Macroeconomics | First cut

Overhang of tight liquidity

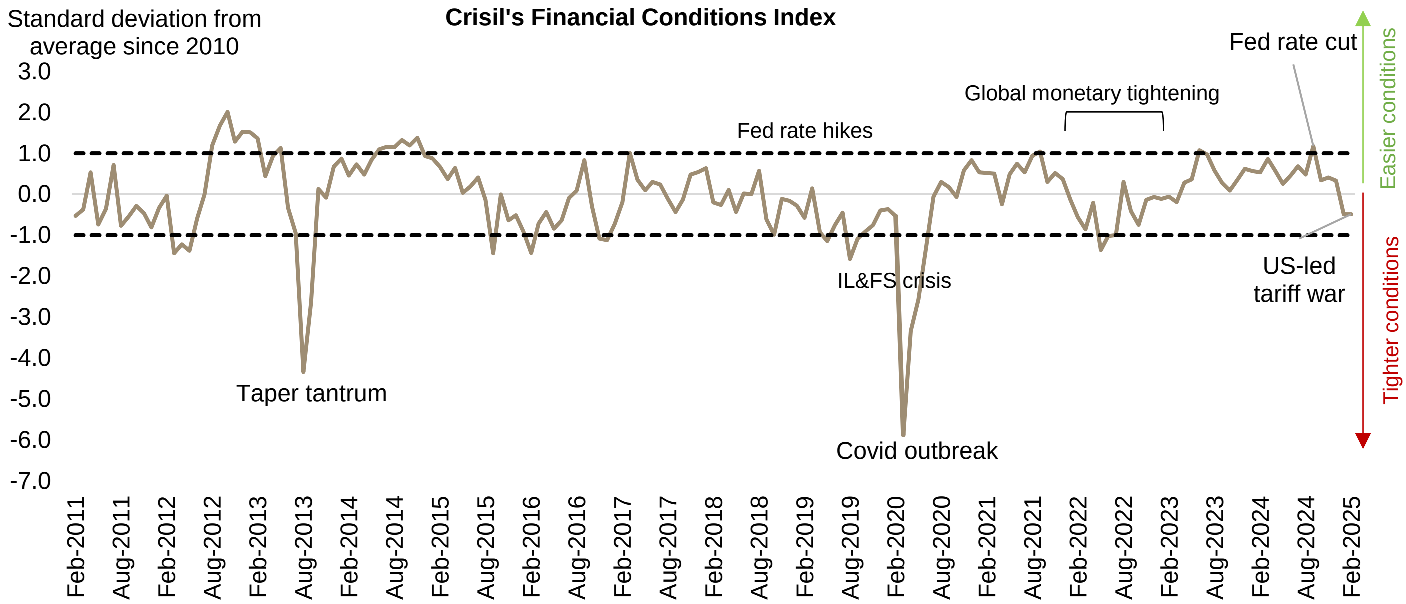
March 2025

Global uncertainty weighs on financial conditions

- Crisil's Financial Conditions Index (FCI) [1] remained steady at -0.5 in February 2025, same as in January. However, the index remained in the negative, implying financial conditions were tighter than the long-term average (measured since April 2010). But the gauge remains in the comfort zone — one standard deviation from the long-term average
- Tightness in systemic liquidity, continual foreign portfolio investor outflows and weakness in the rupee against the US dollar have put pressure on financial conditions in the March quarter so far. The FCI has averaged -0.5 in the quarter so far (January-February average), compared with 0.4 in the December quarter of 2024[2]
- Trade-led uncertainty and the impact on the global economy caused nervousness and foreign investors withdrew funds from Indian markets in February, leading to a depreciation in the rupee even as the dollar index weakened
- Deficit in domestic liquidity, albeit a touch lower than that in the previous month, led to rigidity in key money market rates, hurting the FCI
- Along with the rate cut in February, the RBI has also proactively been infusing liquidity in the system to ensure the transmission of rate cuts

[1] Crisil's FCI gathers 15 parameters across money, debt, equity and foreign exchange markets, along with monetary policy and bank lending conditions.
[2] A lower value implies tighter financial conditions and vice versa

Financial conditions remain tight in February



Note: Higher value indicates easier financial conditions and vice versa. The index within dotted lines (1 standard deviation) represents conditions within the comfort zone

Source: Crisil

Why were the conditions tighter than their long period average in February?

