Macroeconmics | First cut

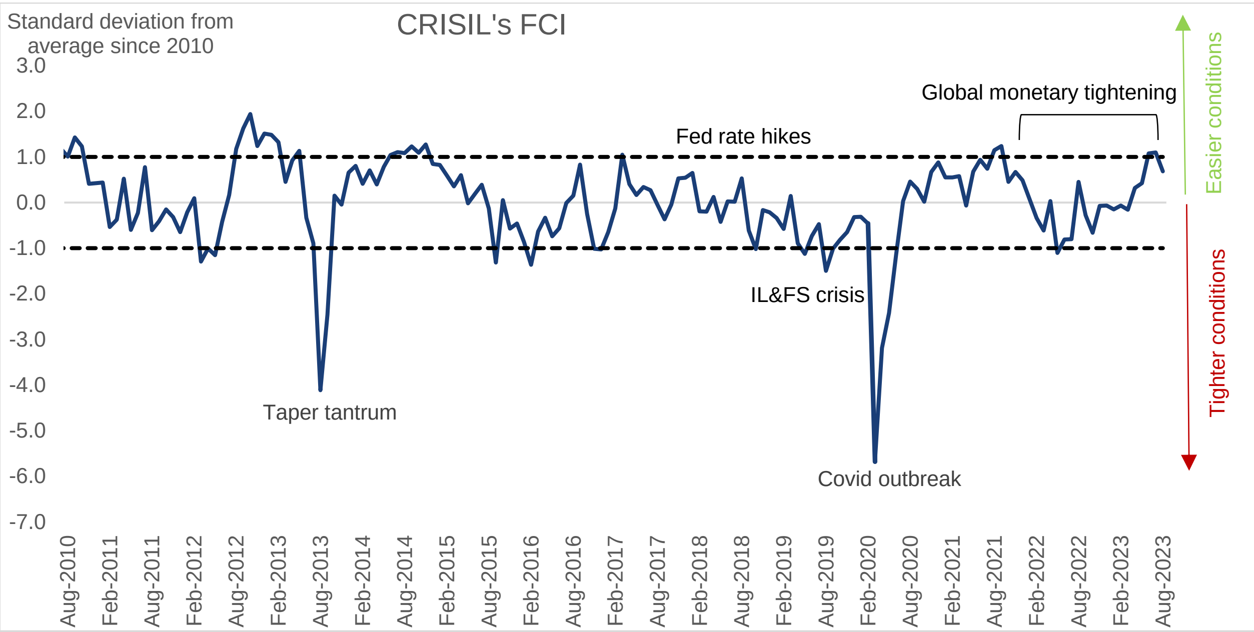
A crude squeeze

September 2023

Financial conditions strained by global macros, lower domestic liquidity

- Domestic financial conditions were tighter in August relative to the previous month, CRISIL's Financial Conditions Index (FCI) shows.
- The index value moderated to 0.7 in August after peaking at 1.1 the previous month. A higher index value indicates easier financial conditions, and vice versa. FCI had trended up in the previous four months.
- Financial conditions were primarily affected by rising crude oil prices, which hit foreign portfolio investor (FPI) flows to India — the primary driver of easing financial conditions in the previous four months. This hurt the Indian rupee as well, and weakened investor sentiment in the domestic equity and debt markets.
- Domestically, reduction in surplus liquidity played spoilsport. The temporary imposition of incremental cash reserve ratio (I-CRR) by the Reserve Bank of India (RBI) reduced systemic liquidity. This led to rising market interest rates, especially in money market and short-term government securities (G-secs).
- Nevertheless, the broader economy remains largely unaffected as bank credit growth rose further and lending rates remained stable in August.
- The recent adverse turn in macroeconomic indicators, such as crude oil prices, inflation and monsoon deficiency could weigh investor sentiment, if sustained.

Financial conditions tighten in August



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

The tightening triggers

- **Rising crude oil prices:** Brent crude oil prices rose 7.6% on-month to $86.2 per barrel, on average, in August, driven by voluntary supply cuts by Saudi Arabia and Russia. This weakened investor sentiment — particularly of FPIs — as rising crude oil prices adversely impact India's current account deficit (CAD), rupee, and inflation.

