Macroeconomics | First cut

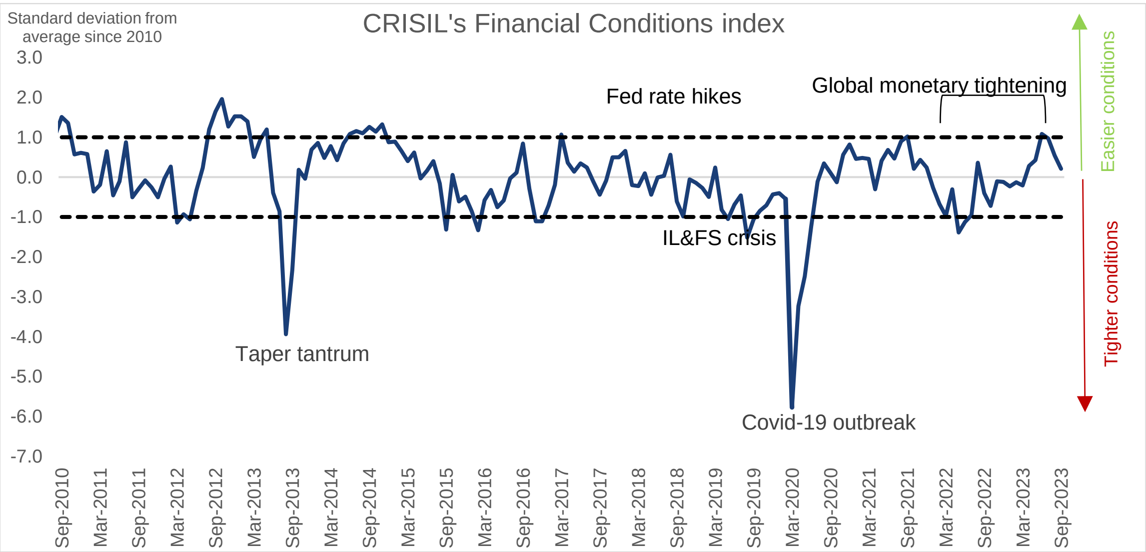
Towards tightening

October 2023

Drying liquidity, rising crude prices weigh down financial conditions

- Domestic financial conditions were tighter in September relative to the previous month, CRISIL's Financial Conditions Index (FCI) shows
- The index value moderated to 0.2 in September compared with 0.5 the previous month. A higher index value indicates easier financial conditions, and vice versa
- Reducing domestic systemic liquidity exerted pressure on domestic interest rates in September, particularly in the money market. The global environment was unsupportive as well with a sharp rise in crude oil prices and United States (US) Treasury yields spurring Foreign Portfolio Investor (FPI) outflows
- However, India's inclusion in the JP Morgan Global Bond Index, and easing domestic inflation were positive cues for investor sentiment. But September saw net capital outflows as adverse global factors offset them
- Markets may not see easing from monetary policy this year as the Reserve Bank of India (RBI) remains committed to aligning inflation to the 4% target. While we expect the RBI to keep the policy rates unchanged this fiscal, the central bank may use liquidity tools to keep the rates consistent with its stance of withdrawal of accommodation. Open market sales of government securities (G-secs) will rein in liquidity and may put pressure on yields.
- The global environment remains a source of volatility. Crude oil prices face risks from geopolitical tensions even as slowing global demand should work towards cooling prices. The spectre of market accidents looms in major economies that see higher interest rates for a longer period, thereby inducing sporadic episodes of volatility.

Financial conditions on a tightening trend in the past three months



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

Factors that tightened financial conditions

- **Surging crude oil prices:** Reacting to extension of supply cuts by major global oil producers, brent crude oil prices rose to $94/barrel average in September from $86.2/bbl in August. A net oil importer, higher oil prices typically impact investor sentiments and in September this phenomenon put pressure on FPI flows, rupee and G-sec yields

- **Rising US interest rates:** In September, the 10-year US Treasury yield rose 21 bps on-month. In addition to safe haven investments, investors in the US bond market are factoring in a prolonged period of tight monetary policy by major central banks. While the US Federal Reserve kept policy rates unchanged in September, it reduced the number of rate cuts expected next year.

