Macroeconomics | First cut

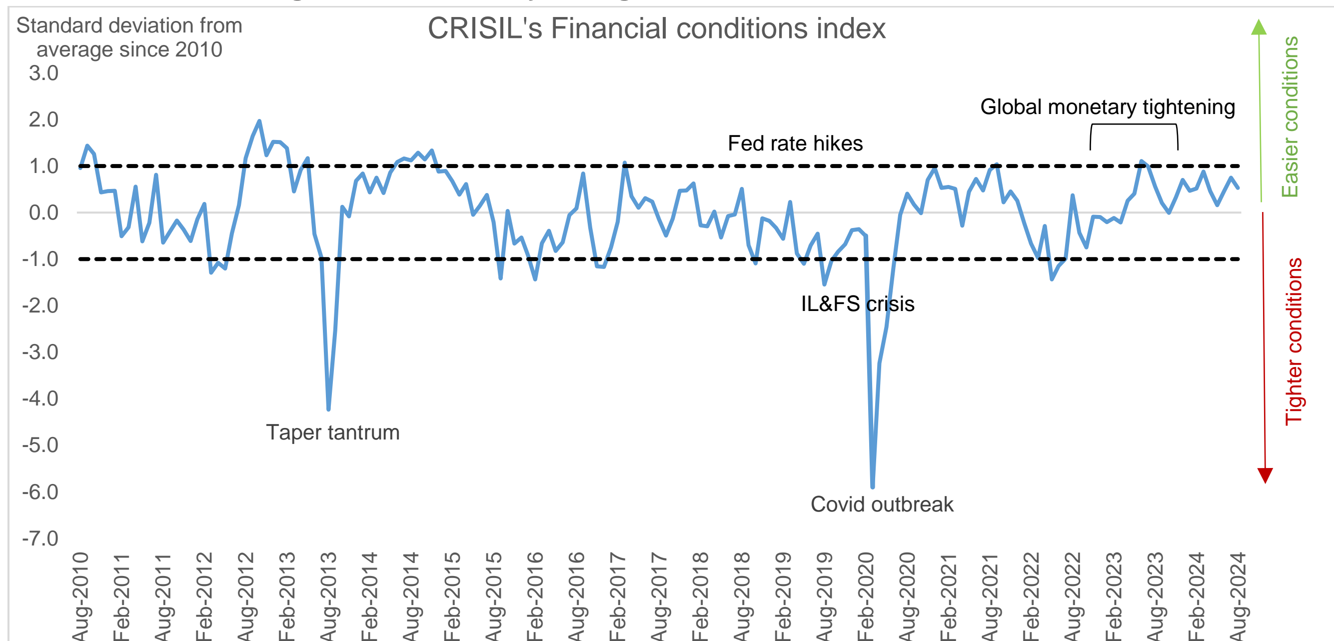
Staying afloat

September 2024

Flighty global markets tighten domestic financial conditions

- Domestic financial conditions were tighter in August relative to July, CRISIL's Financial Conditions Index (FCI) shows. The gauge, which captures India's major market segments[1], moderated to 0.5 in August from 0.8 on-month
- Global investors are readjusting to diverging economic trajectories and monetary policies of major economies. While the Federal Reserve (Fed) began cutting rates in September, Bank of Japan (BoJ) hiked its rate at July-end, which triggered the unwinding of 'yen carry trade' that disrupted global financial flows in August
- Investors factored in signs of weakness in two biggest economies—the US and China—which led to a decline in crude prices, weaker US dollar, and easing US bond yields
- These wide-ranging global developments helped some of the segments of India's markets and hit the others. Foreign Portfolio Investors (FPIs) inflows reduced in August, hitting equity market the most, while the rupee depreciated mildly. However, the bond market, which benefitted from falling crude prices and US yields, and the continuing effects of India's inclusion in the JP Morgan Emerging Market Bond Index, handled the global turbulence better
- Domestic factors remained supportive as systemic liquidity conditions improved and bank credit growth remained strong. Easing domestic inflation, coupled with the Fed rate cut, is further creating conditions for the Reserve Bank of India (RBI) to begin its easing cycle in the second half of this fiscal

Financial conditions tightened moderately in August



Source: CRISIL

[1] CRISIL's FCI is determined based on 15 parameters across money, debt, equity, and foreign exchange markets, along with monetary policy and bank lending conditions. Higher FCI value means easier financial conditions and vice versa

What led to tighter financial conditions?

