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Macroeconomics | First cut

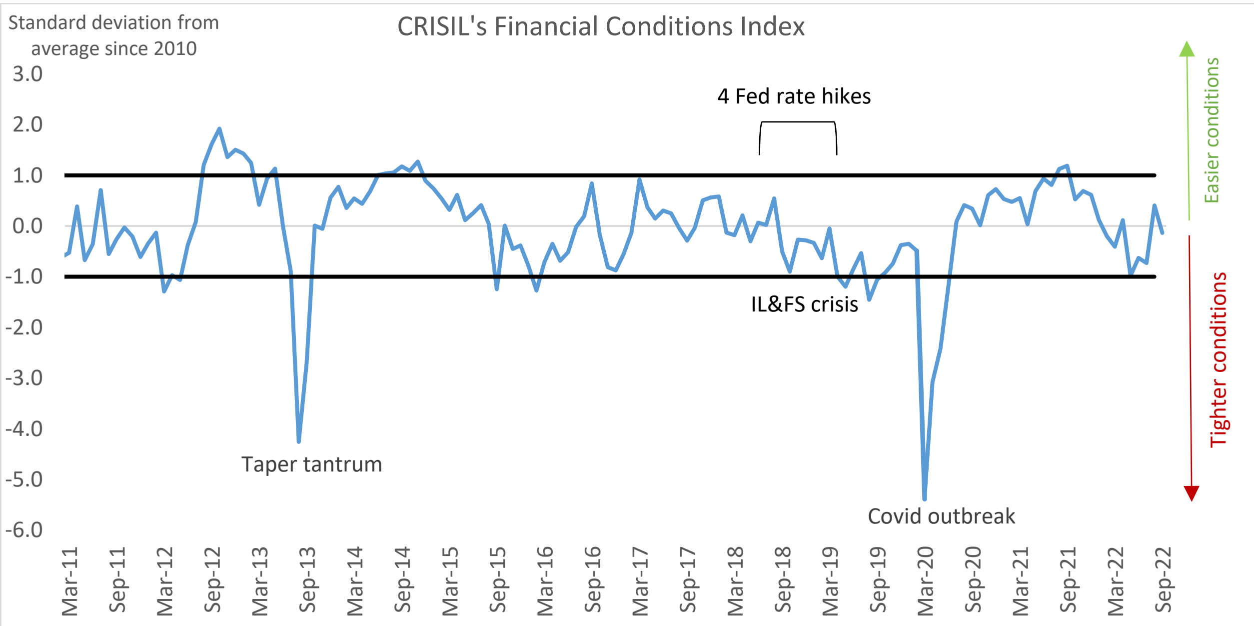
Tightening trend

October 2022

Global headwinds buffet Indian markets in September

- After a brief respite in August, financial conditions tightened in September as continued aggressive rate hikes by the US Federal Reserve (Fed) affected risk sentiment globally.
- CRISIL's Financial Conditions Index (FCI) shows that conditions were tighter than the long-term average, but within the comfort zone. The index printed 0.1 standard deviation (SD) tighter than the long-term average (since 2010) in September, compared with the August reading of 0.4 SD easier than average[1].
- In September, aggressive rate hikes by the Fed turned foreign portfolio investors (FPIs) into net sellers, causing significant weakening in the rupee and equity losses. Going ahead, global shocks could mount more pressure as the Fed stays aggressive and geopolitical uncertainties remain high; both will strengthen the dollar.
- Domestic monetary tightening and liquidity reduction have also contributed to rising interest rates, though credit growth is unaffected so far.

Domestic financial conditions tighten in September



Note: 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. A positive index value implies easier conditions, and a negative index tighter conditions relative to long-term average since 2010

Source: CRISIL

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[1] A lower value indicates tighter financial conditions, and vice versa. Value < 1 SD indicates financial conditions within the comfort zone.

