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Hiking Interest rates by Fed Reserve

Why in news?

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The US Federal Reserve has hiked interest rates by another 25 basis points.

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What is it?

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- **The Fed Funds Rate is the interest rate at which the top US banks borrow overnight money from common reserves.**
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- All American banks are required to park a portion of their deposits with the Federal Reserve in cash, as a statutory requirement.
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- The US Fed, unlike our RBI, isn't a single entity. It is a web of institutions made up of a Board of Governors based in Washington, 12 Federal Reserve Banks across key US cities and private banks.
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- Together, the Board and the 12 Federal Reserve banks regulate US lending institutions, act as lenders of last resort and watch out for the interests of depositors.
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- The Federal Open Market Committee (FOMC), which decides monetary policy in the US, does not actually 'fix' the Fed Funds Rate.
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- What it does, after announcing its target, is to direct open market operations to pull or push this rate into its target range.
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- The Federal Reserve Bank of New York, the kingpin in the Fed system conducts open market operations to ensure that the Fed Funds Rate behaves itself.
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- To push the rate downwards, it mops up government bonds from the common reserve and infuses cash.
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- The higher liquidity then allows banks to trim their lending rates. To lift this rate, it sells government bonds and vacuums up liquidity from the system.
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Why is it important?

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- **The Fed Funds Rate is the key indicator of the direction in which US interest rates are heading at any given point in time**.
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- If the Fed is hiking rates, lending rates for companies and retail borrower increases, and vice versa.
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- Unlike India's repo rate, which may not matter much to anyone across the borders, US interest rates matter a lot to global capital flows.
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- A good chunk of the world's wealthiest investors and institutions have their home in the US.
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- They are therefore constantly comparing interest rates outside the US, to those in their home country, to make their allocation decisions.
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- The dollar is the default reserve and trading currency of the world.
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- This too makes US interest rates an important factor deciding the direction of global trade and investment flows.
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Why should we care?

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- The RBI does keep an eye out for Fed actions when it decides on rate hikes.
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- For instance, with the Fed Funds Rate headed upwards now, RBI will have to think twice about cutting its policy rate, as **this can lead to foreign investor pullouts from the domestic bond market**.
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- The Indian bond market did see immense pullouts of over $6 billion in the six months leading up to the FOMC meeting.
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- The US interest rates matter to stock investors too.
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- For long, the high valuation for Indian stocks was justified on the count that zero or near-zero returns on safe investments in the US and elsewhere made foreign investors more willing to pay a high price for Indian stocks that’s till offered some growth.
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Source: Business Line

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