Fed rate hike

Why in news?

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- US Federal Reserve raised the Fed Funds policy rate for the second time in succession by 25 basis points.
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- It was in line with the market consensus.
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Why was it raised?

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- The raise was due to the tight labour markets, strong gross domestic product (GDP) growth and rising inflation.
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- Despite two successive hikes, rates remain low in historic terms.
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- Fed's outlook did not take changes in fiscal policy into account.
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- The Fed started "quantitative tightening" by selling off the vast portfolio of bonds that it accumulated during several years of quantitative easing.
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- President Donald Trump's promises to increase government spending, combined with tax cuts, plus import tariffs could add to inflationary pressures and force the Fed to make another hike soon.
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What will be the impact on India?

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- The hike was expected. So there was little in the way of immediate reaction across global markets.

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- The rupee strengthened and most equity markets ignored the hike.

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- But tighter American monetary policy always has far-reaching consequences in the long run.

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- India appears to be favoured in relative terms.

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- There will be no problems about the balance of payments so long as crude prices stay low.

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- Given the tag of being the fastest-growing emerging economy, India will also continue to receive foreign portfolio investment even if the pace slows.

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- Exports appear to be pulling out of a long trough, given the expansion across the last six months.

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- A stronger dollar could certainly contribute to higher exports, assuming that the US does not put up barriers.

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- However, a stronger dollar will also increase the burden on companies with overseas debt.

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- Hence, the hike will trigger abundant caution on the part of the Reserve Bank of India (RBI), which held rates steady in the last two policy reviews even as domestic inflation eased to below targeted levels.

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- The central bank is carefully monitoring the difference between sovereign yields and it seems to be nervous about sudden, sharp changes in exchange rates.

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- While a weaker rupee might not be a bad idea, the RBI will have to carefully calibrate its responses to the Fed policy to ensure volatility remains within acceptable limits.

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- As dollar yields rise, money tends to move out of high-risk emerging market assets and into the ultra-safe US bond market.

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- That leads to a stronger dollar and often to weaker commodity prices in

dollar-denominated terms.
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- The shift to dollar-denominated assets can also lead to downtrends across global equity markets.
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- The stronger dollar generally encourages American imports, including service imports, and the resulting American consumption stimulates the global economy.
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- The difference now is that the US government may impose import tariffs on goods and non-tariff barriers on services, including tighter quotas for H1B visas.
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- That will interfere with the normal linkages between enhanced US activity and global growth.
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- Hence, fiscal protectionism is a bigger concern compared to tighter monetary policy.
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Source: Business standard

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