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Adverse global financial conditions drove FCI tightening

- **Strong US dollar** was the main sore point for financial markets. The nominal broad dollar index appreciated 2.7% on-month in September to reach a 20-year high. The dollar gained strength as the Fed hiked policy rate by 75 basis points (bps) in the month, bringing total hikes to 300 bps in 2022 so far. It has been more aggressive than other major central banks such as European Central Bank (125 bps hike in 2022), Bank of England (200 bps hike), and Bank of Japan (no hike). Rising interest rate differentials drove capital flows in favour of the US.

- **FPIs turned net sellers**, net-withdrawing $0.4 billion in September as against net-investing $7.1 billion the previous month. Selling was mainly seen in the equity market (-$0.9 billion in September vs $6.4 billion previous month). However, inflows into the debt market continued ($0.5 billion, same as the previous month) on hopes of India's inclusion in global bond indices.

- **The rupee breached the $80 mark**, averaging 80.2 per dollar in September, 0.9% weaker on-month. Strengthening of the dollar weakened the rupee even as India's trade deficit moderated ($25.7 billion vs $28 billion). However, the rupee's depreciation was lesser than the dollar's pace of appreciation. The Reserve Bank of India's (RBI) significant foreign exchange interventions to supply dollars reduced pressure on the rupee. Also, the rupee fared better than the currencies of major advanced economies.

- **Equities weakened** as a rising dollar and tightening global financial conditions hit sentiment. The benchmark Sensex weakened 0.2% on-month, on average, in September. The market turned more volatile, as reflected in NSE India VIX rising to 19.6 in September from 18.6 in August.

Transmission of the RBI's rate hikes is picking up

- **Money market and bank lending rates continued to rise** in September, reflecting increasing transmission of the RBI's rate hikes. In the money market, the interbank call money rate rose 29 bps on-month to average 5.29% in September, 91-day Treasury bill (T-bill) 24 bps to 5.79%, six-month certificates of deposit (CDs) 31 bps to 6.5%, and six-month commercial papers (CPs) 35 bps to 6.7%. Banks are raising lending rates as well. The six-month MCLR[2] rose 8 bps on-month and home loan rates increased 14 bps, on average.

- **Rates still lower than the pre-pandemic five-year average** for money market instruments and bank lending rates.

- **The RBI raised policy rates** by 50 bps towards September-end, leading to a total of 190 bps hike this fiscal so far.

- **Reduction in liquidity has contributed to increasing transmission** of the RBI's rate hikes. Systemic liquidity moved closer to neutral in September, as the RBI's absorption of funds under liquidity adjustment facility (LAF) reduced to Rs 706 billion (0.4% of NDTL[3]) in September from Rs 1,215 billion the previous month. The RBI's open market sales of government securities (G-secs), dollar sales in the forex market, coupled with a sharp rise in credit growth and tax outflows have been sucking liquidity out of the banking system.

Domestic bond market was the outlier in rising rate cycle

- **Yield on 10-year G-sec eased** 13 bps on-month to average 7.25% in September. G-secs defied pressure from rising US rates and reducing domestic liquidity, as hopes of India's inclusion in global bond indices boosted sentiment and maintained FPI inflows to the debt market.
- **Corporate bond spreads narrowed across rating categories,** as fresh issuances by corporate borrowers remained thin.

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[2] Marginal cost-based lending rate
[3] Net demand and time liabilities

Credit growth surges despite rising lending rates

Bank credit growth grew 16.4% on-year in September, the highest since October 2013. Benign lending rates (lower than pre-pandemic average) and post-pandemic demand recovery have contributed to robust credit growth. Sectoral data available until July indicates a broad-based rise in credit, with retail loans and services sector seeing the strongest growth.

Rising global shocks to test India's resilience in coming months

The Fed is expected to remain aggressive in hiking rates, as US inflation remains at a 40-year high. S&P Global expects the Fed rate to rise by another 100 bps to 4.00-4.25% by early 2023. This will drive the tightening in global financial conditions and strengthen the US dollar. The dollar also gains from its status as a safe-haven currency and the persisting Russia-Ukraine conflict.

