Macroeconomics | First cut

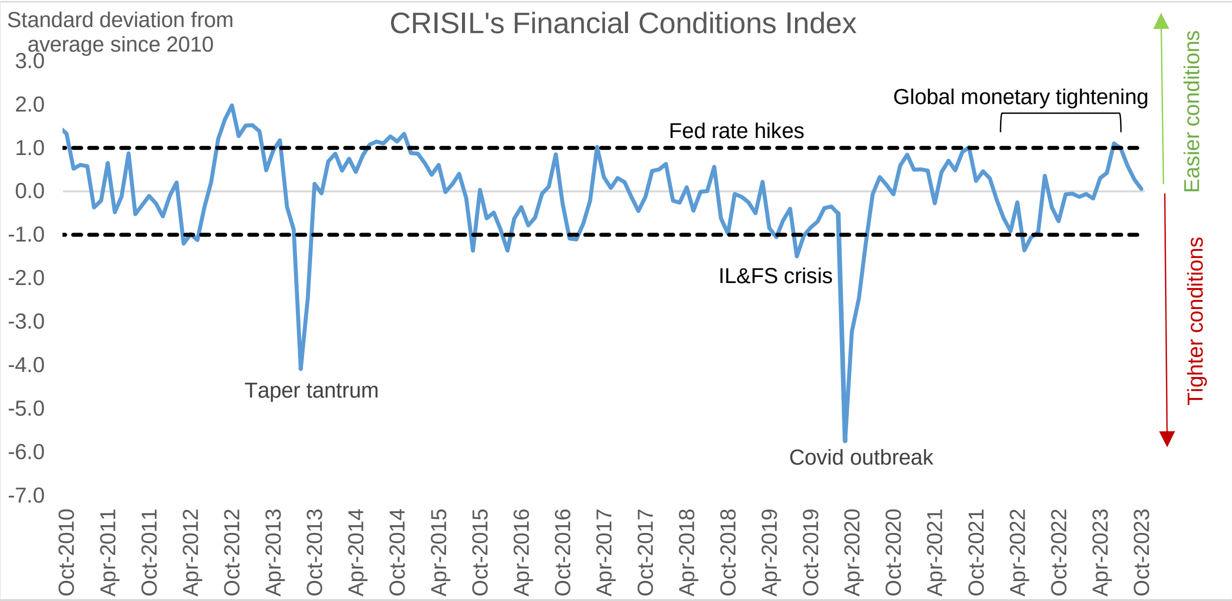
Getting tighter

November 2023

Financial conditions tighten on rising FPI outflows and G-Sec yields

- CRISIL's Financial Conditions Index (FCI) shows domestic financial conditions to have tightened further in October from September
- The index value reduced to 0.1 from 0.3. The average for the first half of fiscal 2024 was 0.6. A lower index value indicates tightening financial conditions. That said, the positive FCI value implies that conditions remained easier when compared with the long-term average period (since April 2010)
- Two factors have a larger role to play behind India's tightening financial conditions – foreign portfolio investor (FPI) outflows for two months in a row (especially from the equity market), and a sharp rise in government security (G-Sec) yields
- Globally, escalating tensions in the Middle East hit Indian markets through crude price hikes, while US Treasury yields touching 5% for the first time post 2007 led to FPI outflows
- Markets may not see monetary policy easing this year as RBI remains committed to aligning inflation to its 4% target. While RBI is expected to keep policy rates unchanged, it may use liquidity tools to keep rates consistent with its withdrawal of accommodation stance. Its recent move to increase risk weights for consumer loans could slow credit growth
- While geopolitical risks remain high and act as a potential source of volatility, higher-for-longer interest rates in advanced economies could sustain pressure on FPI flows

Financial conditions tighten for the fourth consecutive month



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

Global and domestic factors unsupportive

- **Rise in FPI outflows**: FPIs remained net-sellers for the second consecutive month, withdrawing $2.1 billion from Indian markets in October compared with $1.7 billion the previous month. The equity segment saw $2.9 billion of outflows, higher than the $1.8 billion seen a month prior. However, the debt segment saw inflows ($0.8 billion vs $0.1 billion), possibly reflecting pre-positioning in advance of India's inclusion in the JP Morgan bond index next year

- **Rising bond yields:** Bond yields rose in October, with the benchmark 10-year G-sec rising 16 basis points (bps) on-month to 7.33% average in October.

