Macroeconomics | First cut

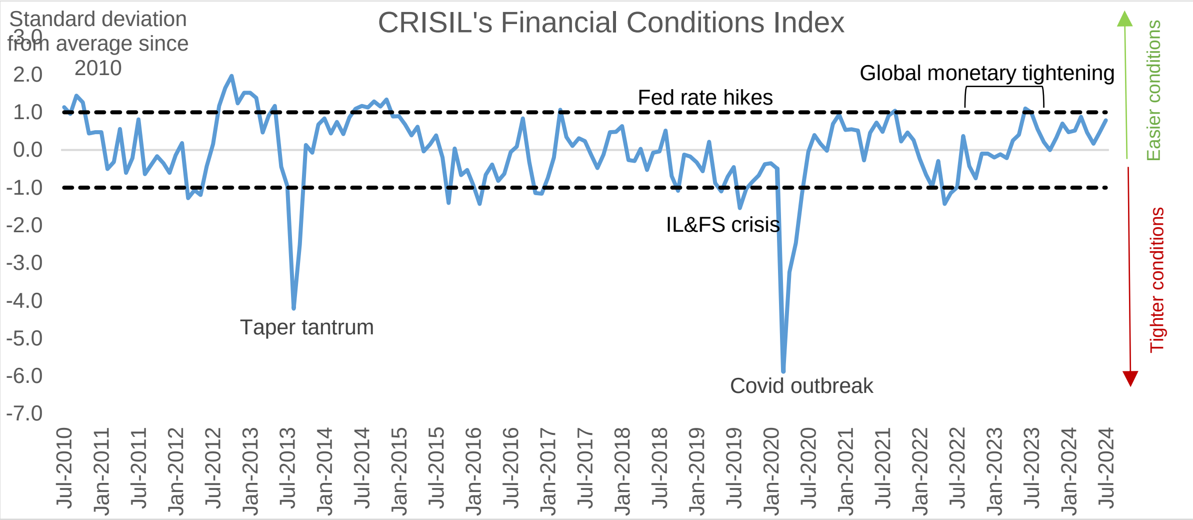
Easing financial conditions, watchful RBI

August 2024

Liquidity, credit and FPI inflows buoy financial markets in July

- Domestic financial conditions eased in July, the CRISIL Financial Conditions Index (FCI) shows. FCI, a summary indicator capturing India's major market segments[1], rose to 0.8 in July from 0.5 previous month
- The global environment was broadly conducive as investors geared up for imminent rate cuts by the US Federal Reserve (Fed). Foreign portfolio investor (FPI) inflows rose sharply to debt and equity markets. India's formal inclusion in the JP Morgan Emerging Markets Bond Index at the end of June also gave a fillip to debt market FPI inflows
- Domestically, liquidity conditions improved and interest rates eased across money and debt markets. For the broader economy, bank credit growth strengthened in the month
- Amid sustained strong credit growth, the RBI governor flagged the need to monitor excessive leverage in certain retail segments mostly for consumption purposes. It flagged high growth in home equity loans and gold loans. The latest sectoral bank credit does indeed show strong growth in these segments
- The governor highlighted a wide credit-deposit gap in the banking system, which could create structural liquidity issues. Bank deposit growth at 11.3% as of mid-July trailed 15.5% bank credit growth
- Lagged transmission of RBI's past rate hikes coupled with regulatory measures to clamp down risky credit is expected to moderate credit growth this fiscal
- Globally, monetary policies are diverging, which induced some market volatility in early August. However, India's low external vulnerability and record-high foreign exchange reserves provide comfort. With the Fed expected to cut rates from September, the RBI will have more room to move towards a rate cut

CRISIL FCI shows easing financial conditions for second consecutive month



Source: CRISIL

[1] CRISIL's FCI is constructed based on 15 parameters across money, debt, equity and foreign exchange markets, along with monetary policy and bank lending conditions. Higher FCI value means easier financial conditions and vice versa