- **Lower FPI flow**: In August, FPI flow to India weakened to $2.2 billion (net inflows) compared with $5.8 billion in July. While flow to the equity market weakened ($1.5 billion in August vs $5.7 billion previous month), the debt market saw a mild uptick ($0.9 billion vs $0.5 billion).

- **Hit to equities:** Equities suffered due to a sharp fall in FPI inflow. The Benchmark S&P BSE Sensex lost 1% on-month in August. Market volatility also increased slightly, as indicated by NSE's India VIX index (see table below).

- **Depreciating rupee:** The rupee depreciated 0.8% on-month to 82.8 per US dollar, on average, in August. Lower FPI inflow, coupled with a stronger dollar, put pressure on the rupee. The trade-weighted dollar index rose 1.5% on-month in August against a basket of six major currencies.

- **Reducing domestic liquidity**: Systemic liquidity, while remaining in surplus, reduced in August. While the RBI net-absorbed Rs 1.2 lakh crore (~0.6% of net demand and time liabilities, NDTL) under its liquidity adjustment facility (LAF), it was lower than Rs 1.6 lakh crore (0.8% of NDTL) the previous month.

  Excess liquidity reduced, firstly, as the RBI's I-CRR came into force in August. The I-CRR required banks to park 10% of their increase in NDTL between May-July 2023. Secondly, liquidity was likely lower because of lower government spending, as the government had higher cash balance with the RBI in August relative to the previous month. Thirdly, credit growth at 14.9% on-year in August outpaced 13.2% deposit growth, leading to a net leakage of bank liquidity.

- **Rising short-term rates**: Money market rates rose due to lower liquidity. The interbank call money rate crossed the repo rate slightly, averaging 6.57% in August, 10 basis points (bps) higher on-month. The 91-day Treasury bill (T-bill) rose 7 bps, 6-month commercial paper (CP) 10 bps, and 6-month certificate of deposit (CD) 6 bps.

- **Rising bond yields**: Bond yields were hit by rising crude oil prices, domestic inflation, and liquidity. Yield on the 10-year G-sec rose 8 bps on-month to 7.19%, on average, in August. Sharp rise in crude oil prices affected yields given its upside risks for India's CAD and inflation. Incoming CPI inflation data in August showed its resurgence to 7.4%, much above the RBI's upper target of 6%. These developments reduced expectations of a rate cut by the RBI in the next few policies.

  Reducing surplus liquidity also contributed to rising yields, especially of shorter tenure. Compared with 8 bps rise in 10-year G-sec, 1-year G-sec rose 16 bps, 2-year 10 bps, 3-year 11 bps, and 5-year G-sec 9 bps. The yield curve at present appears to be the flattest since 2018.

  However, FPI inflow to the debt market increased to $0.9 billion in August from $0.5 billion previous month, maintaining hope for India's possible inclusion in global bond indices.

Comfort zone catalysts

- **The RBI's status quo on policy rates:** The RBI retained the policy rates in its August meeting for the third time in a row — repo rate at 6.50%, standing deposit facility at 6.25%, and marginal standing facility at 6.75% — as well as its stance at withdrawal of accommodation.

- **Stable bank lending rates:** The key bank lending rates saw negligible changes, with the 6-month marginal cost of funds based lending rate (MCLR) averaging 8.65% in August vs 8.63% the previous month, auto loan rate at 9.60% vs 9.59%, and housing loan rate at 9.44% in both months.

  Transmission of the RBI's previous rate hikes to the banking system is not yet complete. Compared with 250 bps hike in the repo rate since April 2022, 6-month MCLR has increased 151 bps, auto loan 192 bps, and housing loan 233 bps. Deposit rates have risen only 177 bps until August, as banking liquidity has been comfortable so far.

- **Rising bank credit growth:** Bank credit growth inched up to 14.9%[1] on-year in August from 14.7% in July. It is higher than the average growth of 9.7% in the five years preceding the pandemic.

  The RBI's Bank Lending Survey released in August reveals bankers' higher optimism on loan demand in the second quarter of fiscal 2024, along with easing of loan terms and conditions. This, coupled with stable bank interest rates, is facilitating higher credit offtake.

Macro risks could keep investors on edge

The impact of recent deterioration in some global and domestic macros on markets and financial conditions needs to be monitored.

From a global standpoint, Brent crude prices crossed the $95 per barrel mark in September — the highest since November 2022; and the 10-year United States Treasury yields crossed 4.3% for the first time after the 2008 financial crisis. Both these developments are a risk to FPI flows to India.