  RBI's open market sales drove rise in G-sec yields. While RBI kept policy rates unchanged in October's monetary policy, it surprised the market by indicating open market sales of G-Secs to drain excess liquidity. Open market sales subsequently increased to Rs. 9915 crore in October from Rs. 8385 crore previous month. External factors such as rising US Treasury yields and crude price hikes also added pressure. Even so, FPI inflows to the debt market increased, capping a further rise in yields

- **Domestic liquidity tightening:** The deficit in systemic liquidity increased slightly in October from the previous month, as evident from RBI net injecting Rs 0.5 lakh crore (0.2% of NDTL[1]) under the liquidity adjustment facility (LAF) compared with Rs 0.2 lakh crore in September (0.1% of NDTL).

  RBI's open market sales of G-Secs, credit growth staying higher than deposit growth, as well as lower government spending, contributed to lower liquidity.

  Rising money market rates: The deficit in liquidity drove up money market rates. The interbank call money rate stayed above the repo rate, averaging 6.7% in October, 6 bps higher on-month. Other money market rates rose as well, including 6-month certificates of deposit (21 bps higher on-month) and 6-month commercial paper (17 bps)

- **Escalating tensions in the Middle East** led crude prices to spike in the first half of October, impacting the domestic equity market and pressurising the 10-year G-sec yield. However, crude prices eased in the second half

- **Rising US yields:** US Treasury yields rose in October, with the 10-year note averaging 4.8%, up 42 basis points (bps) from its September average. It also touched 5% for the first time post 2007. The US Federal Reserve's (Fed's) dot plot at its September meeting indicated that rates will remain higher for longer, leading to higher bond yields. A rise in US government borrowing, along with a spike in crude prices, spurred the rise in US yields. Strong retail sales data, persistent inflation, and a strong dollar also contributed to the rise

Resilient credit growth provides support

- **Bank credit growth stayed robust**, at 15.2%[2] in October. Sectoral data[3] available till September shows double-digit credit growth in services (21.3% vs 20.7%) and agriculture (16.8% vs 16.6%). Credit growth in personal loans remained robust at18.2%. Industry credit grew 6.5% (vs 6.3% in September) due to a pick-up in credit growth in large industries (6.1% vs 5.4%). Alternatively, credit growth in micro and small industries slowed (10.1% vs. 10.7%).

- **Bank lending rates remained stable** in October. The 6-month marginal cost of funds based lending rate (MCLR) rose a nominal 2 bps this month.

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[1] Net demand and time liabilities
[2] Excluding impact of HDFC merger
[3] Excluding impact of HDFC merger

Transmission to lending rates is yet to be completed. Compared with the repo rate's 250 bps rise in the current cycle, the 6-month MCLR rose 160 bps, and deposit rates, 170 bps. Auto loan and housing loan rates rose 150 bps and 238 bps, respectively on average.

Monetary policy transmission may rein in financial conditions

Central bankers globally await the impact of their aggressive rate hikes on their financial conditions. The RBI governor noted in the October policy that the transmission of its rate hikes is still underway. In the US, financial conditions tightened sharply recently, as per S&P Global[4].

Monetary policies are expected to maintain pressure on interest rates this fiscal. While RBI is expected to keep the repo rate unchanged, it can use its liquidity management tools to improve the transmission of past rate hikes to bank deposit and lending rates. Its recent move to increase risk weightage for banks on credit to consumers and non-banking financial companies could also slow the pace of credit offtake. Rates will also rise in real terms with moderating domestic inflation.