- **FPIs continued to be net sellers in February**, but the quantum of outflows decreased compared to the previous month. FPIs withdrew $2.8 billion (vs $9 billion in January) as global uncertainty persisted driven primarily by the equity segment. The equity segment saw a net outflow of $4 billion compared with an outflow of $9 billion previous month. On the other hand, FPIs net invested $1 billion in the debt segment, higher than the $0.5 billion due to a wider spread with US Treasury yields. US yields eased in February as economic data released during the month indicated weak economic activity
- **The rupee weakened** 0.9% on-month against the dollar in February due to FPI outflows. The currency crossed 87 per dollar for the first time ever. That said, a weaker dollar prevented the rupee from sliding further
- **Systemic liquidity remained in a deficit for the third consecutive month** in February. The deficit eased a tad relative to January with the RBI net-injected Rs 1.67 lakh crore (0.7% of net demand and time liabilities, or NDTL) vs Rs 2.04 lakh crore (0.8% of NDTL) in January under its liquidity adjustment facility. The RBI's measures to boost liquidity (discussed later in detail), lower FPI outflows and a pickup in government spending led to the lower deficit in February. That said, liquidity deficit is still constraining domestic financial conditions, as key money market rates remain sticky despite the cut in policy rates
- **The spread between money market rates and repo continued to rise** in February. Although money market rates eased on-month, the easing was by a lesser quantum compared to the repo rate. The weighted average call

money (WACR) rate eased on-month but hovered above the repo rate of 6.25% in February. The WACR, which is the operating target for monetary policy, averaged 6.36% in February. Other money market rates eased a tad but remained relatively sticky given the liquidity deficit in the banking system. The six-month commercial paper (5 bps to 7.88%) and certificate of deposit rose (3 bps to 7.59%).

- **Indian equity markets recorded losses** in February. The benchmark Indian equity indices S&P BSE Sensex and Nifty 50 declined 1.1% and 1.3% respectively in February. Fears of an imminent global trade war and the resultant uncertainty continued to weigh on investor sentiment. That said, market volatility reduced vis-a-vis January as indicated by the NSE volatility index (VIX) declining to an average of 14.5 from 15.9
- **Bank credit growth softened** to 11% on-year in February from 11.4% in January.

  High lending rates and the RBI's regulatory actions have weighed on credit growth this fiscal. Sectoral data[3] (available till January) shows credit growth has slowed in services (12.5% in January from 21.2% average in fiscal 2024), agriculture (12.2% in January from 18.2% in April) and personal loans (11.8% from 18.6%) this fiscal. Industrial credit growth has strengthened to 8% in January compared with 6.9% in fiscal 2024
- **Softer crude oil prices:** Global crude oil prices declined amid trade war concerns and climbing crude oil inventories in the US. Brent crude declined 5.1% on-month to average $75.2 per barrel

What factors supported financial conditions?

- **RBI actions:** The RBI cutting policy rates and liquidity boosting measures in February kept the FCI from slipping further into the negative zone
  - The RBI cut interest rates by 25 bps in February, the first rate cut since May 2020. This move supported lower lending rates and G-sec yields. That said, with inflation trending down the real interest rate remains elevated.
  - For the last few months, the RBI has actively taken actions to boost liquidity as the banking system is facing a liquidity deficit. This includes a cut in the cash reserve ratio in December and stepping up open market operations (OMO) purchases of government securities (G-sec) and variable repo rate auctions. In February, the RBI increased OMO purchases of G-secs to Rs 80,000 crore from 58,835 crore in January. The RBI conducted several variable repo rate auctions injecting Rs 2.5 lakh crore on average in February, similar to January. To inject more durable liquidity into the system and to ensure transmission of rate cuts, the RBI carried out three-year dollar-rupee swap auction of $10 billion on February 28. A six-month dollar-rupee swap action of $5 billion was carried out in January.
- **Decline in domestic bond yields:** Indian government bond yields dipped in February, supported by the RBI's rate cuts and liquidity measures, lower crude oil prices and FPI inflows in debt. The domestic benchmark 10-year government security yield averaged 6.70% vs 6.75% in the previous month
- **Softer bank lending rates:** Key lending rates declined in February. The auto loan rates (to 9.64%) and home loan (to 9%) rates were down 11 bps and 15 bps, respectively. Home loan rates are now below their pre-pandemic 5-year average

[3] *Figures for fiscal 2024 exclude the impact of the HDFC merger*

Easing inflation and fiscal consolidation keep the door open for further rate cuts

The RBI's Monetary Policy Committee (MPC) initiated rate cuts in February amid heightening uncertainty. We believe softer inflation and steady growth will create a room for further rate cuts in fiscal 2026.

