CRISIL
An S&P Global Company

Macroeconomics | First cut

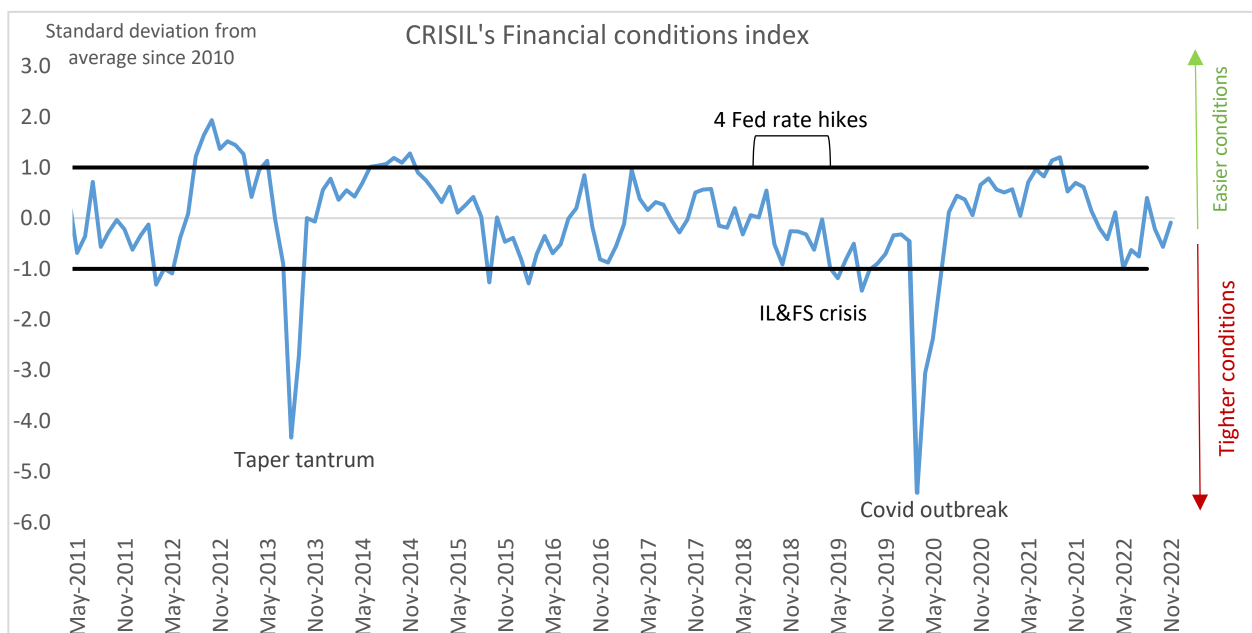
In a tight spot

December 2022

Global cues turn positive but domestic financial conditions tarry

- Domestic financial conditions eased slightly in in November relative to previous month, but remained a bit tighter than long-term average, CRISIL's Financial Conditions Index (FCI) shows.
- The FCI value printed -0.1 in November compared with -0.6 the previous month. A lower value indicates tighter financial conditions, with a negative value reflecting tighter financial conditions than long-term average (since 2010). An FCI value of within one standard deviation is interpreted as conditions remaining within the comfort zone.
- Global cues have been inducing volatile movements in domestic financial conditions. But after a stressful October, foreign portfolio investor (FPI) flows returned to India and the rupee strengthened in November as the US dollar index eased and crude oil prices fell. Risk appetite of global investors returned as they priced in a likely slowdown in the pace of rate hikes by the US Federal Reserve (Fed) in the coming months.
- However, domestic factors continued to lend tightness. The real interest rate – implied by the repo rate adjusted for consumer price index (CPI) inflation – turned zero after staying negative for three years. Short-term rates in money market rose at a faster clip than longer-term bond yields, with 91-day treasury bill (T-bill) and bank certificate of deposit (CD) recording the sharpest rise in November. Transmission of rate hikes towards bank lending and deposit rates is also picking up.

Financial conditions remained mildly tight in November



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.
Source: CRISIL

What helped ease financial conditions

- **Improving global cues**: Expectations of the Fed slowing its pace of rate hikes gained traction in November, which led to fall in the dollar index and long-term US Treasury yields. Crude oil prices also fell in the month amid concerns of a global slowdown. This improved global risk sentiment and increased FPI flows to emerging markets like India.

- **Return of FPIs**: FPIs net-invested $4.1 billion in November in contrast with net-selling $0.4 billion the previous month. The inflows were seen in equity markets ($4.4 billion), while they remained negative in the debt market (-$0.2 billion).

