Macroeconomics | First cut

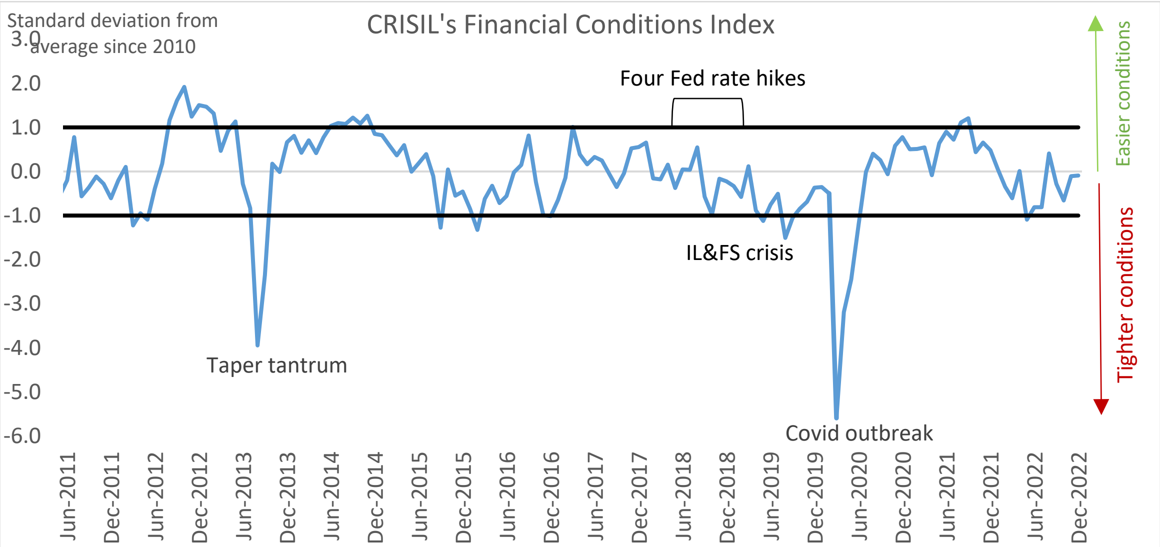
Breather for markets, seeping real impact

January 2023

Financial conditions stabilise, but transmission of rate hikes picks up

- Domestic financial conditions were broadly stable in December 2022 relative to the previous month, CRISIL's Financial Conditions Index (FCI) shows. The FCI value printed -0.1 in December, same as the previous month. A negative value suggests that financial conditions are marginally tight compared with the long-term average (since 2010), but a mild negative number suggests the index is in the comfort zone.
- Broadly, global cues contributed to easing of financial conditions, while domestic cues lent tightness. Falling international crude oil prices and easing dollar index augured well for Indian debt and equity markets.
- Meanwhile, domestic interest rates continued to rise for the broader economy. Real repo rate turned positive in December for the first time in three years as inflation softened and repo rate rose further. Transmission of the RBI's rate hikes is still in progress, leading to a steady rise in bank lending and deposit rates. Key bank lending rates reached close to the pre-pandemic 5-year average in December. Credit growth moderated, albeit remained at a decadal high.

Financial conditions turned neutral in December



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

Easing dollar and oil price shock gives Indian markets some respite

- The US Fed slowed its rate hike to 50 basis points (bps) in December compared with 75 bps each in the previous four policy meetings. Easing US inflation and expectation of recession for next year spurred hopes of further slowing of rate hikes.
- Expectation of slowing Fed hikes saw the dollar index fall 2.2% on-month on average in December. The 10-year US Treasury yield also eased 27 bps on-month to 3.62% on average in December, falling below the Fed policy rate of 4.25-4.50%. US equities also ended the year in the red.
- Brent crude oil prices fell to the lowest level in 2022, averaging $80.9 per barrel in December, 11.2% lower on-month even as the Covid surge in China hit its economic activity.
- While Foreign Portfolio Investors (FPIs) remained net buyers in India, sentiment was subdued amid recession fears and tight financial conditions (relative to the start of the year). December saw $1.1 billion net FPI inflows, lower than $4.1 billion in the previous month
- FPI buying was mainly seen in the equity market ($1.4 billion net inflows in December), while they remained bearish on debt (-$0.2 billion). Equity indices were flat, with the S&P BSE Sensex inching up 0.2% on-month.

Interest rates stabilise in money and debt markets

- Domestic liquidity conditions remained similar to previous month. The RBI absorbed a slightly higher quantum of funds under its liquidity adjustment facility (LAF) (Rs 631 billion net absorption average in December versus Rs 477 billion in the previous month). However, they remained neutral as a percentage of the banks' net demand and time liabilities (NDTL).
- Stable liquidity conditions capped the rise in money market rates. While the interbank call money rate rose 21 bps on-month to 6.17% on average in December, it was lesser than the RBI's 35 bps hike in December, which took the repo rate to 6.25%
- Bond yields eased, driven by expectations of slowing rate hikes by the RBI and the Fed, easing crude oil prices, and improving liquidity conditions. Yield on the benchmark 10-year government security (G-sec) fell 5 bps on-month to 7.28%. With a 35 bps hike in repo rate, the term premium of the 10-year G-sec yield over the repo rate fell to 109 bps, the lowest since March 2020.

But bank rates rise further, showing some impact on credit growth

- Bank lending and deposit rates increased at a sharper pace in December than in the previous month, reflecting some transmission of the RBI's rate hikes. Housing loan rates increased 29 bps on-month in December, while auto loan rates increased 19 bps. Deposit rates for a duration of 1-2 years also saw a sharp rise of 27 bps on-month, driven by banks' need to fuel high credit demand
- Both bank lending and deposit rates have reached the pre-pandemic 5-year average. The impact of increasing rates was felt to some extent on bank credit growth, which moderated to 14.9% on-year in December compared with 16% in the previous month
- Having said that, the transmission of the RBI's rate hikes is yet to be completed. Since the start of the RBI's rate hike cycle, the repo rate has increased 225 bps, while housing loan rates have increased 218 bps, auto loan rates 155 bps, and deposit rates 133 bps.
- Real repo rate turned positive as consumer price index-linked inflation came at 5.7% in December, below the 6.25% repo rate

Tightening financial conditions for broader economy to impact growth

Even as central banks are expected to slow their pace of rate hikes in 2023, financial conditions are expected to remain tight due to following reasons.

First, the Fed's policy rates are at a decadal high in 2023 despite the looming recession. 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's policy rate remaining higher than in the past decade will keep global financial conditions tight and maintain pressure on capital flows.

Secondly, the real repo rate will be on a rising trend, as inflation continues to moderate. Meanwhile, the RBI is expected to remain wary of easing its policy stance in its upcoming policy meeting, given that core inflation remains sticky. Liquidity conditions will also not return to surplus as seen in the pandemic years, which will maintain fundamental pressure on domestic interest rates.

Thirdly, borrowing costs for the broader economy 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
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
	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
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
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
	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
	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
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	7.33	7.28
	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
	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
	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
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
	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
	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
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	16.0	14.9
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
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
	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
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
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
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
	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
	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

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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