

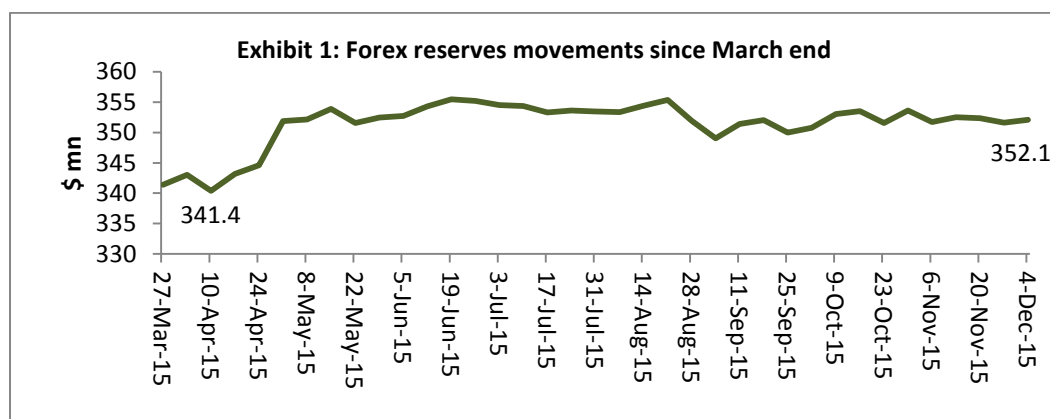
Understanding the Fed rate hike

The rate hike by the Fed is almost certain, as is the quantum and roadmap for further increases in interest rates during the course of 2016. It may be recollected that the Fed had brought down interest rates close to zero in 2008 following the financial crisis. The tightening started in 2014 when the QE programme was tapered down to nil over a period of time on considerations of growth taking off and inflation concerns increasing. The unemployment rate appears to be within the 5% level to reassure that growth has taken off and inflation can be a problem. Statements made by the Fed in the past, as also on the day when the ECB has continued to persevere with QE, indicate that the rate hike is imminent this time and there will be no further deferment.

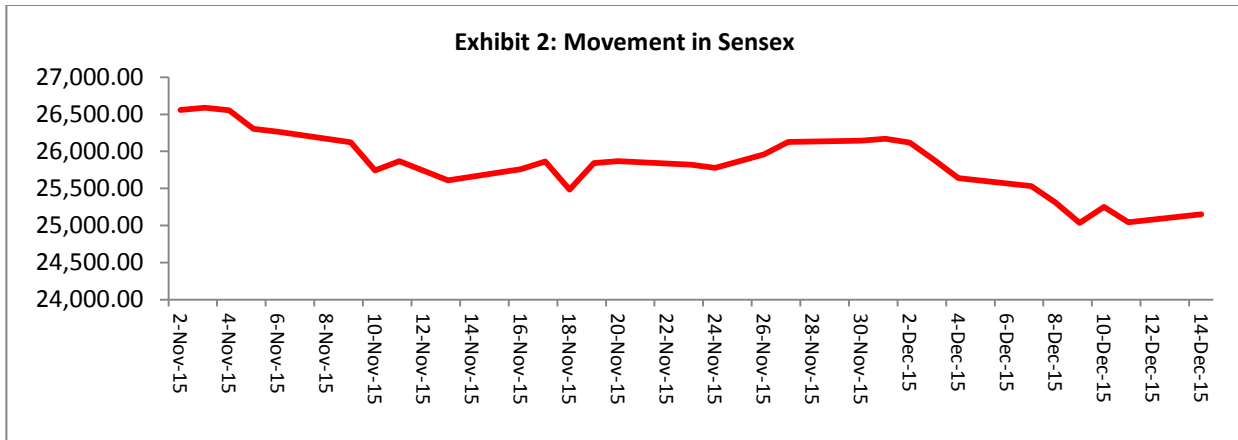
Going by theory any hike in rates will make the dollar stronger in the currency market and by implication the other currencies will weaken. This would be heightened by the stronger growth impulses emanating from the domestic economy.

The markets have reacted with panic just as the Fed meeting begins today. Interest rates have started moving up in the domestic market and the rupee has declined once again to cross the psychological threshold of Rs 67/\$. Why is this happening?

The certain increase in rates has caused foreign investors to pull out from emerging markets; and hence while these countries benefited from the QE measures which supplied cheap money that was partly used to invest in these markets; a withdrawal means that there would be less interest in them. FIIs have withdrawn \$ 1.64 bn in November from the Indian market and the outflows so far in December are \$ 852 mn. Hence, while our overall balance of payments situation looks stable as evidenced by the movements in forex reserves, the rupee continues to be under pressure as demand-supply imbalances have resulted also at the prospects of FII pullout and further depreciation. Demand for dollars has increased as importers are rushing in.