- **Rupee strengthening:** The rupee strengthened 0.6% on-month to 81.8 per dollar on average in November, helped by FPI inflows.

- **Rise in equities**: Major equity indices rebounded in the month, driven by FPI inflows and encouraging global cues. The benchmark S&P BSE Sensex reached a record high during the month. Market volatility also reduced, as reflected in a fall in the NSE India VIX.

- **Easing bond yields**: Yields on government securities (G-secs) eased across most tenors, with the benchmark 10-year G-sec yield falling 11 basis points (bps) on-month to 7.33% on average in November. Signs of moderation in CPI inflation, falling crude oil prices, and easing US Treasury yields augured well for G-sec demand. However, lower-rated corporate bonds continued to see their spreads rising over G-secs, signalling risk aversion towards this segment.

- **Surging credit offtake**: Bank credit growth rose for the 10th month in a row, reaching a decadal high of 17.2% on-year in November[1] compared with 16.7% the previous month. According to sectoral data available until October, services witnessed the strongest credit offtake (22.5% in October), followed by personal loans (20.2%), agriculture (13.6%), and industry (13.6%). Revival in credit demand and benign lending rates are driving the rise in offtake.

What contributed to the tightening

- **Rising real policy rate**: Headline CPI inflation has been moderating since October, and fell below RBI's upper tolerance limit of 6% in November. Consequently, the 'real' repo rate (repo rate minus CPI inflation) turned zero in November, marking the first month of non-negative real rate in three years.

- **Rising short-term rates**: Money market rates continued to rise in November, with 91-day T-bill yield rising 17 bps on-month, 6-month commercial paper (CP) 15 bps, and 6-month CD 19 bps on-month on average in November. The inter-bank call money rate was close to the repo rate at 5.96% on average in November, signalling neutral bank liquidity conditions.

- **Transmission of rate hikes to bank rates**: Bank lending and deposit rates are gradually rising in response to the rate hikes by the RBI. In November, 1-2 year bank deposit rates rose 19 bps on-month on average, while 6-month marginal cost of funds-based lending rate (MCLR) rose 18 bps. Compared with the 190 bps hike in repo rate until November, deposit rates have risen 106 bps, and 6-month MCLR, 81 bps.

  It is notable that with the adoption of external benchmark-based lending (EBLR) for fresh loans, the transmission to final lending rates has been faster than what is being reflected in MCLR. For instance, home loan rates have risen 190 bps, and auto loan rates 137 bps over April to November 2022.

  Nevertheless, bank lending rates remain lower than pre-pandemic five-year average till date. This, coupled with recovering demand is supporting the strong surge in credit growth.

[1] Based on data available till November 18, 2022

Even if rate hikes slow, transmission of rate hikes to maintain pressure on financial conditions

Central banks across the world including the RBI and the Fed frontloaded their monetary tightening in 2022 to fight the sharp rise in inflation. Inflation has indeed begun to show signs of moderation, but it might be too early to let down the guard. Risks from geopolitical developments and weather disruptions remain significant. The trajectory of inflation and central banks' responses will keep financial conditions on the edge in the coming months.

The RBI slowed its pace of rate hikes to 35 bps in December from 50 bps each in the previous three meetings. Between now and the next policy, the RBI has said it would closely monitor the impact of its previous rate hikes on domestic demand/core inflation, as well as the actions of the Fed. We expect the RBI to tighten monetary policy further if inflation stays elevated.

Globally, major central banks might still undertake some rate hikes in 2023. S&P Global expects the Fed policy rate to peak at 5.00-5.25% in April-June 2023, with rate cuts only towards the end of the year. The Fed policy rate remaining higher than in the past decade will keep global financial conditions tight and maintain pressure on capital flows.

Even if monetary policies may be reaching the end of the rate hike cycle, the transmission of existing rate hikes to bank lending rates will continue. This could take some steam off credit growth next fiscal year. As the RBI governor signalled in the December policy, liquidity conditions will not return to surplus as seen in the pandemic years. This will maintain fundamental pressure on domestic interest rates next year too.

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
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
	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
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
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
	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
	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
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
	Term premium (%)	**1.0**	*1.9*	*2.3*	3.1	3.0	2.7	2.5	2.0	1.8	1.5	1.4
	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
	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
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
	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
	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
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	16.7	17.2
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
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
	NSE VIX	**15.6**	*25.8*	*17.9*	18.9	22.6	21.1	18.3	18.6	19.6	18.3	14.6
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
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
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
	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
	Brent ($/barrel)	**57.4**	*44.8*	*80.0*	105.8	112.4	120.1	108.9	98.6	90.2	93.1	91.1

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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