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Macroeconomics | First cut

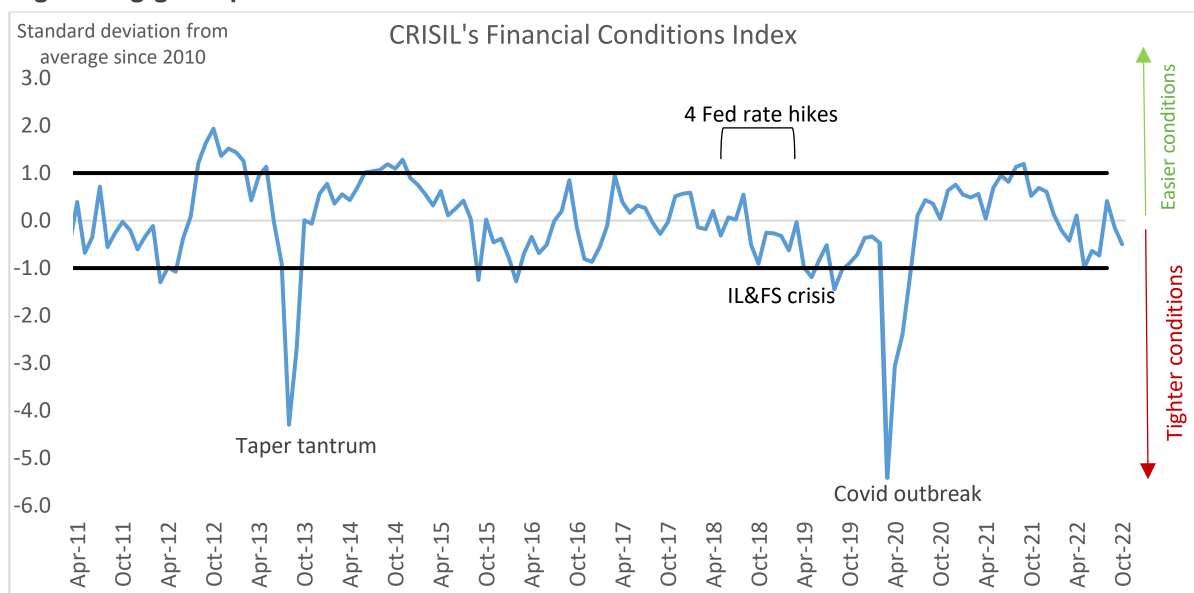
Tightening quickens

November 2022

Global and domestic factors tighten India's financial conditions

- Domestic financial conditions tightened in October relative to the previous month. Though conditions were mildly tight compared with the long-term average, as indicated by CRISIL's Financial Conditions Index (FCI), they remained in the comfort zone[1].
- The FCI value printed 0.5 standard deviation (SD) tighter than the long-term average (since 2010), compared with the September reading of 0.1 SD tighter than the average[2].
- Domestic monetary tightening gained momentum after the Reserve Bank of India (RBI) hiked policy rates by 50 basis points (bps) at September-end. Liquidity went into deficit by October-end, driven by surging credit demand, rising currency in circulation, and foreign portfolio investor (FPI) outflows. Money market rates and bond yields rose, while banks hiked lending rates at a greater pace sequentially. Yet, bank lending rates remained lower than the pre-pandemic 5-year average, supporting the continued surge in credit growth.
- Globally, financial conditions remained tight with the US dollar index strengthening further, Treasury yields reaching a 14-year high, and equities sinking lower. FPI outflows and elevated trade deficit ramped up pressure on the rupee.
- While global factors drove the initial tightening in India's financial conditions, domestic factors have begun contributing more to the tightening of late.

Tightening gains pace



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

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 value tighter conditions relative to the long-term average since 2010.
Source: CRISIL

Drivers of tightening of financial conditions

1. Domestic monetary tightening

- **The RBI hiked the policy rate** by 50 bps towards September-end, bringing the repo rate to 5.90% — the highest level since June 2019. This narrowed the gap between the repo rate and headline consumer price index-based inflation, which printed at 6.8% in October (compared with 7.4% previous month). Yet, real policy rates remained negative for the 36th month in a row.

- **Systemic liquidity turned from surplus to deficit** in October, driven by bank credit growing faster than deposits and rising currency in circulation amid the festive season. On average, liquidity was neutral in the month, as indicated by the RBI absorbing negligible amount under the liquidity adjustment facility, compared with net-absorption (i.e. surplus) of 0.4% of NDTL[3] previous month.

2. Increasing transmission of rate hikes

- **Money market rates rose quicker than the repo rate** in October as liquidity turned to deficit. The interbank call money rate averaged above the repo rate for the first time since June 2019 – at 6.04%, up 76 bps on-month. Additionally, the 91-day Treasury Bill (T-Bill) rose 45 bps to 6.24%, 6-month certificate of deposit (CD) 59 bps to 7.1%, and 6-month commercial paper (CP) 72 bps to 7.5%. These rates are now close to their pre-pandemic 5-year average *(see heatmap below)*.

