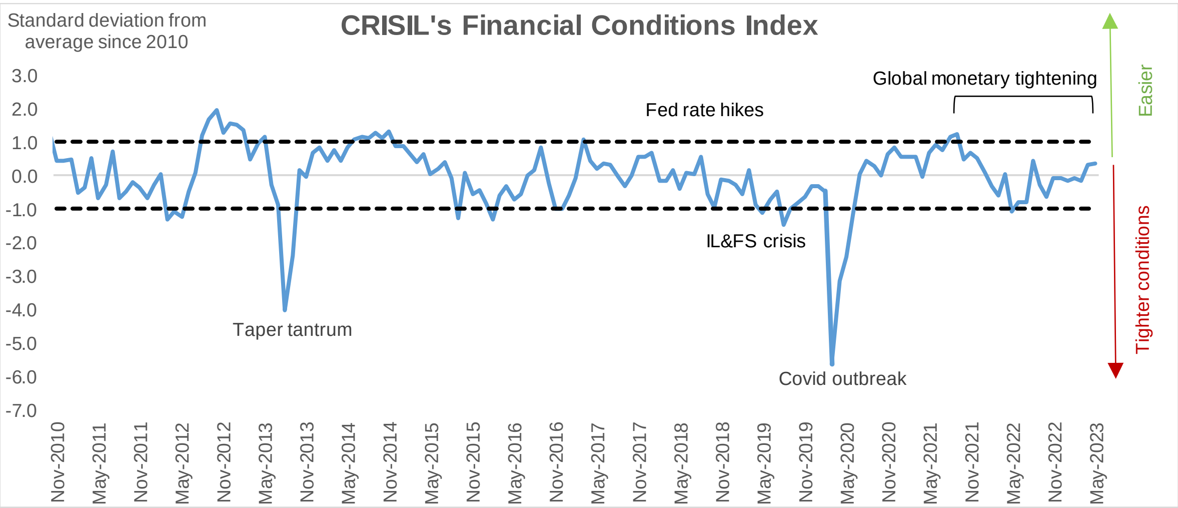
June 2023

Revival of foreign investor interest supports India's financial conditions

Domestic financial conditions remained stable in May relative to the previous month, CRISIL's Financial Conditions Index (FCI) shows. The index value was 0.3, unchanged from the previous month, but higher than the average of -0.1 seen in the March quarter. A higher value of the index indicates easier financial conditons. *CRISIL's FCI is a monthly tracker that combines 15 key parameters across equity, debt, money and forex markets along with policy and lending conditions.*

- In May, foreign portfolio investor (FPI) inflows to India surged to a nine-month high, even as global cues were volatile. Capital inflows to both equity and debt markets increased, boosting returns in these segments.
- Domestic interest rates have stabilised after the Reserve Bank of India (RBI) paused rate hikes in April. A steady deceleration in inflation eased expectations of further monetary tightening.
- Yet, most interest rates have stabilised at levels higher than the pre-pandemic five-year (fiscal 2016 to fiscal 2020) average. Moreover, rates are increasing in real terms, with softening inflation.
- Although overall bank credit growth remains strong, certain segments under industry and personal loans experienced a moderation amid rising interest rates. Rates at current levels are expected to temper demand in the economy in the coming months.
- We expect the RBI's Monetary Policy Committee (MPC) to maintain status quo on policy rates in the August meeting, as it evaluates the impact of past rate hikes on growth and inflation. We expect it to initiate rate cuts in the last quarter of this fiscal as growth slows and exerts downside pressure on inflation.

Financial conditions stabilise in May



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

Factors that supported financial conditions in May

- **Surging FPI inflows:** FPI inflows increased to $5.9 billion (net) in May — the highest since September 2022 — from $1.7 billion in the previous month.

  Even as the US Federal Reserve (Fed) and European Central Bank continued their rate hikes in May, India's robust growth, falling inflation, and easing trade deficit helped attract foreign investors. A sharp fall in crude oil prices ($75.7 per barrel in May vs $84.1 in the previous month) also augurs well for these domestic macros.

  The majority of the inflows were directed towards equities ($5.3 billion in May vs $1.4 billion in the previous month). Inflows also improved for debt ($0.4 billion vs $0.1 billion).

