Macroeconomics | First cut

External cues buoy financial conditions

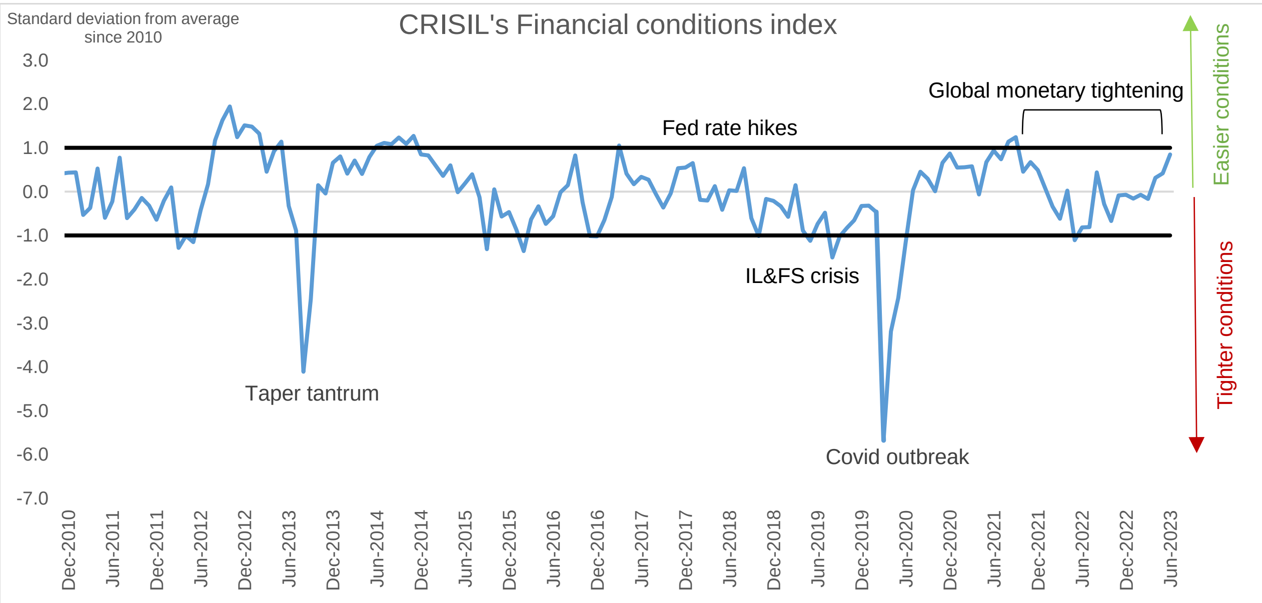
July 2023

Financial conditions improve in June with strengthening foreign inflows

Domestic financial conditions improved in June relative to the previous month, CRISIL's Financial Conditions Index (FCI) shows[1]. The index value was 0.9 in June compared with 0.4 the previous month. A higher value of the index indicates easier financial conditons, and vice versa.

- The improvement was driven by foreign portfolio investor (FPI) inflows that reached a 10-month high in June, led by strong domestic macros. This benefitted India's equity and debt markets, and caused mild appreciation of the rupee.
- From the domestic side, bank credit growth was the strongest segment of financial conditions. While bank lending rates have stabilised near pre-pandemic five-year average, credit growth continued to rise, signalling robust demand conditions in the Indian economy, as well as banks' improved appetite towards retail borrowers.
- For the first quarter overall, financial conditions were better, as indicated by FCI averaging 0.5 in April-June 2023 compared with -0.1 previous quarter, and -0.6 in April-June 2022. Halting rate hikes by Reserve Bank of India (RBI) and the United States (US) Federal Reserve (Fed) led the easing in conditions, while improving domestic macros strengthened India's case for investors.
- However, this may not be the end of rate hikes, especially for advanced economies like US, European Union (EU), and United Kingdom. In India too, upside risks on inflation could keep RBI on the edge. These factors could induce some volatility in financial conditions in the next few months.

Financial conditions ease in June



Note: Higher value indicates easier financial conditions, and vice versa. Index within dotted lines (1 standard deviation) represents conditions within comfort zone
Source: CRISIL

[1] 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.

What led to easier financial conditions in June?

- **Stronger FPI inflows:** FPI inflows increased to $6.8 billion (net) in June – the highest since August 2022 – from $5.9 billion previous month.

