Macroeconomics | First cut

Turning tight amid battle of hustings

June 2024

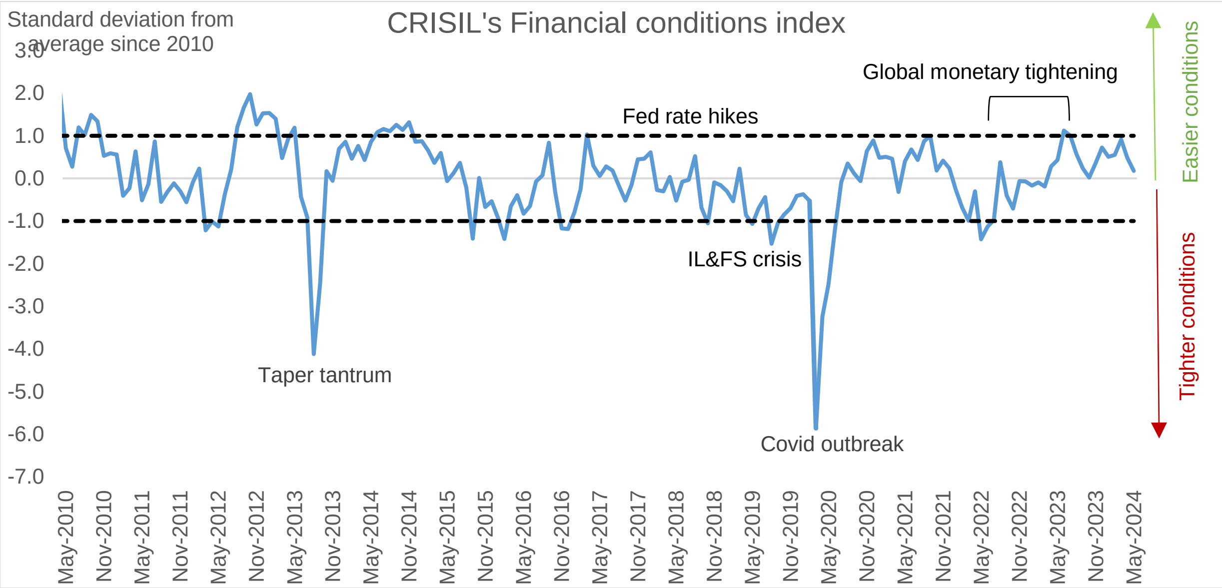
Spillover from flighty equities as well

- CRISIL's Financial Conditions Index (FCI) reflected a tighter environment in May ahead of election outcome. The FCI value came lower at 0.2 during the month compared with 0.5 in April and 0.4 in May last year.[1]
- The FCI was primarily influenced by the equity market, which saw large swings as general elections progressed and after exit poll outcomes were known. Foreign portfolio investors (FPIs) turned net sellers amid elections uncertainty. Tightening liquidity also put mild pressure on money market rates.
- However, conditions remained benign in the bond and currency markets, supported by external cues such as easing crude oil prices and United States (US) Treasury yields. In contrast to equities, the domestic bond market continued to attract FPI flows as inclusion of the Indian bonds in the global bond indices is imminent.
- Financial conditions remained in the comfort zone, as indicated by the FCI value that stayed within 1 standard deviation of long-term average (within the dotted lines in the chart below). Liquidity conditions remained benign relative to pre-pandemic decade. In the broader economy, bank credit was stronger than pre-pandemic average.

Monitorable shifts amid stability

- **Slowing personal loans**: While overall bank credit growth remains strong, growth in consumer loans has been moderating gradually since the second half of last fiscal. Bank retail credit growth stood at 17.4% in April, compared with 18.6% six months ago and 19.2% a year earlier. Most categories of consumer loans (except housing and education loans) are slowing, reflecting a broad trend of waning credit support to growth. However, housing loans continue to rise, indicating buoyant real estate demand.

Financial conditions tighten in May, but remain within comfort zone



Source: CRISIL

[1] A higher FCI value indicates easier financial conditions, and vice versa.