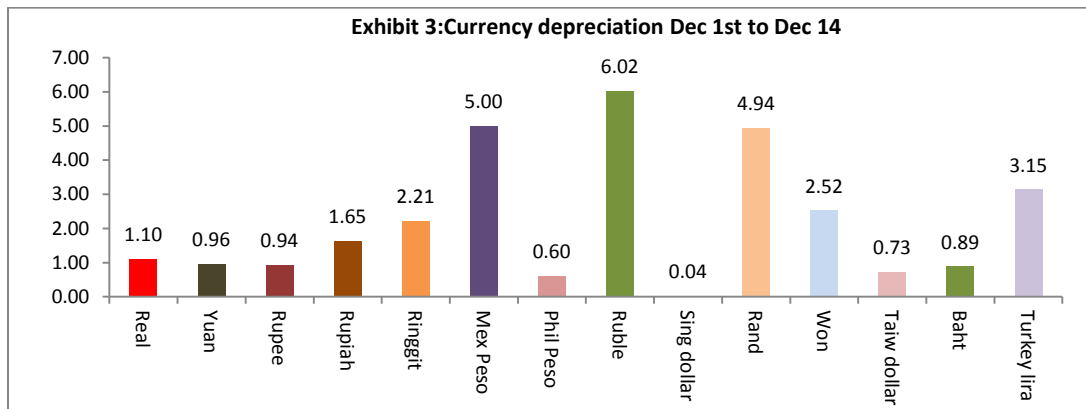


The stock markets have also reacted negatively to such news and coupled with the outflow of FIIs, have trended downwards thus negating the forecast made earlier of the Sensex touching 30,000 by March end.



Is it specific to India?

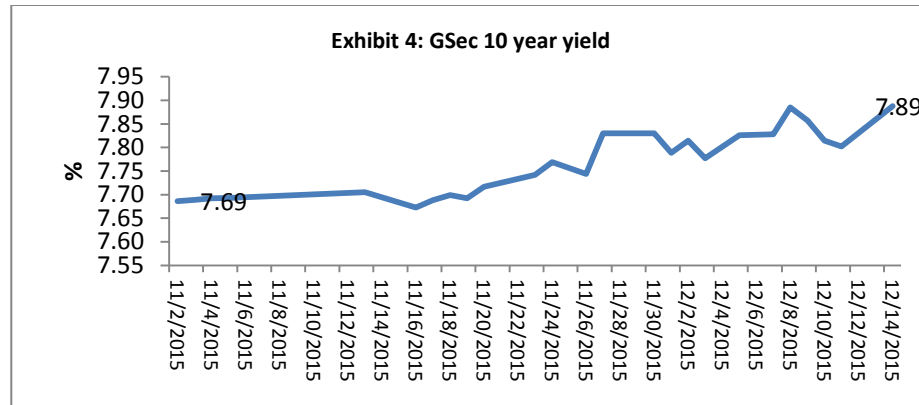
Almost all emerging markets currencies have witnessed a decline in value in December as shown in the diagram below. Therefore, the fall in the rupee is not really unusual to cause concern.



The RBI’s actions in the past in both the spot market as well as the exchange traded currency derivative markets have added to the panic. Central bank intervention in any market is interpreted as a correction which leads to further conjectures on rate movements.

Money markets

Simultaneously, the money market has tightened with money supply under pressure with the withdrawal of FII’s thus leading to GSec yields moving up. The repo limits have been virtually exhausted – both overnight and term put together. This has been heightened by the slower growth in deposits too up to November end where growth was 6.9% over March compared with 7.2% last year. There are expectations of announcements of OMOs by the RBI to buyback bonds to inject liquidity.



Source: FIMMDA

What now to expect?

With the rise interest rate by Fed, foreign investors would exhibit an impulsive reaction of withdrawing money from India adversely impacting the rupee and thereby creating pressure on RBI.

The view here is that most of this phenomenon is due to expectations of a Fed rate hike and are not long lasting in nature. Just like how the QE tapering news was more potent than the actual tapering, markets will self-adjust once the rate hike is announced as this news gets factored in. At this stage however, the central bank's comfort level has to be gauged to understand if an exchange rate is being targeted which can create expectations. The balance of payments appear to be stable to justify a range of around Rs 66/\$ though volatility in the FII flows and demand-supply imbalances can keep it closer to the Rs 66-66.5 range.

GSec yields should correct in course of time and the present tendency to increase should get arrested. A range of 7.6-7.7% appears to be the fair value given the state of the deficit, credit growth and medium term liquidity.

Going ahead, we shall expect the situation to even out once the dollar stabilizes making the inflows into the Indian economy and other emerging economies more favorable. This shall also give a clearer picture to RBI to take its stance in its next monetary policy.

Contact:

Madan Sabnavis

Chief Economist

madan.sabnavis@careratings.com

91-022-67543489

Jyoti Wadhvani

Associate Economist

jyoti.wadhvani@careratings.com

91-022-67543531

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