  Most of the flows went to equity ($5.7 billion in June versus $5.3 billion previous month), but debt saw a sharp rise ($1.1 billion vs $0.4 billion).

  India's appeal as an attractive investment destination was reinforced with positive incoming data on major macroeconomic parameters. In June, investors cheered the stronger-than-expected growth in gross domestic product (GDP) - at 6.1% in the fourth quarter of fiscal 2023 from 4.5% previous quarter. Inflation slid to a 26-month low of 4.3% in May.

  External cues supported the risk appetite for the month. The US Fed paused on rate hike in June. Falling crude oil prices ($74.9 per barrel in June vs $75.7 previous month) augured well for net importers like India.

- **Rising equities**: Benchmark equities scaled record highs in June, supported by FPI inflows, encouraging domestic macroeconomic data and RBI's status quo on rates. S&P BSE Sensex gained 2% on average in June, and market volatility reduced in the month (as indicated by NSE's India VIX index, see table below).

- **Stabilising rupee**: Rupee averaged 82.2 per US dollar in June, 0.1% stronger on-month. Besides higher FPI inflows, falling trade deficit, and weaker dollar contributed to stronger rupee in June.

- **Improving domestic liquidity:** Overall surplus liquidity was higher in June, as indicated by the RBI net-absorbing Rs. 1.3 trillion (0.6% of NDTL[2]) average in June compared with Rs. 0.8 trillion (0.4% of NDTL) previous month. The ongoing return of Rs. 2000-denomination notes, coupled with rising government spending and FPI inflows helped raise banking liquidity.

  However, liquidity seemed to be unevenly spread across banking sector. On one side, some banks parked funds under variable rate reverse repo window, but on the other some resorted to availing funds under marginal standing facility.

- **Stable market interest rates**: Money market rates eased mildly in June under improving liquidity conditions. The interbank call money rate eased 7 basis points (bps) on-month, 91-day Treasury Bill (T-Bill) yield 7 bps, and 6-month commercial paper (CP) 10 bps average in June.

  Domestic bond yields were supported by positive FPI inflows, along with easing inflation and pause on rates by RBI and the Fed. However, Fed's dot plot projections indicated two more rate hikes this year, which capped the gains. Overall, yield on the benchmark 10-year government security (G-Sec) averaged 7.03% in June, only 2 basis points up on-month.

  Bank lending rates have stabilized after RBI paused hiking rates from April. Broadly, a major part of rate hikes has been transmitted to lending rates. Compared to the 250 bps rate cumulative rate hike by RBI since 2022, housing loan rates have risen 246 bps, and auto loan rates 198 bps until June. These are also above average rates seen in five years before the pandemic (see table below).

- **Surging credit growth**: Higher lending rates have had a limited impact on bank credit so far. Overall bank credit growth rose to 16% on-year in June compared with 15.4% previous month.

  However, some sectors have seen a moderation in recent months. As per sectoral data available until May, credit to industry slowed to 6.0% from 7.0% previous month. However, this may be driven by lower working

[2] Net demand and time liabilities

capital requirements as input cost pressures are receding. While retail credit remained strong (19.2% in May vs 19.4% previous month), it slowed for consumer durables (14.2% vs 30.8%) and auto loans (22.2% vs 23.1%).

Uncertain monetary policy trajectory could keep markets on the edge

Financial markets are enjoying a breather in recent months after an aggressive streak of rate hikes by major central banks in 2022. Inflation slowed in India and major advanced economies in the initial months of 2023 as per central bank expectations.

Yet the war with inflation is far from over. In India, food prices have risen yet again since June, and uneven monsoon and El Niño are upside risks to outlook for this fiscal. In advanced economies like the US, growth has stayed stronger than expected and tight labour markets could keep inflation elevated.

The RBI’s MPC is expected to be on an extended pause for the next few meetings, as it evaluates the inflation trajectory, and impact of monsoon and El Niño. As growth slows, we expect the RBI to initiate rate cuts in the last quarter of this fiscal.

More rate hikes are expected by advanced economies this year. The Fed’s latest dot-plot projections in June indicated two more 25 bps-rate hikes in 2023. Rate hikes are expected in EU and UK as well thie year, according to S&P Global.

While the risk of tight and volatile global financial conditions persists, India’s vulnerability to these shocks is likely to be lower this year. India’s key external liability — current account deficit — will likely be pared this fiscal on the back of lower crude oil prices. This, coupled with the RBI's adequate forex reserves and the country’s good growth prospects, should cushion the impact of a global spillover on overall macros.