India's reserves are adequate relative to short-term liabilities such as current account deficit (CAD) and short-term external debt. However, these have been depleting fast, and persisting external shocks could increase pressure. The rupee continues to face significant risks from tight global financial conditions and increased CAD.

Domestic monetary policy may remain tight as well since inflation is way above the target and the rupee faces significant external risks. The transmission of rate hikes is expected to pick up further with reducing liquidity. Bond yields, too, will face renewed pressure, as India's inclusion in global bond indices has been delayed.

How financial conditions moved across various market segments

		Pre-pandemic trend	Covid years		Current fiscal year					
		FY16-20	FY21	FY22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22
Policy rate	Repo rate (%)	**6.3**	*4.0*	*4.0*	4	4.4	4.9	4.9	5.4	5.4#
	Repo rate, inflation-adjusted (%)	**2.0**	*-2.2*	*-1.5*	-3.8	-2.6	-2.1	-1.8	-1.6	-2.0
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	-0.4
Money market	Call money rate (%)	**6.2**	*3.4*	*3.3*	3.5	4.0	4.4	4.8	5.0	5.3
	91 day T-bill (%)	**6.5**	*3.3*	*3.5*	3.9	4.8	5.0	5.3	5.5	5.8
	CP 6-month rate (%)	**7.6**	*4.4*	*4.3*	4.9	5.9	6.3	6.3	6.4	6.7
Debt market	10-year G-sec (%)	**7.2**	*6.0*	*6.3*	7.1	7.3	7.5	7.4	7.3	7.3
	Term premium (%)	**1.0**	*1.9*	*2.3*	3.1	3.0	2.7	2.5	2.0	1.8
	AAA bond spread' (%)	**0.6**	*0.7*	*0.5*	0.1	0.2	0.2	0.2	0.2	0.1
	AA bond spread" (%)	**2.0**	*3.6*	*2.0*	3.0	3.0	3.1	3.3	3.1	2.9
Lending rates	MCLR (6 month) (%)	**8.3**	*7.4*	*7.1*	7.1	7.2	7.3	7.5	7.6	7.7
	Auto loan rate (%)	**9.6**	*8.0*	*7.7*	7.6	7.8	7.7	8.3	8.5	8.5
	Housing loan rate (%)	**9.1**	*7.4*	*7.1*	7.0	7.3	7.6	7.9	8.3	8.4
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	*5.9*	*7.0*	10.1	11.1	12.1	13.4	14.3	16.4
Money supply	M3 growth (y-o-y %)	**9.7**	*12.2*	*9.6*	9.5	8.8	7.8	8.6	8.9	8.6
Equity market	Sensex (%*)	**8.7**	*7.6*	*27.0*	17.8	8.1	4.5	5.4	11.8	9.8
	NSE VIX	**15.6**	*25.8*	*17.9*	18.9	22.6	21.1	18.3	18.6	19.6
Forex market	Rs/$ (m-o-m, %)	**0.2**	*-0.2*	*0.4*	-0.1	1.5	1.0	2.0	-0.1	0.9
Foreign capital	Net FPI ($ bn)	**0.6**	*3.0*	*-1.3*	-3.0	-4.7	-6.6	0.2	7.1	-0.4
Global conditions	S&P 500 (%*)	**8.9**	*14.0*	*24.3*	11.6	1.3	-3.2	-3.6	1.5	-6.4
	10-year US Treasury yield (%)	**2.3**	*0.9*	*1.6*	2.7	2.9	3.1	2.9	2.9	3.5
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	105.8	112.4	120.1	108.9	98.6	90.2

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

*Note: #The RBI hiked the repo rate to 5.90% on September-end; ^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 dollar and vice versa.*
Source: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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