- **Improving equity gains**: Equities were boosted by the resurgence of FPI inflows. The benchmark S&P BSE Sensex gained 3.2% on-month in May. However, market conditions were slightly more volatile than the previous month, as indicated by National Stock Exchange's India VIX index.

- **Easing bond yields**: Yields on government securities (G-sec) softened for all tenors in May, with long-term bond yields falling the highest. Yield on the benchmark 10-year G-sec sank 20 basis points (bps) on-month to average 7.01%, the lowest since April 2022. Its term premium over the repo rate (i.e., the yield's difference with the repo rate) averaged 50 bps, the lowest since August 2017 and well below the pre-pandemic five-year average of 95 bps.

  Both global and domestic factors contributed to the softening of bond yields. Falling crude oil prices and rising FPI flows were the key external factors. Domestically, the deceleration in Consumer Price Index (CPI)-based inflation to within the RBI's target range of 2-6% eased expectations of further tightening of the monetary policy. Investors also factored in improving liquidity prospects in the coming months after the government announced withdrawal of Rs 2,000 denomination banknotes from circulation.

Factors that were a drag

- **Domestic liquidity:** Systemic liquidity reduced in May, as indicated by the RBI net-absorbing a lower quantum of funds under the liquidity adjustment facility (Rs 0.73 lakh crore net in May vs Rs 1.49 lakh crore in the previous month). Liquidity was also uneven across banks, as noted by the RBI Governor in the June monetary policy review.

  The maturing of pandemic-period TLTROs[1], a moderation in government spending, and rising currency in circulation contributed to the reduction in liquidity.

  Lower liquidity led to higher money market rates — such as call money rates, Treasury bills (T-Bills), and commercial paper (CP) rates — in May on average, relative to the previous month (see table below).

- **Elevated bank rates:** The pause in the RBI's rate hikes has halted the increase in bank lending rates as well. Yet, the benchmark MCLR[2], home loan rates, and auto loan rates have surpassed the pre-pandemic five-year average (see table below).

- **Moderating credit growth**: Overall bank credit growth moderated a tad to 15.4% on-year in May from 15.9% in the previous month. While this growth is still the strongest in a decade, a few sub-components are witnessing more slowdown, reflecting some impact of elevated lending rates.

  According to sectoral data available until April, personal loan growth slowed (19.4% on-year in April vs 20.6% in the previous month), driven by housing loans (14.3% vs 15%) and auto loans (23.1% vs 24.9%). Under

[1] Targeted long-term repo operations
[2] Marginal cost-based lending rate

industrial credit (7% vs 5.7%), growth accelerated for large firms (5.3% vs 3.0%) but slowed for micro enterprises (9.7% vs 12.4%). Services continued to rise (21.6% vs 19.8%), driven by trade, IT and professional services.

As financial conditions stabilise, broader economy to face elevated rates

The RBI's MPC is expected to be on an extended pause for the next few meetings, as it evaluates the inflation trajectory and growth momentum. While inflation has fallen in the past four months, progress of monsoon and impact of El Nino will be a monitorable. The impact of past rate hikes on growth will be the most prominent this fiscal. As growth slows, we expect the RBI to initiate rate cuts in the last quarter of this fiscal.

While the pause on rate hikes has augured well for financial markets, elevated bank lending rates could tighten financial conditions for some segments of the economy. Rates will rise further in real terms as inflation moderates. Even as the repo rate remained unchanged in May, the 'real repo rate' (i.e., repo rate adjusted for CPI inflation) increased to 2.2%, the highest since August 2019. It is worth noting that tight financial conditions had contributed to growth slowdown in fiscal 2020.

On the global front, the US Fed paused rate hikes in June, but remains on the edge as the economy continues to witness tight labour market conditions. S&P Global expects the Fed rate to remain at peak levels in calendar year 2023. While the risk of tight and volatile global financial conditions persists, India's vulnerability to these shocks is likely to be lower this year. India's key external liability — current account deficit — will likely be pared this fiscal on the back of lower crude oil prices. This, coupled with the RBI's adequate forex reserves and the country's good growth prospects, should cushion the impact of a global spillover on overall macros.

