Macroeconomics | First cut

Exit from easing

June 2022

CRISIL's Financial Conditions Index tightens in May, remains in comfort zone

Domestic financial conditions tightened in May, driven by both domestic and external factors, CRISIL's Financial Conditions Index (FCI) — a summary indicator combining key parameters across equity, money, debt, and foreign exchange markets with policy and lending conditions — shows.

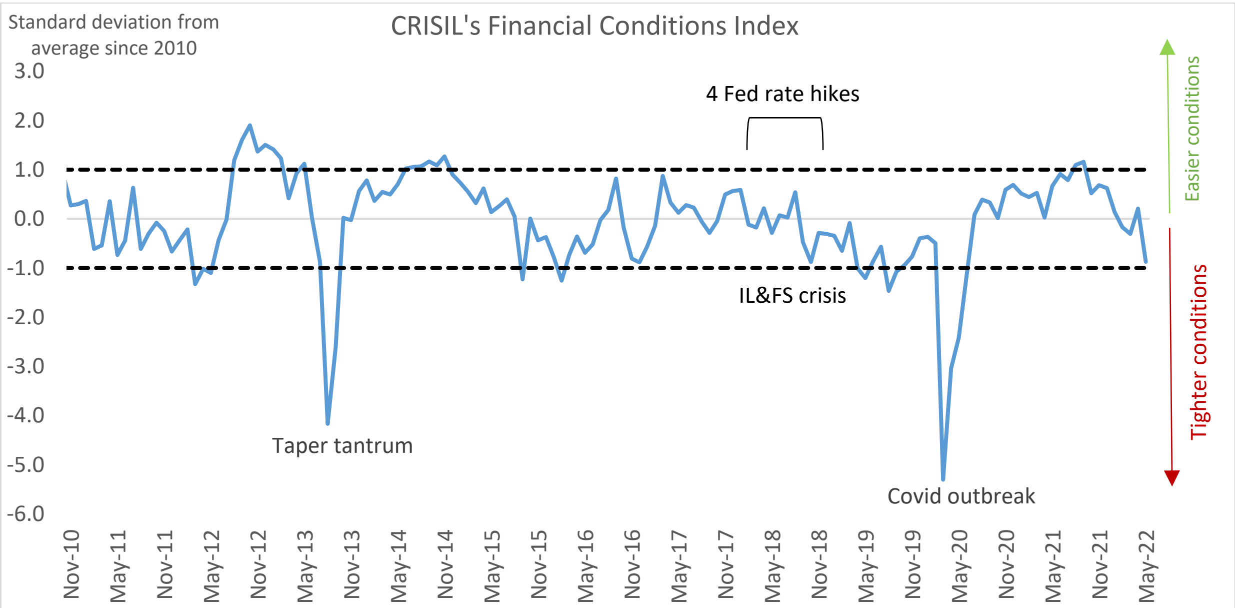
Financial conditions in the month were the tightest in two years, though still in the comfort zone within 1 standard deviation of the long-term average.

The FCI turned negative, reaching the lowest level since June 2020. A negative value indicates financial conditions were tighter than the long-term average since April 2010.

The index reading reflects the impact of the Reserve Bank of India's (RBI) rate hike in May that tightened liquidity in the economy and of strong foreign capital outflows as a reaction to external developments.

Domestic financial conditions hardened quicker with the progressive tightening of monetary policy by the RBI and US Federal Reserve. Surging crude oil price because of geopolitical tensions is also adversely impacting India's external position.