- **Unwinding of yen carry trade:** Bank of Japan raised interest rates at July-end and its announcement that it would lower government bond purchases due to tighter monetary conditions led to a sharp appreciation in the yen and a sharp fall in Japanese equity markets as corporate profit forecasts were negatively impacted. Therefore, investors unwound their carry trades and sold assets denominated in the higher-yielding currencies to fund the now-increased borrowing costs in yen. Consequently, several currencies, including the dollar and the pound, depreciated against the yen at the beginning of August. It also resulted in significant corrections across global equity markets
- **Lower FPI inflows:** FPIs remained net-buyers in Indian markets in August, but net inflows declined to $3.0 billion from $5.8 billion in July. The equity segment saw a significant decline in net FPI inflows from $3.9 billion to $0.9 billion due to increased volatility in equity markets. The debt segment saw robust inflows at $2.1 billion, though they were lower than the previous month ($2.7 billion)
- **Mild depreciation in the rupee:** The rupee depreciated to 83.9 against the US dollar in August, 0.4% weaker compared with July (83.6), led by lower FPI inflows and a wider trade deficit. However, a weaker dollar supported the rupee
- **Increased volatility in equity markets:** Volatility increased in August, with the Volatility Index averaging 14.9 in August (vs 13.9 in July) due to the unwinding of yen carry trade and US recession fears. The benchmark indices S&P BSE Sensex and Nifty 50 were broadly unchanged on average, rising 0.1% and 0.5%, respectively.
- **Rise in bank lending rates:** Some bank lending rates inched up in August compared with in July. The one-year marginal cost of funds-based lending rate (MCLR) increased to 8.9% from 8.85%, while the auto loan rate was up 1 bp averaging 9.82%. Deposit rates were stable at 6.86%

  The transmission of the RBI's past rate hikes to lending and deposit rates is still incomplete. With respect to the 250-bps hike in the repo rate, deposit rates, one-year MCLR and auto loan rate have risen 177 bps, 165 bps and 160 bps, respectively.

Factors that supported financial conditions

- **Higher surplus in systemic liquidity:** The surplus in systemic liquidity increased in August to its highest level in a year, driven by high government spending and a reduction in net G-sec sales through open market operations by the RBI (Rs 7,690 crore in August from Rs 10,105 crore in July). In August, the RBI net absorbed Rs 1.51 lakh crore (0.7% of net demand and time liabilities, or NDTL), higher than the average net injection of Rs 1.03 lakh crore (0.4% of NDTL) in July
- **Softer money market rates:** The weighted average call money rate, the operating target for monetary policy, was broadly steady—averaging 6.5%—in line with the repo rate, while other money market rates eased in August compared with July. The six-month commercial paper rate eased 3 bps to average 7.81%. The 91-day treasury bill rate declined by a shaper 9 bps to 6.62%, its lowest monthly average since February 2023. However, CD (Certificate of Deposit) rates continued to rise
- **Lower crude oil prices:** Brent crude oil prices moderated 5.2% on-month to average $80.9 per barrel due to fears of a demand slowdown in the US and China
- **Declining US treasury yields:** Recession fears in the US drove down US bond yields in August. Downward revision in employment data indicated a weaker job market, while the unemployment rate rose for the fifth straight month. Hence, the yield on the 10-year treasury note averaged 3.87% in August, down from an average of 4.25% in July
- **Softer domestic bond yields:** Indian government bond yields declined for the fourth straight month in August, supported by domestic and global factors. On the domestic front, easier liquidity conditions, lower domestic retail inflation and robust FPI inflows in debt eased pressure off yields. Externally, lower global crude oil prices,

and softer US treasury yields contributed to the decline. The yield on the 10-year benchmark G-sec slid 10 bps to average 6.87% in August from 6.97% in July

- **Strong bank credit growth:** Despite rising lending rates, bank credit growth remained strong at 15%[2] in August, stable compared with 15.1% in July

  Sectoral data shows bank credit strength is broad-based. According to sectoral data[3] for July, credit growth was driven by agriculture (18.1% vs 17.4%) and personal loans (17.8% vs 16.6%). Within personal loans, credit cards continued to see strong growth at 22%, although the growth was slower than the previous month (23.3%). Services credit growth inched up to 15.4% from 15.1%, led by a pickup in non-banking financial companies (12.7% vs 8.5%), while industrial credit growth inched up to 10.2% from 7.7%.