- **FPI outflows**: Higher crude oil prices, rising US interest rates turned FPIs net sellers in India for the first time in seven months. September saw $1.7 billion net outflows, compared with $2.2 billion net inflows the previous month. Outflows were primarily from Indian equities (-$1.8 billion in September versus $1.5 billion the previous month) while debt saw net inflows ($0.1 billion vs $0.9 billion) owing to India's inclusion in the JP Morgan Bond Index

- **Rupee depreciation**: The rupee averaged $83 per US dollar, 0.3% weaker on-month, driven by FPI outflows and stronger dollar – the US dollar index reached a 12-month high in September. However, the rupee did not depreciate to the same extent as the 1.45% increase seen in the US dollar this month. India's narrower trade deficit on-month along with the RBI's intervention in the foreign exchange (forex) market may have controlled the rupee's depreciation.

- **Reducing domestic liquidity:** Systemic liquidity moved into the deficit zone after being in surplus for six consecutive months. Given the deficit in systemic liquidity, the RBI net-injected Rs 0.2 lakh crore (0.1% of NDTL[1]) on average in September compared to a net absorption of Rs 1.2 lakh crore (0.6% of NDTL) in August.

  The RBI's temporary imposition of incremental cash reserve ratio (I-CRR) during August-September reduced liquidity. Its other interventions such as open market sale of G-secs and buying rupees in the forex market also drained liquidity. Advanced tax outflows played a significant role in straining liquidity in September. Other macroeconomic factors such as credit growth outpacing deposits, and a reduction in government spending in September also played a role

  Consequently, the RBI began withdrawing the I-CRR in September, and the scheme ended on October 7. With proactive liquidity management by the central bank, systemic liquidity has stayed in the neutral zone this fiscal (+/-0.5% of NDTL) (refer to the table on page 5).

- **Pressure on money market rates:** The deficit in liquidity drove money market rates higher. The interbank call money rate rose 10 bps, remaining above the repo rate. The 91-day T-bill rate rose 5 bps, the 6-month CP rate rose 12 bps and the 6-month CD rate remained stable, inching up just 1 bp. Trading volumes in commercial paper (CPs) and certificates of deposit (CDs) declined ~20.85% and ~29.65%, respectively, owing to liquidity crunch in the money market.

What lent support

- **India's inclusion in global bond index**: In September, JP Morgan announced that it would include Indian government bonds in its emerging markets index. While the actual inclusion is slated for July 2024, the announcement created positive sentiments, bringing with it FPI inflows to Indian debt despite adverse global cues. This provided some support to yields.

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[1] Net demand and time liabilities

Yet, yields were volatile in September. The benchmark 10-year G-sec closed the month at 7.21% in September as opposed to 7.17% in August, mirroring the trend in US Treasury yields. Rising crude oil prices was another major factor that led to rise in yields. On average though, 10-year G-sec yields were lower at 7.17% in September as compared to 7.19% in August.

- **Rising equities:** Indian equity markets rose in September owing to positive macroeconomic data. First quarter GDP data which was released at the end of August, showed strong growth of 7.8%. Additionally, domestic consumer price index-linked (CPI) inflation eased from its peak of 7.4% in July, to 6.8% in September. Robust GST collections also contributed to the gains. This helped buoy sentiments, with participation from retail buyers staying strong. Despite FPI outflows from equities, domestic SIP[2] contribution was increased in September.
- **Accelerating bank credit growth:** Bank credit growth accelerated to 15.3%[3] in September from 14.9% in August. Sectoral data available till August indicates strongest offtake to services (20.7% on-year in August), followed by personal loans (18.3%), agriculture and allied activities (16.6%) and industry (6.1%).
- **Stable lending rates:** Bank lending rates remained stable in September. A nominal rise was seen in the 6-month MCLR and auto loans, while housing loan rate was unchanged (refer to table on page 5).