Domestic financial conditions stiffen in May



Note: Higher index value indicates easier financial conditions and vice versa; Source: CRISIL

RBI's surprise rate hike jolts money and debt markets

- In an off-cycle meeting in May, the RBI's Monetary Policy Committee raised policy repo rates by 40 basis points (bps) to 4.40%. Consequently, the standing deposit facility (SDF) rose to 4.15%, and the marginal standing facility (MSF) to 4.65%. The committee also increased banks' cash reserve ratio (CRR) by 50 bps to 4.50% in order to further reduce excess liquidity in the banking system.
- The CRR hike, increased FPI outflows, and higher bank credit growth led to a sharp reduction in surplus liquidity in the system. The liquidity reduction was evident in the steep fall in average funds the RBI absorbs through liquidity adjustment facility (LAF) to Rs 4.4 lakh crore in May — the lowest since April 2020 when the amount was Rs 4.7 lakh crore — from Rs 6.5 lakh crore the previous month.
- Money market rates, in turn, rose sharply. The interbank call money rate surged 57 bps to 4.02% on average in the month. However, it remained below the policy corridor, indicating persisting liquidity overhang in the banking system. However, other money market rates, such as 91-day Treasury bill (T-bill) and 6-month commercial paper (CP), saw sharper increases and surpassed the repo rate *(see the heatmap on the next page for more details)*.
- The yield on the benchmark 10-year government security (G-sec) rose 26 bps on-month and 135 bps on-year to 7.34% on average in May. The rise was sharper in shorter-tenure yields, with one-year G-sec rising 87 bps on-month to 5.81%.

Adverse external spillovers increase

- The Federal Reserve (Fed) undertook its second policy rate hike of the year in May with a 50 bps increase. It also announced reduction of its balance sheet beginning June, which would involve decreasing its holdings of Treasury securities. Yields rose across tenures of US Treasuries, with the benchmark 10-year rising 15 bps on-month to 2.90% on average in May — the highest since November 2018.
- The price of Brent crude oil surged 6.2% on-month to average at $112.4 per barrel in May. This heightened investor concerns about worsening outlook for India's current account deficit (CAD), inflation and fiscal health.
- Amid tightening global conditions, fears of weakening global growth, and rising risks on Indian macros, foreign portfolio investor (FPI) outflows swelled to $4.7 billion (net) in May from $3 billion in April. The outflow from equities was larger, resulting in a 6.4% decline in the benchmark Sensex on-month. The equity market also remained extremely volatile, with the National Stock Exchange's (NSE's) volatility index, India VIX, rising above its decadal average.
- The rupee depreciated a sharp 1.5% on-month in May, hitting an all-time low of 77.3 per US dollar, which also worsened domestic investor sentiment.

However, bank credit continues to grow

- Interestingly, despite the rising cost of credit, bank lending rates remained lower than pre-Covid decadal averages. Given the availability of funds and gradual improvement in demand across sectors, bank credit saw a gradual uptick. In May, bank loans increased 12.1% on-year compared with 11.1% previous month. This is the highest growth rate seen since January 2020.

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Accelerated rate hikes to exacerbate pressure on financial markets

Domestic financial markets are expected to face more pressure in coming months as the RBI and other major global central banks accelerate the pace of tightening. The rate actions are expected to be frontloaded this year, given the accelerating inflation.

We expect the RBI to raise the repo rate by at least 75 bps this fiscal, on top of the 90 bps it has already done. This will bring repo rate to 5.65% by fiscal-end, 50 bps above the pre-pandemic level of 5.15% in February 2020.

The Fed, which has already increased its key rate by 150 bps so far, is expected to be even more aggressive. According to the projections made by Fed participants in June, the median expectation of the federal funds rate is to reach 3.4% by the end of 2022, which will be the highest level since 2008. Other major central banks, including the European Central Bank, are also expected to hike policy rates this year. This will tighten global financial conditions further, impacting capital flows into emerging markets, including India.

India is also becoming more vulnerable to external shocks as crude price has risen further to ~$120 per barrel since May. Overall external vulnerability is worsening, though it is lower than in 2013 when taper tantrum had wreaked havoc. We expect CAD to rise to 3% of GDP this fiscal, which would be the highest since fiscal 2013. Foreign exchange reserves remain adequate, but have fallen in recent months with the RBI's interventions in forex to control the rupee's depreciation.

All these factors are expected to tighten domestic financial conditions further, which will reflect in rising interest rates and bank lending rates, weak capital inflows, and a depreciating currency.