All eyes on the Fed

The Fed began cutting rates in September while the European Central Bank and Bank of England have already begun cutting rates since June. Easing policy rates globally, particularly by the Fed, will give space to the RBI for a rate cut this fiscal.

Domestic inflation remains a key gauge for the RBI's monetary policy decision. Elevated food prices have been the biggest hurdle in shifting its stance so far.

However, conditions are turning favourable for a rate cut. Monsoon continues to fare well (7% above long period average as of September 19), and kharif sowing remains higher on-year. Easing food inflation, coupled with benign non-food inflation, is expected to aid in headline CPI reaching close to RBI's 4% target this fiscal.

Owing to these factors, we expect the RBI to begin cutting rates from October at the earliest, lest unpredictable weather events and geopolitical tensions play spoilsport. Overall, we expect two rate cuts this fiscal.

[2] As on August 23, excluding the impact of the HDFC merger
[3] Excluding impact of HDFC merger

Table: How financial conditions fare across different segments

		Pre-pandemic 5-year average	Annual average				Current fiscal				
		FY16-20	FY21	FY22	FY23	FY24	Apr-24	May-24	Jun-24	Jul-24	Aug-24
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	1.1	1.7	1.7	1.4	2.9	2.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	**-0.5**	-3.0	-3.9	-0.9	0.0	-0.1	0.6	0.2	-0.4	-0.7
Money market	Call money rate (%)	**6.2**	3.4	3.3	5.4	6.6	6.5	6.6	6.6	6.5	6.5
	91 day T-bill (%)	**6.5**	3.3	3.5	5.8	6.9	6.9	6.9	6.8	6.7	6.6
	CP 6-month rate (%)	**7.6**	4.4	4.3	6.9	7.8	7.9	7.9	7.9	7.8	7.8
Debt market	10-year G-sec (%)	**7.2**	6.0	6.3	7.3	7.2	7.2	7.0	7.0	7.0	6.9
	Term premium (%)	**1.0**	1.9	2.3	1.8	0.7	0.7	0.5	0.5	0.5	0.4
	AAA bond spread' (%)	**0.6**	0.7	0.5	0.2	0.3	0.2	0.3	0.4	0.4	0.4
	AA bond spread" (%)	**2.0**	3.6	2.0	3.5	2.6	2.0	2.1	2.1	2.1	2.3
Lending rates	MCLR (1 year) (%)	**8.3**	7.4	7.1	7.9	8.7	8.9	8.8	8.9	8.9	8.9
	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	9.3	9.4	9.4	9.4	9.4	9.3
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	5.9	7.0	14.2	15.7	15.3	16.1	13.9	15.1	15.0
Money supply	M3 growth (y-o-y %)	**9.7**	12.2	9.6	8.9	10.9	10.9	12.1	9.7	10.0	10.2
Equity market	Sensex (%*)	**8.7**	7.6	27.0	8.7	11.4	17.0	15.5	18.2	21.8	20.2
	NSE VIX	**15.6**	25.8	17.9	17.5	12.4	11.7	20.2	15.6	13.5	14.9
Forex market	Rs/$ (m-o-m, %)	**0.2**	-0.2	0.4	0.6	0.1	0.5	0.0	0.1	0.1	0.4
Foreign capital	Net FPI ($ bn)	**0.6**	3.0	-1.3	-0.5	3.4	-1.9	-1.5	5.0	5.8	3.0
Global conditions	S&P 500 (%*)	**8.9**	14.0	24.3	-2.8	7.5	19.1	21.0	23.6	24.5	21.5
	10-year US Treasury yield (%)	**2.3**	0.9	1.6	3.4	4.1	4.5	4.5	4.3	4.2	3.9
	Brent ($/barrel)	**57.4**	44.8	80.0	95.4	83.0	90.1	82.0	82.6	85.3	80.9

Favourable
Neutral
Adverse

*Notes: ^Spread over the repo rate; term premium is the 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 data excludes the impact of a bank with non-bank*
Sources: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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