We expect inflation to ease further to 4.4% in fiscal 2026 (versus an estimated 4.7% in fiscal 2025), driven by food inflation. Food inflation is expected to ease further, supported by a healthy rabi crop and expectations of softer global food prices, assuming a normal southwest monsoon. A high base for food inflation this fiscal will also provide some relief. Expectations of benign global commodity prices should help keep non-food inflation in the comfort zone. A weather shock to food inflation, or an extended depreciation in the rupee which pushes up the imported component of inflation, pose risks to inflation

We expect GDP growth to be steady at 6.5% in fiscal 2026. Private consumption is expected hold up, supported by a reduction in income tax burden, softer food inflation and repo rate cuts. That said, a lower overall fiscal impulse and risks to exports from the uncertainty in trader tarriffs will cap the upside to growth.

The timing and quantum of the MPC's rate cuts could be impacted by the global market volatility. The US Federal Reserve (Fed) is expected to hold rates higher for longer than previously expected. S&P Global does not expect any rate cuts in 2025 (calendar year), based on the tariff position until March 5. It expects rate cuts to resume in 2026.

Overall, we expect the MPC to cut rates by another 50-75 bps by March 2026. We also expect the RBI to use liquidity-management tools to support overall financial conditions.

Table: How the financial conditions are evolving across segments

	Pre-pandemic average	Annual averages				Quarterly averages for this fiscal			
	FY16-20	FY21	FY22	FY23	FY24	Q1 FY25	Q2 FY25	Q3 FY25	Q4 FY25*
Repo rate (%)	6.3	4.0	4.0	5.5	6.5	6.5	6.5	6.5	6.4
Repo rate, inflation-adjusted (%)	2.0	-2.2	-1.5	-1.1	1.1	1.6	2.3	0.9	2.4
Net absorption(-)/injection(+) under LAF (% of NDTL)	-0.5	-3.0	-3.9	-0.9	0.0	0.3	-0.5	-0.3	0.8
Call money rate (%)	6.2	3.4	3.3	5.4	6.6	6.6	6.5	6.5	6.5
91 day T-bill (%)	6.5	3.3	3.5	5.8	6.9	6.9	6.6	6.5	6.5
CP 6-month rate (%)	7.6	4.4	4.3	6.9	7.8	7.9	7.8	7.7	7.9
10-year G-sec (%)	7.2	6.0	6.3	7.3	7.2	7.1	6.9	6.8	6.7
Term premium (%)	1.0	1.9	2.3	1.8	0.7	0.6	0.4	0.3	0.3
AAA bond spread' (%)	0.6	0.7	0.5	0.2	0.3	0.3	0.4	0.4	0.4
AA bond spread" (%)	2.0	3.6	2.0	3.5	2.6	2.1	2.2	2.1	2.3
MCLR (1 year) (%)	8.7	7.5	7.2	7.9	8.7	8.8	8.9	9.0	9.0
Auto loan rate (%)	9.6	8.0	7.7	9.0	9.8	9.7	9.7	9.7	9.7
Housing loan rate (%)	9.1	7.4	7.1	8.4	9.3	9.3	9.3	9.2	9.1
Bank credit growth (y-o-y,%)	9.7	5.9	7.0	14.2	15.7	15.1	13.4	11.1	11.2
M3 growth (y-o-y %)	9.7	12.2	9.6	8.9	10.9	10.9	10.3	10.5	9.6
Sensex (%*)	8.7	7.6	27.0	8.7	11.4	16.9	21.5	15.0	7.4
NSE VIX	15.6	25.8	17.9	17.5	12.4	15.8	13.9	14.4	15.2
Rs/$ (m-o-m, %)	0.2	-0.2	0.4	0.6	0.1	0.2	0.1	0.5	1.2
Net FPI ($ bn)	0.6	3.0	-1.3	-0.5	3.4	0.5	6.7	-3.6	-5.9
S&P 500 (%*)	8.9	14.0	24.3	-2.8	7.5	21.2	23.0	24.9	21.6
10-year US Treasury yield (%)	2.3	0.9	1.6	3.4	4.1	4.4	3.9	4.3	4.5
Brent ($/barrel)	57.4	44.8	80.0	95.4	83.0	84.9	80.2	74.6	77.2

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; *percentage change with respect to a two-year moving average; a positive percentage rupee change implies depreciation against the US dollar, and vice versa; credit data for April-June excludes the impact the merger of a bank with non-bank; * FY25 Q4 is the Jan-Feb average*

Sources: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, Crisil

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