Why financial conditions eased in July

- **FPIs surged further:** Net FPIs increased for the third straight month to $5.8 billion in July compared to $5 billion in June, driven by higher inflows in both debt and equity segments. Inflows rose to $2.7 billion from $1.8 billion in the debt segment and to $3.9 billion from $3.2 billion in equity markets
- **US treasury yields declined:** The yield on the 10-year treasury note was down 6 basis points (bps) on-month at an average of 4.25%. A higher unemployment rate at 4.1% and lower inflation at 3% in June (data released in July) sparked hopes of a rate cut, leading to softer yields
- **Surplus liquidity:** Systemic liquidity was in surplus in July (vs a deficit in the previous month) due to a boost in government spending and robust FPI inflows. Accordingly, the RBI net absorbed Rs1.03 lakh crore (0.4% of net demand and time liabilities, or NDTL) in July compared to an average net injection of Rs 0.55 lakh crore (0.2% of NDTL) in June. The central bank net sold G-secs worth Rs 10,105 crore through open market operations
- **Money market rates eased:** Excess liquidity in the system pulled down money market rates. The weighted average call money rate (WACR) eased 8 bps averaging 6.51%, about the same as the repo rate. The 6-month commercial paper and certificate of deposit rates eased 5 bps each, while the 91-day treasury bill rate (T-bill) fell 12 bps
- **Indian bond yields declined:** Domestic G-sec yields continued their decline. The yield on the 10-year benchmark G-sec was marginally down (3 bps) to 6.97% on average in July from 7% in the previous month. A lower fiscal deficit target for fiscal 2025 in the Union Budget, surplus systemic liquidity, a surge in FPI inflows into debt, and lower US treasury yields helped pull down yields. The decline, however, was capped by the RBI's open market operation sales, higher crude oil prices ($85.3 per barrel in July vs $82.6 in June) and a higher domestic inflation print
- **Equity markets saw gains:** Equity markets hit all-time highs during the month. The S&P BSE Sensex was up 4.7%, while the Nifty 50 was up 4.8% on average. Robust quarterly earnings of domestic companies, positive global cues, and rising FPI flows boosted the markets. Volatility was down with the India Volatility Index averaging 13.5 in July (vs 15.6 in June)
- **The rupee was stable:** The rupee remained steady against the dollar in July supported by FPI inflows. It averaged 83.6 per dollar during the month
- **Bank credit growth accelerated:** Bank credit growth accelerated to 15.5%[2] from 13.9% in June

  As per sectoral data[3] (available till June), agriculture saw the strongest growth in bank credit at 17.4%, followed by personal loans (16.6%)

  In personal loans, though credit card outstanding continued to drive growth (23.3%), it has slowed considerably after the RBI increased risk weights for unsecured lending. Loans against gold jewellery also saw high credit growth at 30.6%, but this category has a lower weight within personal loans. Home loans, accounting for the largest retail loan share, also saw robust growth (18.2%). The RBI cautioned against excessive leverage in these segments in the August monetary policy

  Services credit growth was at 15.1%, while industry credit grew 7.7%. Credit growth in non-banking financial companies (NBFCs), a key component of services, stood at 8.5%

- **Bank lending rates:** Bank lending rates were steady in July, remaining above their pre-pandemic levels. The one-year marginal cost of funds-based lending rate (MCLR) and the home loan rate were stable at 8.85% and 9.35%, respectively. The auto loan rate was up one bp to 9.81%. Despite high lending rates, credit growth accelerated relative to the previous month

[2] As on July 12, excluding the impact of the HDFC merger
[3] Excluding impact of HDFC merger

Transmission of the 250-bps hike in the repo rate since April 2022 to bank lending rates is in progress. The one-year MCLR and auto loan rates have risen 160 bps and 159 bps, respectively, while home loan rates have seen almost complete transmission rising 237 bps

RBI awaits easing of food inflation to begin rate cuts

The RBI's Monetary Policy Committee (MPC) kept policy rates unchanged for the 17th month in a row. The MPC has its eyes on food prices, which have been the biggest hurdle in reducing overall inflation.

