US Fed rate hike - Effects

Why in news?

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US Federal Reserve recently raised interest rates for a third time this year and it is a cause of concern for India.

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What could be the effects?

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- Investing in dollars will get higher returns with the rising interest rates.
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- It may induce foreign portfolio investors (FPIs) to pull out of emerging markets, including rupee debt and equity, where they get lower returns.
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- That could have a cascading effect where the rupee will further depreciate and affects investor sentiments with lower returns on their investments.
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- Also, continued strengthening of the dollar will make crude oil imports more expensive in rupee terms.
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- Higher crude oil prices and a tighter, more expensive dollar will put further pressure on India's already high trade and current account deficits.
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- Given that trade accounts for over 40% of our GDP, it could trigger more domestic inflation.
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How could it trigger further volatility?

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- The RBI's Monetary Policy Committee will have to consider the possible consequences carefully.
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- Though RBI has reserves of almost $400 billion, it has substantial overseas obligations in the next 12 months.
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- India's balance of payment is largely balanced by its capital inflow in recent times.
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- Yet, a large proportion of reserves consists of "hot money" accrued from portfolio investments.
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- FPIs have sold Rs 750 billion worth of rupee assets in the past six months and this could further trigger volatility in the trade balance.
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- This would make RBI to raise the policy rates in order to maintain the interest rate differential between the rupee and the dollar at the current level.
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- The recent policy of protectionism through the levying of higher import duties may add impetus to the **import-driven inflation**.
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- The core inflation, which excludes food and fuel, will get impacted by costly imports and it will surely rise as the rupee falls.
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What could a higher interest rate do?

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- Higher policy rates in India may help to protect the rupee from further depreciation through increased inflow of capital from portfolio investors.
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- But they would inevitably impact consumption and reduce the volume of credit offtake within the domestic space.
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- Tightening policy rates would also result in costly borrowing for the nascent corporate sector.
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- Bank bad loans continue to pose a huge problem and the recent IL&FS defaults have created anxiety and fears of a liquidity crisis across the NBFC space.
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- The market value of a bond will fluctuate as interest rates rise and fall and a higher interest rate could make bond market to freeze.
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What lies ahead?

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- Protecting the rupee against capital flight, infusing liquidity into a tight bond market, and ensuring that consumption doesn’t contract are important factors to be considered.
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- Balancing such conflicting imperatives will require sensible prioritisation from the RBI.
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- Along with monetary action from RBI, policymakers must find creative ways to stimulate exports in order to exploit the weak rupee and reverse the current adverse trade position.
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Source: Business standard

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Quick facts

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Bond markets and interest rates

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- A bond is generally purchased at a coupon rate, say 5%, with a maturity period attached to it.
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- The market value of a bond will fluctuate after the purchase as interest rates rise or fall.
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- When the interest rate rises, new bonds will be issued at a coupon rate, say 7%, which is higher than what the current holding bond fetches the investor.
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- This makes the previously purchased bond not worth as much as when it was bought.

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- Investors get a leverage to purchase a bond that pays a higher interest rate and hence the lower yielding bond would be trading at a discount.

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- Conversely if interest rates were to fall after one purchases a bond, the value of that bond would rise because investors cannot buy a new issue bond with a higher coupon rate.

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