US Federal Reserve & Indian Market

Why in News

Recently, the **US Federal Reserve** (central bank of US) has signalled a possible hike in interest rates. This has led to a nervous reaction in Indian markets.

- Rate hikes by the **Federal Reserve** affects not only the US economy, but also shapes the **macroeconomic outlook** and exerts a certain degree of influence on the **monetary policies in other emerging economies.**

Key Points

- **Co-relation of Federal Reserve & Indian Markets:**
  - **Emerging economies** such as India tend to have **higher inflation and higher interest rates** than those in **developed countries** such as the US and many of the (primarily Western) European nations.
  - As a result, financial institutions, particularly Foreign Institutional Investors **(FIIs) would want to borrow money in the US at low interest rates in dollar terms and then invest that money in government bonds of emerging countries** such as **India in local currency terms** to earn a higher rate of interest.
  - When the US Federal raises its domestic interest rates, the difference between the **interest rates of the two countries decreases.**
  - This **makes India less attractive for the currency carry trade,** consequently, some of the money may be expected to move out of the Indian markets and flow back to the US.
    - A currency carry trade is a strategy whereby a **high-yielding currency funds the trade with a low-yielding currency.**
  - Therefore **decreasing the value of India's currency against the US dollar.**
- **Impact of Increased Interest Rates on India:**
  - **On Equity Market:**
    - Bond yields **will rise due** to growing dollar shortage in the global market.
    - Previously, in India, the debt and equity markets witnessed **outflows of over Rs 40,000 crore rupees**, due to the strengthening dollar and uncertainties perpetrated by the trade war between the US, China, **European Union**, and other major nations.
  - **On Export and Forex:**
    - India being one of the **largest crude oil importers** of the world.
    - A **weaker rupee vis-à-vis a dollar** results in more expensive imports of crude oil that may put **cost-driven inflationary** push across the whole economy and especially in those sectors that are highly sensitive to crude oil price movements.
    - India's exports on the other hand, notably **IT and IT-enabled services** – will benefit to some extent from a stronger dollar with respect to the rupee.
    - However, the **same benefit may not fully accrue to exporters** due to strong

competition in the export market.

Source: IE