  Transmission is almost complete to housing loan rates which have risen 245 bps since April 2022 compared to a 250-bps hike in the repo rate. Transmission to other lending rates, however, remains incomplete. The 6-month MCLR has risen 158 bps, while the auto loan rate has risen 162 bps.

  That said, the growing deposit pool may be reducing banks' need to raise lending rates further. Banks have raised deposit rates by an average 173 bps since April 2022, which is gradually attracting more deposits. Deposit growth stood at 12.3%[4] in September compared with 9.8% in April 2022.

Global risks, vigilant monetary policy may maintain pressure on financial conditions

Financial markets are facing three pressure points at present: (1) geopolitical tensions, (2) US rates remaining higher for longer period, and (3) rangebound domestic liquidity.

The recent emergence of conflict in the Middle East is impacting Indian markets through rising crude oil prices. Brent crude prices are back above $90 per barrel in the third week of October after falling to ~$84 in the first week. They remain vulnerable to supply disruptions, even as slowing global growth is expected to ease pressure in the second half of this fiscal. FPIs flows may be influenced by the impact of crude oil prices on India's current account deficit and rupee movement.

At the same time, rising global interest rates and tighter global financial conditions are risks to foreign capital flows. The 10-year US Treasury yield crossed 4.8% so far in October – the first time since 2007. S&P Global expects one more Fed rate hike in November 2023, and a cut only in April-June 2024.

On the domestic front, the war with inflation is far from over. While CPI inflation eased to 5% in September, it remains above the 4% target of the RBI's Monetary Policy Committee (MPC) and faces risks from uneven monsoon, tight global food supplies and crude prices. RBI expects consumer inflation at 5.7% in the third quarter-closer to the upper limit of the tolerance band.

We expect the MPC to keep rates unchanged for the remainder of this fiscal, given inflation risks, but incomplete transmission of past rate hikes. The RBI may use liquidity tools rather than policy rates to manage monetary

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[2] Systematic Investment Plans
[3] excluding the impact of HDFC merger
[4] Excluding impact of bank merger

conditions consistent with its stance of withdrawal of accommodation. The RBI has continued open market sales of G-secs in October, thus putting pressure on G-sec yields. Volatile global financial conditions will further keep the RBI vigilant.

All these suggest monetary conditions may take longer to ease and support financial conditions. The impact of adverse macroeconomic cues can also influence market sentiment. Nevertheless, India's encouraging macros vis-à-vis other major economies 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
Policy rate	Repo rate (%)	**6.3**	*4.0*	*4.0*	*5.5*	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
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
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
	91 day T-bill (%)	**6.5**	*3.3*	*3.5*	*5.8*	6.8	6.8	6.7	6.7	6.8	6.8
	CP 6-month rate (%)	**7.6**	*4.4*	*4.3*	*6.9*	7.6	7.6	7.5	7.4	7.5	7.6
Debt market	10-year G-sec (%)	**7.2**	*6.0*	*6.3*	*7.3*	7.2	7.01	7.0	7.1	7.2	7.2
	Term premium (%)	**1.0**	*1.9*	*2.3*	*1.8*	0.7	0.5	0.5	0.6	0.7	0.7
	AAA bond spread' (%)	**0.6**	*0.7*	*0.5*	*0.2*	0.2	0.3	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	2.7
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
	Auto loan rate (%)	**9.6**	*8.0*	*7.7*	*9.0*	9.8	9.8	9.8	9.8	9.8	9.8
	Housing loan rate (%)	**9.1**	*7.4*	*7.1*	*8.4*	9.4	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	15.3
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	10.8
Equity market	Sensex (%*)	**8.7**	*7.6*	*27.0*	*8.7*	4.4	6.8	8.0	12.0	10.1	11.2
	NSE VIX	**15.6**	*25.8*	*17.9*	*17.5*	11.9	12.5	11.2	11.2	11.6	11.2
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
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
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
	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
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	*95.4*	84.1	75.7	74.9	80.1	86.2	94.0

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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