Globally, monetary policies are shifting and diverging across major central banks. The European Central Bank initiated a rate cut in June, followed by the Bank of England at July-end. However, the Bank of Japan hiked its policy rate at July-end. And while the Fed has not changed its policy rates so far, it is expected to cut rates in September following a sharp weakening in the country's labour market.

Diverging monetary policies have induced volatility in global markets. In particular, the unwinding of the yen carry trade put pressure on foreign portfolio inflows and the rupee in early August.

That said, Fed rate cuts are expected to give room for RBI to ease rates. S&P Global expects the Fed to cut rates by a total of 50 bps in calendar year 2024 and 100 bps in 2025.

The food challenge to a rate cut is expected to ease as agriculture prospects look better than last year with an above-normal monsoon and higher kharif sowing. This picture will become clearer by September.

Due to these factors, we expect the RBI to begin cutting rates from October at the earliest, lest weather and international commodity prices play spoilsport. Overall, we expect two rate cuts this fiscal.

Table: How financial conditions fare across different segments

		Pre-pandemic 5-year average	Annual average				Current fiscal			
		FY16-20	FY21	FY22	FY23	FY24	Apr-24	May-24	Jun-24	Jul-24
Policy rate	Repo rate (%)	**6.3**	4.0	4.0	5.5	6.5	6.5	6.5	6.5	6.5
	Repo rate, inflation-adjusted (%)	**2.0**	-2.2	-1.5	-1.1	1.1	1.7	1.7	1.4	3.0
Liquidity conditions	Net absorption(-)/injection(+) under LAF (% of NDTL)	**-0.5**	-3.0	-3.9	-0.9	0.0	-0.1	0.6	0.2	-0.4
Money market	Call money rate (%)	**6.2**	3.4	3.3	5.4	6.6	6.5	6.6	6.6	6.5
	91 day T-bill (%)	**6.5**	3.3	3.5	5.8	6.9	6.9	6.9	6.8	6.7
	CP 6-month rate (%)	**7.6**	4.4	4.3	6.9	7.8	7.9	7.9	7.9	7.8
Debt market	10-year G-sec (%)	**7.2**	6.0	6.3	7.3	7.2	7.2	7.0	7.0	7.0
	Term premium (%)	**1.0**	1.9	2.3	1.8	0.7	0.7	0.5	0.5	0.5
	AAA bond spread' (%)	**0.6**	0.7	0.5	0.2	0.3	0.2	0.3	0.4	0.4
	AA bond spread'' (%)	**2.0**	3.6	2.0	3.5	2.6	2.0	2.1	2.1	2.1
Lending rates	MCLR (1 year) (%)	**8.3**	7.4	7.1	7.9	8.7	8.9	8.8	8.9	8.9
	Auto loan rate (%)	**9.6**	8.0	7.7	9.0	9.8	9.8	9.8	9.8	9.8
	Housing loan rate (%)	**9.1**	7.4	7.1	8.4	9.3	9.4	9.4	9.4	9.4
Credit availability	Bank credit growth (y-o-y,%)	**9.7**	5.9	7.0	14.2	15.7	15.3	16.1	13.9	15.5
Money supply	M3 growth (y-o-y %)	**9.7**	12.2	9.6	8.9	10.9	10.9	12.1	9.7	10.0
Equity market	Sensex (%*)	**8.7**	7.6	27.0	8.7	11.4	17.0	15.5	18.2	21.8
	NSE VIX	**15.6**	25.8	17.9	17.5	12.4	11.7	20.2	15.6	13.5
Forex market	Rs/$ (m-o-m, %)	**0.2**	-0.2	0.4	0.6	0.1	0.5	0.0	0.1	0.1
Foreign capital	Net FPI ($ bn)	**0.6**	3.0	-1.3	-0.5	3.4	-1.9	-1.5	5.0	5.8
Global conditions	S&P 500 (%*)	**8.9**	14.0	24.3	-2.8	7.5	19.1	21.0	23.6	24.5
	10-year US Treasury yield (%)	**2.3**	0.9	1.6	3.4	4.1	4.5	4.5	4.3	4.2
	Brent ($/barrel)	**57.4**	44.8	80.0	95.4	83.0	90.1	82.0	82.6	85.3

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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