How financial conditions moved across various market segments

		Pre-pandemic average														
		FY16-20	FY21	FY22	Jul-2022	Aug-2022	Sep-2022	Oct-2022	Nov-2022	Dec-2022	Jan-2023	Feb-2023	Mar-2023	Apr-2023	May-23	Jun-23
Policy rate	Repo rate (%)	6.3	4.0	4.0	4.9	5.4	5.4	5.9	5.9	6.25	6.25	6.5	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	2.0	-2.2	-1.5	-1.8	-1.6	-2.0	-0.9	0.0	0.5	-0.3	0.1	0.8	1.8	2.2	1.7
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	-0.5	-3.0	-3.9	-1.1	-0.7	-0.4	0.0	-0.3	-0.3	-0.3	0.0	0.0	-0.8	-0.4	-0.6
Money market	Call money rate (%)	6.2	3.4	3.3	4.8	5.0	5.3	6.0	6.0	6.2	6.2	6.4	6.5	6.5	6.6	6.5
	91 day T-bill (%)	6.5	3.3	3.5	5.3	5.5	5.8	6.2	6.4	6.4	6.4	6.7	6.9	6.8	6.8	6.7
	CP 6-month rate (%)	7.6	4.4	4.3	6.3	6.4	6.7	7.5	7.6	7.6	7.7	7.9	7.9	7.6	7.6	7.5
Debt market	10-year G-sec (%)	7.2	6.0	6.3	7.4	7.3	7.3	7.4	7.3	7.3	7.3	7.4	7.4	7.2	7.01	7.03
	Term premium (%)	1.0	1.9	2.3	2.5	2.0	1.8	1.5	1.4	1.1	1.1	0.9	0.9	0.7	0.5	0.5
	AAA bond spread' (%)	0.6	0.7	0.5	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3
	AA bond spread" (%)	2.0	3.6	2.0	3.3	3.1	2.9	3.7	4.0	4.0	4.4	3.8	3.5	2.9	2.9	3.0
Lending rates	MCLR (6 month) (%)	8.3	7.4	7.1	7.5	7.6	7.7	7.8	7.9	8.1	8.3	8.4	8.5	8.6	8.6	8.6
	Auto loan rate (%)	9.6	8.0	7.7	8.3	8.6	8.6	9.1	9.0	9.2	9.3	9.5	9.5	9.6	9.6	9.6
	Housing loan rate (%)	9.1	7.4	7.1	7.9	8.3	8.4	8.8	8.9	9.2	9.2	9.4	9.4	9.4	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	9.7	5.9	7.0	13.4	14.3	15.3	16.6	16.0	14.9	16.3	15.5	15.0	15.9	15.4	16.0
Money supply	M3 growth (y-o-y %)	9.7	12.2	9.6	8.6	8.9	8.6	9.1	8.9	8.7	9.8	9.5	9.0	9.5	10.1	11.3
Equity market	Sensex (%*)	8.7	7.6	27.0	5.4	11.8	9.8	7.8	11.8	10.7	7.3	6.5	2.6	4.4	6.8	8.0
	NSE VIX	15.6	25.8	17.9	18.3	18.6	19.6	18.3	14.6	14.2	15.0	14.1	14.4	11.9	12.5	11.2
Forex market	Rs/$ (m-o-m, %)	0.2	-0.2	0.4	2.0	-0.1	0.9	2.6	-0.6	0.8	-0.7	0.9	-0.4	-0.3	0.4	-0.1
Foreign capital	Net FPI ($ bn)	0.6	3.0	-1.3	0.2	7.1	-0.4	-0.4	4.1	1.1	-3.2	-0.5	0.7	1.7	5.9	6.8
Global conditions	S&P 500 (%*)	8.9	14.0	24.3	-3.6	1.5	-6.4	-9.8	-5.6	-6.0	-5.1	-2.5	-5.3	-1.8	-1.2	3.3
	10-year US Treasury yield (%)	2.3	0.9	1.6	2.9	2.9	3.5	4.0	3.9	3.6	3.5	3.7	3.7	3.5	3.6	3.7
	Brent ($/barrel)	57.4	44.8	80.0	108.9	98.6	90.2	93.1	91.1	80.9	83.1	82.7	78.5	84.1	75.7	74.9

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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