Impact of Federal Reserve Decision

The Federal Reserve gave the market a jerk when it announced the probability of a rate hike this year in a statement made in August'15. However, since its last meeting in September'15, Federal Open Market Committee (FOMC) has provided almost clear signals that there would be an interest rate hike in December. To that extent the decision taken yesterday does not come as a surprise.

The **Federal Reserve has changed target range for federal funds rate from 0%-0.25% to 0.25%-0.50% while declaring accommodative stance henceforth.** The increase hence works out to 25 bps and it may be conjectured that all future increases would be of the same magnitude.

The increase of 25 basis points comes after nearly a decade of unchanged rates. The last rate hike was in June 2006, just before the 'housing bubble burst' hit the economy. The Federal Reserve had brought rates to zero-base in December 2008 in an attempt to uplift the economy after the collapse. The Financial crisis of 2008 and its aftermath had been responsible for soaring unemployment which peaked at 10% which is now stands at half the rate. Subsequently the Fed went in for quantitative easing which was unwound last year.

The FOMC monetary statement came with the key following takeaways:

- The rise in interest rate serves as a positive sign for the U.S economy as indicated by strong trends in household spending and business fixed investment. A hike in rate indicates increased confidence that the economy has picked up and is ready to bear the higher borrowing costs.
- Inflation has remained below the 2% target set by the Committee largely supported by the softening of energy prices and non-energy imports.
- Inflation target of 2% will remain the prime focus of the Committee as transitory decline in energy and import prices subsides and labor market strengthens.
- The Committee will seek to increase rates gradually once the impact of current rate increase is seen on the economic activity.

Impact on the Indian Economy

Unlike the high volatility and significant fall witnessed in domestic markets when Fed had raised rates last time, the domestic markets have been factoring in the policy change for some time now. The markets remained in green yesterday and opened with a gain today. The Rupee which had been volatile had witnessed depreciation but strengthened just a day before the Federal Reserve was due to make its announcement. GSec yields also increased almost in consonance even as the domestic liquidity situation has become tight in the last couple of weeks.

Here, we look at the likely impact the rate hike will have on the domestic economy.

A) **Foreign Portfolio Investments**:

FPIs in both debt and equity market are already been withdrawing since the last month.

- Equities: A large proportion of foreign investments come as equities. Equities recorded an outflow of USD 1,071 mn in Novemeber'15 a significant fall from inflow of USD 1,641 mn recorded in October'15. For the current month, an outflow of USD 724 mn was already seen as investors had been cautious of the rate hike. Equity outflows are likely to moderate as uncertainty of rate hike is eliminated. Future movements would also depend on how the economy performs with corporate results holding the clue.
- Debt: Foreign capital has been withdrawing from the Indian debt market at a fast pace. A rise in interest rate in U.S generates greater returns to investors. The Reserve Bank of India has been maintaining a rather dovish stance by cutting rates by 75bps in FY16. Both the rise in U.S rate and decline in key rate in India may have a negative impact on the debt flows. Besides, the debt limits in GSecs has been virtually used up and while the corporate debt window is open to FIIs there are limited funds flowing here.

B) Rupee Movement

The Indian Rupee has been bearing the weight of the impending rate hike for some time now. It reached a 2-year low level of Rs. 67.10 one week ahead of FOMC meeting. The high foreign capital outflows had caused the rupee to depreciate below Rs.66 mark against the American currency in November'15 and have remained weak since then.

- The rupee will stabilize soon as net forex reserves are fairly stable.
- Volatility can be expected before all Fed meetings as future rate hikes have been kept open-ended.
- The RBI's intervention in the spot and derivatives market will need to be tracked to get an idea of how it views the rupee movement.
- The rupee may be expected to decline over a period of time due to the slower FII flows **and Rs 66 may be the new floor.** However, if corporate earnings justify higher FII inflows, the rupee can strengthen.

C) Interest rates

The key repo rate stands at 6.75% after a 75 bps cut since April'15. RBI will keep a focus on the inflation index which is seen to be tightening with November'15 retail inflation at 5.4%, while deciding its next steps in February'16 monetary policy review. The Fed rate will not have a bearing as of now.

D) Inflation

The inflation rate for the Indian economy has been in the comfortable range given the easing of commodity prices led in particular by falling oil import bill. Increasing food inflation has been the main concern with a second consecutive season of deficient monsoon having a bearing on the crop output. The weakening of rupee against the Greenback as a result of the U.S rate hike may reflect in the inflation numbers for subsequent months as imports become dearer. But in net terms the impact will be negligible as the rupee has also shown signs of strengthening after the announcement.

E) Foreign Direct Investment

Foreign Direct Investments are unlikely to be significantly impacted by the rate hike as they come in as long-term investments in the economy. Higher rates in the USA are unlikely to affect decision on this score and will depend more on the opportunities as well as policy framework available to them.

F) Government Budget

There may not be any significant impact on fiscal indicators on account of this move. Expenditures are unlikely to be impacted with limits being placed on subsidies even in case the rupee value of crude oil rises.

G) Corporate debt

Given the forex exposures of companies, their profitability could come under pressure which in turn can impact their own ability to service their debt. They would be affected by both the variable interest loans (denominated as LIBOR plus) as well as rupee depreciation, if it is significant.

H) Gross Domestic Product

The economy recorded GDP growth rate of 7.4% in the second quarter of FY16 and appears to be on the path of 7.5-7.6% for the year. Being a domestic driven economy, growth impulses from consumption and investment will be from within. To the extent that US increases imports from India, there could be some benefit, albeit marginal.

Concluding remarks

The decision of the Fed does indicate that there could be more rate hikes in 2016. India will be affected through the flow of foreign funds which will have a bearing on the currency. The exact movement will depend however, also on the overall dynamics of the balance of payments line items and the stance taken by the RBI. Inflation should increase due to currency movement and higher cost of imports, but is unlikely to be significant in the overall scheme of things presently.

In terms of policy responses on interest rates and fiscal measures, such hikes would be generally neutral. The real economy as indicated by GDP trends would be largely unaffected by these rate hikes and direction will be provided from within.

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