# US Fed Rate Hike

**For Prelims:** US Fed Rate Hike's impact on Indian Economy, **Inflation**, **RBI**, **Exchange Rate**

**For Mains**: US Fed Hike's impact on Indian Economy and options available

## Why in News?

After raising interest rates aggressively to tame **inflation**, the US Federal Reserve has **once again raised its benchmark overnight interest rate** by a quarter of a percentage point **to the 5.00%-5.25% range.**

- Overnight rates are the rates at which banks lend funds to each other at the end of the day in the overnight market.
- In many countries, the overnight rate is the interest rate the central bank sets to target **monetary policy** (Repo Rate in India).

## What could be the Possible Impact of this Hike on India?

- The economists have expected that the latest **Fed hike may not have a material impact on India** as the **RBI** has paused hikes and there is weakness in the crude oil prices as well.
- **Domestic markets are likely to remain resilient** and if there is volatility, it would have a limited impact on the economy.
- It is also expected that the strength of the rupee and the continued buying by foreign institutional investors (FIIs) will strengthen the market.
    - FIIs **have already started investing in India,** with inflows in April 2023 rising to Rs 13,545 crore and Rs 8,243 crore in May so far.
- Moreover, this hike is being viewed as last one for this year,2023 and the Fed will start cutting rates from the second half of 2023.
- If the Fed opts for a cut later in the year, **capital inflows are expected to pick up.**
    - If the **Fed starts cutting rates** from July 2023, **markets are expected to rise sharply.**

## Why do Central Banks resort to a Rate Hike?

- The central bank may increase interest rates **to control** inflation.
- This is being done to **reduce the amount of money available for borrowing, which can help to cool down the economy** and prevent prices from rising too quickly.
- **With higher borrowing costs, people and companies may be less willing to borrow**, which can slow down economic activity and growth.
    - Businesses may take fewer loans, hire fewer people, and reduce production in response to the increased costs of borrowing.

## What are the Impacts of US Fed Rate Hike on Indian Economy?

- **Capital Flows:** A US Fed rate hike can lead to a rise in interest rates in the US, which can attract capital flows from other countries. This can **lead to a reduction in foreign investment in India,** which can affect economic growth.

- **Depreciation of rupee:** It can also lead to a **depreciation of rupee**, which can have an impact on India's trade balance and current account deficit.
  - Depreciation of Indian rupee may result in costlier imports such as crude oil and other goods. This **may bring the imported inflation** in Indian Economy.
- **Domestic Borrowing Costs**: It can lead to an **increase in borrowing costs in India,** as investors may choose to invest in US securities instead of Indian securities. This can lead to a reduction in domestic investment and higher borrowing costs for businesses and individuals.
- **Stock Market:** It can also impact the stock market in India. Higher US interest rates can lead to a reduction in demand for risky assets such as equities, which can **lead to a decline in stock prices in India.**
- **External Debt:** India's external debt is mostly denominated in US Dollars, a US Fed rate hike **can increase the cost of servicing that debt,** as the value of the rupee may fall against the dollar. This can lead to an **increase in India's external debt burden** and a negative impact on the economy.
- **Banks: The banking industry gets benefited by the interest rates rise**, as banks re-price their loan portfolio much quicker than their deposit rates, which helps them to increase their net interest margin.

## What Options are Available with India to Counter Fed Hikes?

- **Adjusting Domestic Interest Rates:** The RBI, could **raise interest rates in response to the Fed hikes to attract foreign investors to invest in Indian markets,** which would increase demand for Indian currency and help maintain its value. However, this could also slow down domestic economic growth.
- **Diversifying Reserves:** India could **diversify its foreign exchange reserves to reduce its dependence on the U.S. dollar** and mitigate the impact of Fed rate hikes. For instance, India could increase its holdings of other major currencies such as the Euro, Yen, and Chinese Yuan.
- **Enhancing Trade Relations with Other Countries:** India could **focus on expanding trade ties with other countries to boost its economic growth and reduce the impact of the Fed rate hikes.** This could include exploring new export markets, attracting foreign investment, and increasing bilateral trade agreements.
- **Encouraging Domestic Consumption:** If the Fed rate hikes lead to a slowdown in the Indian economy, **the government could boost domestic consumption through measures such as tax cuts, subsidies,** or public works programs to stimulate economic activity.
- **Reduce Dependence on Crude Oil:** One of the major effects of a stronger US dollar is the increase in crude oil prices, which in turn contributes to the overall rise in commodity prices. To address this, it is important to promote the use of alternative sources of energy such as **renewable energy** and **ethanol.**

## UPSC Civil Services Examination, Previous Year Question (PYQ)

**Q. Indian Government Bond Yields are influenced by which of the following? (2021)**

1. Actions of the United States Federal Reserve
2. Actions of the Reserve Bank of India
3. Inflation and short-term interest rates

**Select the correct answer using the code given below.**

**(a)** 1 and 2 only
**(b)** 2 only
**(c)** 3 only
**(d)** 1, 2 and 3

**Ans: (d)**

**Q. Consider the following statements: (2022)**

1. Tight monetary policy of US Federal Reserve could lead to capital flight.
2. Capital flight may increase cost of firms with existing External Commercial Borrowings (ECBs)
3. Devaluation of domestic currency decreases the currency risk associated with ECBs

**Which of the statements given above are correct?**

**(a)** 1, 2 and 3
**(b)** 1 and 2 only
**(c)** 2 and 3 only
**(d)** 1, 2 and 3

**Ans: (b)**

**Source: IE**