Impact of US Federal Reserve's Policy on Indian Markets

Why in News?

The recent **US Federal Reserve** policy meeting, keeping the policy rate unchanged at 5.25% but signaling two rate hikes to reach 6% by end-2023, has sparked speculation on India's **interest rates** and markets.

- While the **Fed chose to maintain the status quo, it hinted at the possibility of two more rate hikes this year to combat** inflation.

What is the Impact of Fed's Policy on the Indian Market?

- The **Indian markets fell by 0.49% on June 29, 2023,** following the Fed's policy announcement.
- The Fed's policy affects the Indian markets through various channels such as:
    - **Exchange Rate Channel:** The Fed's rate hikes **tend to strengthen the US dollar against other currencies, including the** Indian rupee.
        - **A weaker rupee also increases the debt servicing costs** for Indian borrowers who have taken loans in foreign currency.
    - **Capital Flow Channel:** The Fed's rate hikes also **reduce the interest rate differential between the US and India**, which makes India less attractive for foreign investors who seek higher returns.
        - This **could lead to** capital outflows **from India's equity and debt markets,** which could lower asset prices and increase volatility.
        - **Capital outflows could also reduce India's foreign exchange reserves** and create liquidity crunches in domestic markets.
    - **Inflation Channel:** The Fed's rate hikes could also affect India's inflation through two ways.
        - First, **a weaker rupee could increase the imported inflation for India**, as it raises the cost of imported goods such as oil, gold and electronics.
        - Second, **higher global commodity prices due to strong US demand could also push up India's domestic inflation**, as it affects the input costs for various sectors such as agriculture, manufacturing and services.
    - **Growth Channel:** The Fed's rate hikes could also have an impact on India's economic growth through two ways.
        - First, a **tighter US monetary policy could slow down the global economic recovery** from the pandemic, which could hurt India's export prospects and external demand.
        - Second, **higher domestic interest rates due to capital outflows and inflation pressures** could dampen India's domestic demand and investment activity.

What are Some of the Possible Scenarios for Indian Markets?

- **Best-case Scenario:** The **Fed's rate hikes are gradual and moderate,** and are accompanied by clear and credible communication.
    - The **RBI maintains an** accommodative stance and supports the liquidity and credit conditions in India.

    - **India’s economic recovery is robust and resilient,** supported by strong domestic and external demand. India’s inflation is contained and manageable, and its fiscal and current account deficits are under control.
    - **Global risk appetite is high** and foreign investors remain positive on India’s growth potential and reforms.

Note: An accommodative stance means the central bank is prepared to expand the money supply to boost economic growth. The central bank, during an accommodative policy period, is willing to cut the interest rates.

- **Worst-case Scenario:** The **Fed’s rate hikes are sudden and aggressive,** and are driven by unexpected inflation shocks.
    - The **RBI is forced to tighten its policy to defend the rupee and curb inflation.** India’s economic recovery is weak and uneven, hampered by pandemic-related uncertainties and structural bottlenecks.
    - **India’s inflation is high and persistent**, and its fiscal and current account deficits are unsustainable.
    - **Global risk appetite is low and foreign investors flee from India’s markets** due to geopolitical tensions, policy uncertainty and governance issues.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Q1. 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)

Q2. Consider the following statements: (2022)

1. Tight monetary policy of the 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