Macroeconomics | First cut

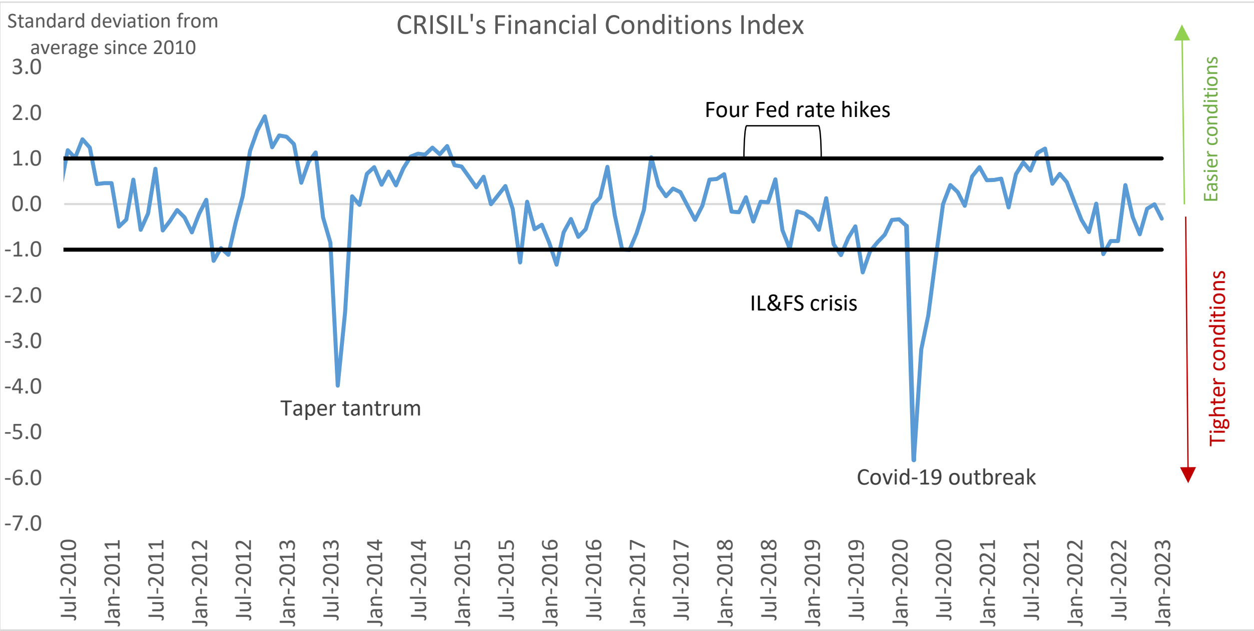
Staying on the edge

February 2023

Financial conditions tighten moderately in January

- Domestic financial conditions were slightly tighter in January relative to the previous month, CRISIL's Financial Conditions Index (FCI) shows. The FCI value printed at -0.3 in January from 0 the previous month. A lower FCI value indicates tighter financial conditions, and vice versa.
- Compared with the long-term average, financial conditions remained mildly tight but within the comfort zone. A negative FCI value implies tighter financial conditions than average since 2010, and the value between -1 and 1 suggests the index is within the comfort zone.
- Tightening of conditions in January was primarily driven by a fall in equities, as negative news on a large Indian conglomerate shook market sentiment. The sector also saw large outflows by foreign portfolio investors (FPIs) in the month.
- However, the rupee remained stable in the month. Domestic monetary and liquidity conditions were also similar as the previous month, which lent stability to the money and debt markets.
- Transmission of the Reserve Bank of India's (RBI's) rate hikes continued, amid credit growth outpacing deposit collections. Bank deposit rates reached the pre-pandemic 5-year average in January, while lending rates were close to reaching those rates. More hikes are expected in the coming months as transmission is yet to be completed.

Financial conditions were mildly tighter in January



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 higher value indicates easier financial conditions, and vice versa

Source: CRISIL

Weak sentiment in equity markets drags financial conditions

- Domestic equity markets saw high volatility and heavy selling, pulled down by negative news on a large corporate conglomerate towards the end of the month. The benchmark S&P BSE Sensex fell 2.2% on average on-month. NIFTY's index of volatility (NSE India VIX) also rose sharply to 18.4, above the long-term average of 15.6.
- FPI outflows mounted to -$3.2 billion in January in contrast with $1.1 billion net inflows in the previous month. Outflows were primarily seen in the equity market (-$3.5 billion in January), while the debt market saw inflows ($0.4 billion).
- Barring equities, other market segments remained broadly stable:
    - The rupee averaged 82.5 per US dollar, 0.7% stronger on-month. The US dollar, that weakened 2% on-month, supported the domestic currency.
    - The slowing pace of rate hikes by the US Federal Reserve (Fed) helped ease the dollar and stabilise US Treasury yields.
    - Systemic liquidity stayed close to neutral in January, as indicated by the RBI net absorbing Rs 559 billion (0.3% of banks' net demand and time liabilities (NDTL)) compared with $631 billion absorption (0.3% of NDTL) in the previous month
    - Money market rates were stable, with the interbank call money rate averaging 6.20%, close to the 6.25% repo rate in January
    - Bond yields were rangebound for the benchmark 10-year government security (G-sec), and AAA-rated corporate bonds. They were supported by stable liquidity conditions and rangebound movement in long-term US Treasury yields and international crude oil prices. However, the rise was sharper for lower-rated corporate bonds.