How financial conditions moved across various market segments

		May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22
Policy rate	Repo rate (%)	4	4	4	4	4	4	4	4	4	4	4	4	4.4
	Repo rate, inflation-adjusted (%)	-2.3	-2.3	-1.6	-1.3	-0.3	-0.5	-0.9	-1.7	-2.0	-2.1	-3.0	-3.8	-2.6
Liquidity conditions	Net absorption(-)/injection(+) under LAF (Rs bn)	-4621	-4794	-5774	-7438	-7876	-7485	-7618	-7388	-6372	-6881	-6422	-6545	-4390
Money market	Call money rate (%)	3.2	3.1	3.2	3.2	3.2	3.3	3.3	3.3	3.5	3.3	3.3	3.5	4.0
	CP 6-month spread^ (%)	0.0	0.0	0.1	0.1	-0.1	0.4	0.5	0.6	0.6	0.8	0.8	0.9	1.5
	91 day T-bill (%)	3.4	3.4	3.4	3.3	3.3	3.4	3.5	3.6	3.6	3.8	3.8	3.9	4.8
Debt market	10-year G-Sec (%)	6.0	6.0	6.1	6.2	6.2	6.3	6.3	6.4	6.6	6.8	6.8	7.1	7.3
	Term premium (%)	2.0	2.0	2.1	2.2	2.2	2.3	2.3	2.4	2.6	2.8	2.8	3.1	3.0
	AAA bond spread' (%)	0.7	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.1	0.05	0.21
	AA bond spread" (%)	2.0	1.9	1.4	1.3	1.3	1.8	1.9	2.1	2.8	2.8	2.6	3.0	3.0
Lending rates	MCLR (6 month) (%)	7.2	7.2	7.2	7.2	7.2	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.2
	Housing loan rate (%)	7.2	7.2	7.2	7.2	7.2	7.1	7.0	7.0	7.0	7.0	7.0	7.0	7.3
	Auto loan rate (%)	7.8	7.8	7.8	7.8	7.8	7.7	7.6	7.6	7.6	7.6	7.6	7.6	7.8
Credit availability	Bank credit growth (y-o-y,%)	5.9	5.8	6.1	6.7	6.7	6.8	7.0	9.1	7.1	7.9	9.6	11.1	12.1
Money supply	M3 growth (y-o-y %)	10.3	10.7	9.9	9.5	9.3	9.7	9.5	9.9	8.4	8.7	8.7	9.5	8.8
Equity market	Sensex (%*)	22.6	27.3	26.2	29.9	35.5	36.4	31.8	26.0	28.0	22.1	16.9	17.8	8.1
	NSE VIX	20.1	14.9	12.6	13.2	15.7	16.9	16.9	17.2	18.4	22.1	25.1	18.9	22.6
Forex market	Rs/USD (m-o-m %)	-1.6	0.4	1.3	-0.5	-0.8	1.8	-0.6	1.2	-1.2	0.8	1.7	-0.1	1.5
Foreign capital	Net FPI (USD bn)	-0.3	1.8	-1.0	2.2	3.8	-1.7	-0.3	-3.9	-3.8	-5.1	-6.6	-3.0	-4.7
Global conditions	S&P500 (%*)	26.5	26.5	28.0	28.4	25.9	24.3	27.6	25.7	21.1	16.1	13.6	11.6	1.3
	US 10Y Treasury yield (%)	1.6	1.5	1.3	1.3	1.4	1.6	1.6	1.5	1.8	1.9	2.1	2.7	2.9
	Brent ($/barrel)	68.0	73.1	74.4	70.0	74.6	83.7	80.8	74.3	85.5	95.8	115.6	105.8	112.4

Favourable Adverse Neutral

*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 2-year moving average; a positive % rupee change implies depreciation against the US dollar and vice-versa*

Source: RBI, National Securities Depository Ltd, US Treasury department, CEIC, CRISIL

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