Why financial conditions tightened in May

- **Volatile equity market:** The equity market was highly volatile in May as indicated in the volatility index (VIX), which hit its highest monthly average value since June 2022. The benchmarks S&P BSE Sensex and Nifty 50 were flat, gaining 0% and 0.2%, respectively, on average. Uncertainty about the outcome of the general elections weighed on investor sentiments.
- **Net FPI outflow:** FPIs were net sellers for the second straight month in May though overall net outflows reduced to $1.5 billion from $1.9 billion in April, owing to inflows into the debt market. The outflows were driven by the equity segment which saw $3.1 billion moving out compared with $1.0 billion in April. In contrast, the debt segment saw net inflows of $1.1 billion compared with outflows of $1.3 billion in April.
- **Deficit systemic liquidity:** After just one month of surplus, systemic liquidity switched back to deficit in May. The Reserve Bank of India (RBI), on average, net injected Rs 1.38 lakh crore (0.6% of net demand and time liabilities, or NDTL), compared with an average net absorption of Rs 0.2 lakh crore (0.2% of NDTL) in April. A drop in government spending and a rise in the credit-deposit ratio (0.8 in May vs 0.79 in April) were the main factors behind the deficit.
- **Rise in money market rates:** Given the systemic deficit, money market rates hardened in May. The weighted average call money rate (WACR) rose 9 bps to an average of 6.5% while the rate on the 91-day Treasury bills (T-bills) rose 7 bps to an average of 6.9%. In comparison, rates on six-month commercial papers (CPs) and six-month certificates of deposit (CDs) were stable, hardening 3 bps and 2 bps to 7.47% and 7.89%, respectively.
- **Rising real interest rates:** Although the RBI has held policy rate stable, interest rates have risen in real terms from December as inflation has been on a downward trend. The real policy rate rose to 1.8% in May from 1.7% in April (as retail inflation eased to 4.7% from 4.8%). The real policy rate stood at 0.8% in December.

Factors that limited the tightening

- **Domestic bond yields decline:** Indian government security (G-sec) yields softened considerably in May, with the yield on the new benchmark 10-year paper averaging 7.04%. It closed the month at 7.0%, down 15 bps on-month. Both global and domestic factors helped ease the yields. On the domestic front, the RBI's announcement of a record dividend payout to the central government helped, while global cues included softer US Treasury yields, declining crude oil prices and FPI inflows into debt.
- **Pick-up in bank credit growth:** Bank credit growth accelerated to 15.8%[2] in May from 15.3% in the previous month.

  Sectoral data[3] (available with a month's lag) indicates credit growth in April moderated across major categories such as agriculture (19.7% vs 20.1%), industry (6.9% vs 8.5%), services (19.2% vs 20.2%) and personal loans (17.4% vs 17.7%). Within personal loans, credit growth slowed in outstanding credit cards (23% vs 25.6%) and other personal loans (18.7% to 17.1%). Credit growth to non-banking financial companies (NBFCs) also moderated (14.6% vs 15.3%). This could be owing to the RBI's regulatory measures such as increasing risk weights on NBFCs and consumer credit.
- **Softer global crude oil prices:** After trending up for four straight months, crude oil prices eased in May. Brent crude oil prices slid 8.9% on-month to an average of $82 per barrel.
- **Moderation in US Treasury yields:** The yield on the 10-year Treasury bond note remained high at an average of 4.48% but eased marginally compared with the previous month. The US Federal Reserve's (Fed) announcement that it would be slowing the pace of reducing its balance sheet was a major factor behind softer

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[2] As on May 17, excluding the impact of the HDFC merger
[3] Excluding impact of HDFC merger

yields. Other factors such as moderation in inflation and an increase in unemployment rate (easing some fears of higher-for-longer rates) also helped.

- **Stable bank lending rates:** Back home, bank lending rates were largely stable in May compared with April. The auto loan and home loan rates were unchanged at 9.78% and 9.35%, respectively. The one-year marginal cost of funds-based lending rate (MCLR) eased 6 bps to 8.79%. Deposit rates, too, were unchanged averaging 6.85%.

  The transmission of the 250-bps hike in the repo rate to other lending rates is still incomplete. The one-year MCLR and auto loan rate have risen 149 bps and 156 bps, respectively. That said, the transmission in home loans is almost complete as the rate in the segment has risen 237 bps in the current interest rate cycle.
- **Stable rupee:** The rupee remained strong against the dollar in May, averaging 83.4 per dollar, unchanged from the previous month.

Strong growth conditions keep RBI wary of monetary easing

Amid strong economic growth, the RBI has been wary of monetary easing, remaining focussed on inflation risks. Like the Fed, the RBI's Monetary Policy Committee (MPC) kept policy rates and stance unchanged in June.

Higher-for-longer rates could cap the easing of financial conditions this fiscal.