- **Bond yields rose,** driven by the repo rate hike, reducing liquidity, and FPI outflows from debt. Yield on the benchmark 10-year government security (G-sec) rose 19 bps on-month to average 7.44%. Corporate bond yields also rose, with the rise being sharper for lower-rated bonds.

- **Banking lending rate hikes gained momentum**, with auto loan rates rising an average 43 bps on-month and home loan rates 42 bps on-month. Yet, the rates remained lower than their pre-pandemic 5-year average.

3. Adverse global cues

- **US bond yields rose in October,** with the benchmark 10-year US Treasury yield crossing 4% for the first time post the 2008 financial crisis.

- **The US dollar index** rose an average1.6% on-month, reaching a 20-year high.

- **FPIs remained net sellers for the second consecutive month,** net-withdrawing $0.4 billion (same as previous month).

- **Rupee depreciated a sharp** 2.6% on-month to average 82.3 per US dollar, driven by a stronger US dollar, FPI outflows, and seemingly lower use of foreign exchange reserves by the RBI to stabilise the rupee.

Lending rates remain benign

- **Bank credit growth rose to a decadal high** of 17.9% on-year in October, compared with 16.4% previous month. Benign lending rates, coupled with robust credit demand, is leading to a broad-based rise in credit growth. Services and personal loans are seeing the sharpest rise.

Rate hike transmission and tight global conditions to remain a drag

The RBI's rate hike of 190 bps so far this fiscal is yet to be completely transmitted to lending rates. The central

[3] Net demand and time liabilities

bank is expected to keep monetary and liquidity conditions tight amid persisting elevated inflation. With reducing liquidity, the transmission of rate hikes to market interest rates will increase in the coming months. This could take off some steam from the strength in credit growth, and hit growth by next year.

Global factors remain adverse with a sharp rise in the US policy rate, a stronger dollar and elevated crude oil prices. The US Federal Reserve's (Fed's) policy rate is already at the post-2008 financial crisis high of 3.75-4.00% in November. S&P Global expects the Fed rate to rise to 4.00-4.25% by early 2023. The US dollar also benefits from its status as a safe-haven currency and the ongoing Russia-Ukraine conflict. A strong US dollar, along with elevated crude oil prices, will maintain pressure on the rupee.

In sum, overall financial conditions in India are expected to tighten further with rising market interest rates and a weakening rupee.

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	Oct-22
Policy rate	Repo rate (%)	6.3	4.0	4.0	4	4.4	4.9	4.9	5.4	5.4	5.9
	Repo rate, inflation-adjusted (%)	2.0	-2.2	-1.5	-3.8	-2.6	-2.1	-1.8	-1.6	-2.0	-0.9
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	0.0
Money market	Call money rate (%)	6.2	3.4	3.3	3.5	4.0	4.4	4.8	5.0	5.3	6.0
	91 day T-bill (%)	6.5	3.3	3.5	3.9	4.8	5.0	5.3	5.5	5.8	6.2
	CP 6-month rate (%)	7.6	4.4	4.3	4.9	5.9	6.3	6.3	6.4	6.7	7.5
Debt market	10-year G-sec (%)	7.2	6.0	6.3	7.1	7.3	7.5	7.4	7.3	7.3	7.4
	Term premium (%)	1.0	1.9	2.3	3.1	3.0	2.7	2.5	2.0	1.8	1.5
	AAA bond spread' (%)	0.6	0.7	0.5	0.1	0.2	0.2	0.2	0.2	0.1	0.1
	AA bond spread" (%)	2.0	3.6	2.0	3.0	3.0	3.1	3.3	3.1	2.9	3.7
Lending rates	MCLR (6 month) (%)	8.3	7.4	7.1	7.1	7.2	7.3	7.5	7.6	7.7	7.8
	Auto loan rate (%)	9.6	8.0	7.7	7.6	7.84	7.70	8.3	8.5	8.5	8.9
	Housing loan rate (%)	9.1	7.4	7.1	7.0	7.30	7.57	7.88	8.3	8.4	8.8
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	17.9
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	9.1
Equity market	Sensex (%*)	8.7	7.6	27.0	17.8	8.1	4.5	5.4	11.8	9.8	7.8
	NSE VIX	15.6	25.8	17.9	18.9	22.6	21.1	18.3	18.6	19.6	18.3
Forex market	Rs/$ (m-o-m, %)	0.2	-0.2	0.4	-0.1	1.5	1.0	2.0	-0.1	0.9	2.6
Foreign capital	Net FPI ($ bn)	0.6	3.0	-1.3	-3.0	-4.7	-6.6	0.2	7.1	-0.4	-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	-9.8
	10-year US Treasury yield (%)	2.3	0.9	1.6	2.7	2.9	3.1	2.9	2.9	3.5	4.0
	Brent ($/barrel)	57.4	44.8	80.0	105.8	112.4	120.1	108.9	98.6	90.2	93.1

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% at 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 US dollar and vice versa*
Source: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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