Continuing resilience in the US economy can lead Fed to hike rates once more in December, as per S&P Global. It is then expected to hold rates steady in the first half of 2024.

Elevated geopolitical risks act as a potential source of volatility, especially if they raise crude prices. FPI flows may be influenced by the impact of crude prices on India's current account deficit and rupee movement.

Nevertheless, the impact of these developments on India's financial markets is unlikely to be pronounced as healthy domestic growth prospects, low vulnerability of the external sector and the inclusion in the global bond index, could keep investors interested in the domestic markets.

Table: 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	Sep-23	Oct-2023
Policy rate	Repo rate (%)	**6.3**	*4.0*	*4.0*	*5.5*	6.5	6.5	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	1.5	1.6
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	0.1	0.2
Money market	Call money rate (%)	**6.2**	*3.4*	*3.3*	*5.4*	6.5	6.6	6.5	6.5	6.6	6.7	6.7
	91 day T-bill (%)	**6.5**	*3.3*	*3.5*	*5.8*	6.8	6.8	6.7	6.7	6.8	6.8	6.9
	CP 6-month rate (%)	**7.6**	*4.4*	*4.3*	*6.9*	7.6	7.6	7.5	7.4	7.5	7.6	7.8
Debt market	10-year G-sec (%)	**7.2**	*6.0*	*6.3*	*7.3*	7.2	7.0	7.0	7.1	7.2	7.2	7.3
	Term premium (%)	**1.0**	*1.9*	*2.3*	*1.8*	0.7	0.5	0.5	0.6	0.7	0.7	0.8
	AAA bond spread' (%)	**0.6**	*0.7*	*0.5*	*0.2*	0.2	0.3	0.3	0.3	0.3	0.3	0.2
	AA bond spread" (%)	**2.0**	*3.6*	*2.0*	*3.5*	2.9	2.9	3.0	2.9	2.6	2.7	3.2
Lending rates	MCLR (6 month) (%)	**8.3**	*7.4*	*7.1*	*7.8*	8.6	8.6	8.6	8.7	8.7	8.7	8.7
	Auto loan rate (%)	**9.6**	*8.0*	*7.7*	*9.0*	9.8	9.7	9.7	9.8	9.8	9.8	9.8
	Housing loan rate (%)	**9.1**	*7.4*	*7.1*	*8.4*	9.4	9.4	9.5	9.5	9.5	9.5	9.5
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	15.3	15.2
Money supply	M3 growth (y-o-y %)	**9.7**	*12.2*	*9.6*	*8.9*	9.5	10.1	13.4	10.6	10.8	10.9	10.8
Equity market	Sensex (%*)	**8.7**	*7.6*	*27.0*	*8.7*	4.4	6.8	8.0	12.0	10.1	11.2	8.9
	NSE VIX	**15.6**	*25.8*	*17.9*	*17.5*	11.9	12.5	11.2	11.2	11.6	11.2	11.1
Forex market	Rs/$ (m-o-m, %)	**0.2**	*-0.2*	*0.4*	*0.6*	-0.3	0.4	-0.1	-0.1	0.8	0.3	0.2
Foreign capital	Net FPI ($ bn)	**0.6**	*3.0*	*-1.3*	*-0.5*	1.7	5.9	6.8	5.8	2.2	-1.7	-2.1
Global conditions	S&P 500 (%*)	**8.9**	*14.0*	*24.3*	*-2.8*	-1.8	-1.2	3.3	6.9	5.6	4.5	1.4
	10-year US Treasury yield (%)	**2.3**	*0.9*	*1.6*	*3.4*	3.5	3.6	3.7	3.9	4.2	4.4	4.8
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	*95.4*	84.1	75.7	74.9	80.1	86.2	94.0	91.1

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; credit and money supply data excludes impact of a bank with non-bank*
Source: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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