GDP growth continues to surprise both the RBI and Fed, giving them time to ensure a durable reduction in inflation to their target levels before cutting rates. While inflation in the US has been above the Fed's 2% target, the headline inflation in India is now within the MPC's 2-6% target range, but not at 4% mid-point.

The RBI faces risks from sticky and elevated food inflation that could disturb inflation expectations. Monsoon holds key to inflation and monetary easing this year.

We do not expect the MPC to cut rates before October. Assuming normal monsoon and gradual slowing in GDP growth, we expect two rate cuts in the second half of this fiscal.

The US Fed is likely to wait longer for a rate cut until December, according to S&P Global.

Amid higher-for-longer rates, the impact of the past monetary tightening is likely to continue, moderating credit growth, especially in segments such as NBFC and unsecured consumer credit targeted by the RBI. This is likely to weigh on the GDP growth this fiscal.

Table: How financial conditions are evolving across market segments

		May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24
Policy rate	Repo rate (%)	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	2.2	1.7	-0.9	-0.3	1.5	1.6	0.9	0.8	1.4	1.4	1.6	1.7	1.8
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	-0.4	-0.6	-0.8	-0.6	0.1	0.2	0.3	0.5	0.9	0.8	0.2	-0.1	0.6
Money market	Call money rate (%)	6.6	6.5	6.5	6.6	6.7	6.7	6.8	6.8	6.8	6.7	6.6	6.5	6.6
	91 day T-bill (%)	6.8	6.7	6.7	6.8	6.8	6.9	6.9	7.0	7.0	7.0	6.9	6.9	6.9
	CP 6-month rate (%)	7.6	7.5	7.4	7.5	7.6	7.8	7.9	8.0	8.2	8.5	8.1	7.9	7.9
Debt market	10-year G-Sec (%)	7.0	7.0	7.1	7.2	7.2	7.3	7.3	7.2	7.2	7.1	7.1	7.2	7.0
	Term premium (%)	0.5	0.5	0.6	0.7	0.7	0.8	0.8	0.7	0.7	0.6	0.6	0.7	0.5
	AAA bond spread' (%)	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.4	0.4	0.3	0.3	0.2	0.3
	AA bond spread" (%)	2.9	3.0	2.9	2.6	2.7	3.2	3.3	3.3	0.9	1.8	1.8	2.0	2.1
Lending rates	MCLR (1 year) (%)	8.6	8.7	8.7	8.6	8.7	8.7	8.7	8.8	8.8	8.8	8.8	8.9	8.8
	Auto loan rate (%)	9.8	9.8	9.8	9.8	9.8	9.7	9.7	9.7	9.7	9.8	9.8	9.8	9.8
	Housing loan rate (%)	9.4	9.4	9.4	9.4	9.4	9.3	9.3	9.3	9.3	9.3	9.3	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	15.4	16.2	14.7	14.9	15.3	15.2	16.2	15.6	16.1	16.5	16.3	15.3	15.8
Money supply	M3 growth (y-o-y %)	10.1	13.4	10.6	10.8	10.9	10.8	11.2	11.0	11.0	10.9	11.2	10.9	12.1
Equity market	Sensex (%*)	6.8	8.0	12.0	10.1	11.2	8.9	8.7	16.0	17.1	16.8	17.0	17.0	15.5
	NSE VIX	12.5	11.2	11.2	11.6	11.2	11.1	11.6	13.5	14.1	15.5	13.8	11.7	20.2
Forex market	Rs/USD (m-o-m %)	0.4	-0.1	-0.1	0.8	0.3	0.2	0.1	0.0	-0.2	-0.2	0.0	0.5	0.0
Foreign capital	Net FPI (USD bn)	5.9	6.8	5.8	2.2	-1.7	-2.1	2.9	10.1	-0.8	3.8	6.3	-1.9	-1.5
Global conditions	S&P500 (%*)	-1.2	3.3	6.9	5.6	4.5	1.4	5.9	11.2	13.9	18.4	21.3	19.1	21.0
	US 10Y Treasury yield (%)	3.6	3.7	3.9	4.2	4.4	4.8	4.5	4.0	4.1	4.2	4.2	4.5	4.5
	Brent ($/barrel)	75.7	74.9	80.1	86.2	94.0	91.1	83.2	77.9	80.2	83.8	85.4	90.1	82.0

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; *% change with respect to a two-year moving average; a positive % rupee change implies depreciation against the US dollar, and vice versa; credit data excludes the impact of a bank with non-bank*
Sources: RBI, National Securities Depository Ltd, US Department of the Treasury, CEIC, CRISIL

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