Domestically, CPI inflation softened to 6.8% in August, but remains above the RBI's target. We expect inflation to fall further in Spetember. Beyond that monsoon outcome in September and movements in crude oil prices. This can influence the timing of monetary policy easing by the RBI.

We expect the Monetary Policy Committee (MPC) to maintain status quo on rates in the October meeting, as it awaits a clearer picture on inflation. The first rate cut is likely early next fiscal.

Major global central banks have not moved so far on rate cuts. The European Central Bank hiked policy rates in September for the 10th consecutive time. While the US Federal Reserve, kept policy rate unchanged in September, S&P Global does not expect a rate cut in the US before June 2024.

All these suggest monetary conditions may take longer to ease and support financial conditions. The impact of adverse macro cues can also influence market sentiment. Nevertheless, India's encouraging macros vis-à-vis other major economies could keep investors interested in the Indian markets.

[1] Credit excluding the impact of merger of HDFC non-bank with the bank.

Financial conditions across market segments

		Pre-pandemic average	Past 3 years' annual average			Current fiscal				
		FY16-20	FY21	FY22	FY23	Apr-2023	May-23	Jun-23	Jul-23	Aug-2023
Policy rate	Repo rate (%)	**6.3**	*4.0*	*4.0*	*5.5*	6.5	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	**2.0**	*-2.2*	*-1.5*	*-1.1*	1.8	2.2	1.7	-0.9	-0.3
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	**-0.5**	*-3.0*	*-3.9*	*-0.9*	-0.8	-0.4	-0.6	-0.8	-0.6
Money market	Call money rate (%)	**6.2**	*3.4*	*3.3*	*5.4*	6.5	6.6	6.5	6.5	6.6
	91 day T-bill (%)	**6.5**	*3.3*	*3.5*	*5.8*	6.8	6.8	6.7	6.7	6.8
	CP 6-month rate (%)	**7.6**	*4.4*	*4.3*	*6.9*	7.6	7.6	7.5	7.4	7.5
Debt market	10-year G-sec (%)	**7.2**	*6.0*	*6.3*	*7.3*	7.2	7.01	7.0	7.1	7.2
	Term premium (%)	**1.0**	*1.9*	*2.3*	*1.8*	0.7	0.5	0.5	0.6	0.7
	AAA bond spread' (%)	**0.6**	*0.7*	*0.5*	*0.2*	0.2	0.3	0.3	0.3	0.3
	AA bond spread" (%)	**2.0**	*3.6*	*2.0*	*3.5*	2.9	2.9	3.0	2.9	2.6
Lending rates	MCLR (6 month) (%)	**8.3**	*7.4*	*7.1*	*7.8*	8.6	8.6	8.6	8.7	8.7
	Auto loan rate (%)	**9.6**	*8.0*	*7.7*	*8.7*	9.6	9.6	9.6	9.6	9.6
	Housing loan rate (%)	**9.1**	*7.4*	*7.1*	*8.4*	9.4	9.4	9.4	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	*5.9*	*7.0*	*14.2*	15.9	15.4	16.0	14.7	14.9
Money supply	M3 growth (y-o-y %)	**9.7**	*12.2*	*9.6*	*8.9*	9.5	10.1	13.4	11.3	11.5
Equity market	Sensex (%*)	**8.7**	*7.6*	*27.0*	*8.7*	4.4	6.8	8.0	12.0	10.1
	NSE VIX	**15.6**	*25.8*	*17.9*	*17.5*	11.9	12.5	11.2	11.2	11.6
Forex market	Rs/$ (m-o-m, %)	**0.2**	*-0.2*	*0.4*	*0.6*	-0.3	0.4	-0.1	-0.1	0.8
Foreign capital	Net FPI ($ bn)	**0.6**	*3.0*	*-1.3*	*-0.5*	1.7	5.9	6.8	5.8	2.2
Global conditions	S&P 500 (%*)	**8.9**	*14.0*	*24.3*	*-2.8*	-1.8	-1.2	3.3	6.9	5.6
	10-year US Treasury yield (%)	**2.3**	*0.9*	*1.6*	*3.4*	3.5	3.6	3.7	3.9	4.2
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	*95.4*	84.1	75.7	74.9	80.1	86.2

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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