US Fed Interest Rates Hike

What is the issue?

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- U.S. Federal Reserve again raised its benchmark short-term interest rate by 25 basis points to 1.75%, the highest in a decade.
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- This monetary tightening is driven by the confidence in the markets, but there are inherent risks which call for caution.
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What is the trend in US monetary policy?

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- The 2008 economic crisis pushed central banks worldwide to cut interest rates to historic lows in order to overcome recession.
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- These loans were facilitated by public borrowings and monetary policy easing and hence had to be serviced at some point in the future.
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- So, US Federal Reserve (which control's monetary policy), has been tapering liquidity lately, as the US economy seems to have recovered fully.
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- While the current increase is only the 6^{th} since the financial crisis of 2008, the trend ahead seems unambiguous for further increases.
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- Notably, US economy is projected to register strong growth ahead.
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- The resultant inflationary pressures might push Fed rates further for the next 2 years.
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How has its impact been?

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- To reverse the post-2008 liquidity easing, the Fed and other central banks have initiated normalisation of monetary policy.
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- The impact of these on the wider credit markets is slowly beginning to show in the markets.
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- The “interbank lending market” has been directly influenced.
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- Significantly, the benchmark “London Interbank Offered Rate” (LIBOR), at which international banks lend to each other has also been increasing.
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- LIBOR has risen for more than 30 consecutive sessions and is currently at its highest since the financial crisis.
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- Also, the corporate debt market has clearly been impacted.
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- The rising rates could adversely affect the capacity of private firms to service their debt.
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What are the challenges?

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- **Debt Default -** The risk of default by private borrowers has been flagged by various organisations recently, including the IMF.
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- Notably, private corporations attracted by ultra-low interest rates had heavily loaded up on debt over the last decade.
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- Also, some companies borrowed heavily from across the borders, thus making them prone to exchange rate risks as well.
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- Ironically, the 2004-2006 period saw the Fed raising rates to tackle inflation.
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- But it ultimately led to a mass default of mortgage debt and precipitated the 2008 crisis.
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- **Trade Protectionism -** US President Trump’s steep tariff raise against

imports from China had recently forced down stock values across markets.
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- These trade wars will clearly have a negative impact on global growth.
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- Corporate earnings and these policy uncertainties seem to be a long haul.
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- **Capital Flux -** Rising interest rates would also see capital outflow from emerging markets due to liquidity crunches.
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- This is particularly a concern for India.
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Source: The Hindu

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