U.S. Federal Reserve rates and India

In its recent policy stance, the U.S. Federal Reserve has left the policy rates unchanged.This was done primarily because of the ongoing economic growth, a strong labour market and an eventual rise in inflation.

Why is it Important?

Rate hikes and/or hawkish messaging by the Federal Reserve affects not only the U.S. economy, but also shapes the macroeconomic outlook and exerts a certain degree of influence on the monetary policies in other emerging economies.

For instance, this hike by the Fed seems to have influenced, at least partially, the repo rate hike by 25 basis points that was implemented by the Reserve Bank of India's (RBI) Monetary Policy Committee, in March 2019, effectively implying a reversal of the easy monetary policy regime that was being followed in the Indian economy for the past three years.

Why the U.S.A. Fed Rates Impact Emerging Economies?

- Emerging economies such as India tend to have higher inflation and higher interest rates than those in developed countries such as the U.S. 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 U.S. 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 U.S. Fed raises its domestic interest rates, **the difference between the interest rates** of the two **countries decreases,** thus making 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 U.S., therefore decreasing the value of India's currency against the U.S. dollar.

How Increased Interest Rates Impact India?

- **On Equity Market**
    - Bond yields will rise due to growing dollar shortage in the global market.
    - Last year, in India, the debt and equity markets have witnessed outflows of over 40,000 crore rupees, due to the strengthening dollar and uncertainties perpetrated by the trade war between the U.S., 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.