Bank deposit and lending rates continue to rise

- Rising bank lending and deposit rates also contributed to tighter financial conditions. Deposit rates of 1-2 year tenors rose an average 27 bps on-month in January, whereas the 6-month MCLR rose 21 bps, auto loan rate 8 bps, and housing loan rate 8 bps.
- Cumulatively, compared with a 225 bps hike in repo rate until January this fiscal, deposit rates have risen 160 bps, MCLR 116 bps, auto loan rate 164 bps, and housing loan rates 226 bps. This suggests some transmission is pending, with more pressure expected after the additional hike in February.
- The rising credit-deposit ratio is further pushing banks to raise deposit rates. While bank credit grew 16.3% on-year in January, deposits grew 10.5%.

- Despite rising lending rates, credit growth remains at decadal highs. However, as per sectoral data available until December, signs of moderation were seen in the agriculture, industry and services segments, but lending rates continued to rise in retail loans.

Conditions expected to remain tight amid shrinking monetary policy space

Major central banks have been slowing the pace of rate hikes, including the RBI (25 bps hike in February versus 35 bps in December) and the US Federal Reserve (25 bps versus 50 bps). Yet, policy rates will stay elevated for longer, given that the war on inflation is not over.

On the domestic front, even as the RBI slowed its pace of rate hikes, it reiterated its concern on sticky core inflation. Fears came true as headline inflation again crossed the RBI's upper tolerance limit of 6% in January. The RBI is not expected to maintain tight monetary conditions until it sees a decisive easing in core inflation. Liquidity conditions will also not return to surplus as seen in the pandemic years, which will maintain fundamental pressure on domestic interest rates.

For the Fed, the strong jobs market could threaten inflation and come in the way of easing its monetary policy. S&P Global expects the Fed policy rate to peak at 5.00-5.25% in April-June 2023. Persisting strength in the labour market could make the Fed stick to this rate for longer. This will be the highest rate seen post the Global Financial Crisis in the past decade, which will keep global financial conditions tight and maintain pressure on capital flows.

For the broader economy, borrowing costs will continue to rise, given the pending transmission of the RBI's rate hikes. This is likely to have some impact on the growth prospects of the Indian economy in the next fiscal as well.

How financial conditions moved across various market segments

		Pre-pandemic trend	Covid years		Current fiscal year									
		FY16-20	FY21	FY22	Apr-2022	May-2022	Jun-2022	Jul-2022	Aug-2022	Sep-2022	Oct-2022	Nov-2022	Dec-2022	Jan-2023
Policy rate	Repo rate (%)	**6.3**	*4.0*	*4.0*	4	4.4	4.9	4.9	5.4	5.4	5.9	5.9	6.3	6.3
	Repo rate, inflation-adjusted (%)	**2.0**	*-2.2*	*-1.5*	-3.8	-2.6	-2.1	-1.8	-1.6	-2.0	-0.9	0.0	0.5	-0.3
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	-0.3	-0.3	-0.3
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	6.0	6.2	6.2
	91 day T-bill (%)	**6.5**	*3.3*	*3.5*	3.9	4.8	5.0	5.3	5.5	5.8	6.2	6.4	6.4	6.4
	CP 6-month rate (%)	**7.6**	*4.4*	*4.3*	4.9	5.9	6.3	6.3	6.4	6.7	7.5	7.6	7.6	7.7
Debt market	10-year G-sec (%)	**7.2**	*6.0*	*6.3*	7.1	7.3	7.5	7.4	7.3	7.3	7.4	7.3	7.3	7.3
	Term premium (%)	**1.0**	*1.9*	*2.3*	3.1	3.0	2.7	2.5	2.0	1.8	1.5	1.4	1.1	1.1
	AAA bond spread' (%)	**0.6**	*0.7*	*0.5*	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	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	4.0	4.0	4.4
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	7.9	8.1	8.3
	Auto loan rate (%)	**9.6**	*8.0*	*7.7*	7.6	7.8	7.7	8.3	8.6	8.6	9.0	8.9	9.1	9.2
	Housing loan rate (%)	**9.1**	*7.4*	*7.1*	7.0	7.3	7.6	7.9	8.3	8.4	8.8	8.9	9.2	9.2
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	*5.9*	*7.0*	10.1	11.1	12.1	13.4	14.3	15.3	16.6	16.0	16.7	16.3
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	8.9	8.7	9.8
Equity market	Sensex (%*)	**8.7**	*7.6*	*27.0*	17.8	8.1	4.5	5.4	11.8	9.8	7.8	11.8	10.7	7.3
	NSE VIX	**15.6**	*25.8*	*17.9*	18.9	22.6	21.1	18.3	18.6	19.6	18.3	14.6	14.2	18.4
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	-0.6	0.8	-0.7
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	4.1	1.1	-3.2
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	-5.6	-6.0	-5.1
	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	3.9	3.6	3.5
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	105.8	112.4	120.1	108.9	98.6	90.2	93.1	91.1	80.9	83.1

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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