How financial conditions moved across various market segments

		Pre-pandemic average FY16-20	May-2022	Jun-2022	Jul-2022	Aug-2022	Sep-2022	Oct-2022	Nov-2022	Dec-2022	Jan-2023	Feb-2023	Mar-2023	Apr-2023	May-2023
Policy rate	Repo rate (%)	**6.3**	4.4	4.9	4.9	5.4	5.4	5.9	5.9	6.25	6.25	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	**2.0**	-2.6	-2.1	-1.8	-1.6	-2.0	-0.9	0.0	0.5	-0.3	0.1	0.8	1.8	2.2
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	**-0.5**	-2.5	-1.7	-1.1	-0.7	-0.4	0.0	-0.3	-0.3	-0.3	0.0	0.0	-0.8	-0.4
Money market	Call money rate (%)	**6.2**	4.0	4.4	4.8	5.0	5.3	6.0	6.0	6.2	6.2	6.4	6.5	6.5	6.6
	91 day T-bill (%)	**6.5**	4.8	5.0	5.3	5.5	5.8	6.2	6.4	6.4	6.4	6.7	6.9	6.8	6.8
	CP 6-month rate (%)	**7.6**	5.9	6.3	6.3	6.4	6.7	7.5	7.6	7.6	7.7	7.9	7.9	7.6	7.6
Debt market	10-year G-sec (%)	**7.2**	7.3	7.5	7.4	7.3	7.3	7.4	7.3	7.3	7.3	7.4	7.4	7.2	7.0
	Term premium (%)	**1.0**	3.0	2.7	2.5	2.0	1.8	1.5	1.4	1.1	1.1	0.9	0.9	0.7	0.3
	AAA bond spread' (%)	**0.6**	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.5
	AA bond spread" (%)	**2.0**	3.0	3.1	3.3	3.1	2.9	3.7	4.0	4.0	4.4	3.8	3.5	2.9	2.9
Lending rates	MCLR (6 month) (%)	**8.3**	7.2	7.3	7.5	7.6	7.7	7.8	7.9	8.1	8.3	8.4	8.5	8.6	8.6
	Auto loan rate (%)	**9.6**	7.8	7.7	8.3	8.6	8.6	9.1	9.0	9.2	9.3	9.5	9.5	9.6	9.6
	Housing loan rate (%)	**9.1**	7.3	7.6	7.9	8.3	8.4	8.8	8.9	9.2	9.2	9.4	9.4	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	11.1	12.1	13.4	14.3	15.3	16.6	16.0	14.9	16.3	15.5	15.0	15.9	15.4
Money supply	M3 growth (y-o-y %)	**9.7**	8.8	7.8	8.6	8.9	8.6	9.1	8.9	8.7	9.8	9.5	9.0	9.5	10.1
Equity market	Sensex (%*)	**8.7**	8.1	4.5	5.4	11.8	9.8	7.8	11.8	10.7	7.3	6.5	2.6	4.4	6.8
	NSE VIX	**15.6**	22.6	21.1	18.3	18.6	19.6	18.3	14.6	14.2	15.0	14.1	14.4	11.9	12.5
Forex market	Rs/$ (m-o-m, %)	**0.2**	1.5	1.0	2.0	-0.1	0.9	2.6	-0.6	0.8	-0.7	0.9	-0.4	-0.3	0.4
Foreign capital	Net FPI ($ bn)	**0.6**	-4.7	-6.6	0.2	7.1	-0.4	-0.4	4.1	1.1	-3.2	-0.5	0.7	1.7	5.9
Global conditions	S&P 500 (%*)	**8.9**	1.3	-3.2	-3.6	1.5	-6.4	-9.8	-5.6	-6.0	-5.1	-2.5	-5.3	-1.8	-1.2
	10-year US Treasury yield (%)	**2.3**	2.9	3.1	2.9	2.9	3.5	4.0	3.9	3.6	3.5	3.7	3.7	3.5	3.6
	Brent ($/barrel)	**57.4**	112.4	120.1	108.9	98.6	90.2	93.1	91.1	80.9	83.1	82.7	78.5	84.1	75.7

Easier than pre-pandemic five-year average

Close to pre-pandemic five-year average

Worse than pre-pandemic five-year average

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

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