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Implications of Fed rate hike

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Two important announcements were made by the Fed on the 14th of June 2017 which will have implications for the world economy.

First, the Fed has invoked its second rate hike of 2017 despite inflation running well below the target. Its expectation is that inflation will end at 1.6% in 2017 which is well below the 2% target. However, the Fed believes that a large part of the decline in inflation is due to decreases in specific prices like cell-phone plans and prescription drug prices. In this context it may be pointed out that even in case of the low CPI inflation number for India for May, it was caused by sharp fall in inflation rates for pulses and vegetables. Over time this impact is expected to diminish and the FOMC expects inflation to get to the target in time.

This is the Fed's third rate hike since December and signals that the US economy is getting stronger. The Fed has increased its benchmark interest rate by a full percentage point over the last two years, after leaving the rate close to zero from late 2008 to late 2015.The new range will be 1% to 1.25% for a rate that currently is 0.91 percent. There are indications that there would be one more rate hike during the course of 2017.

The Fed has increased its GDP forecast for the year to 2.2% while unemployment is expected to decline to 4.3% by the end of the year.

Second, the Fed has announced that it will unwind its $ 4.5 trillion balance sheet, or portfolio of bonds including Treasury bills, MBS, etc which was picked up during the QE phases. A limit may be set every month where it will lower their level of reinvestments (actual purchases stopped in 2014 but all the investments were rolled over on maturity to retain its holdings of such securities).

Hence, the Fed intends to use both these measures to raise borrowing costs for businesses and consumers after almost a decade of low interest rates and easy liquidity policy.

Have costs gone up so far?

A look at how interest rates have behaved in the last year shows that rates on auto loans have increased only marginally since the Fed started raising rates in 2015, while rates on mortgage loans are just about the same. Some of the rates on corporate loans have even declined. Hence, the rate hikes may not have actually deterred borrowing by increasing the cost.

The proposed calendar

The Fed would initially shed $10 billion a month for three months, divided 60-40 between Treasuries and mortgage bonds. It will then raise the pace by $10 billion every three months, maintaining the same division, until reaching $50 billion a month.

What happens immediately?

- All revolving debt like credit cards as well as home loans will become more expensive.
- Prime rates of banks would move up.

Both these moves point to tightening of policies.

What does the unwinding of the balance sheet mean?

Reduction of balance sheet size would mean withdrawing liquidity which will have an impact on the flow of funds to the emerging markets including India. India has been a beneficiary of these flows in both the FDI and FPI spaces. The latter is more likely to be impacted as the inflows in the debt segment have been buoyant this year. With US interest rates moving up and domestic interest rates bound southwards, there would be a tendency for funds to remain within the domestic frontiers of USA. While the RBI has stated that monetary policy would be targeting domestic inflation such developments would definitely play out in the background as the external account would also tend to be under pressure if there is any reversal of flow of funds. It may be pointed out that the strong rupee has resulted partly from a strong capital account where investment flows have steadied the balance of payments.

From the point of view of global forex changes the dollar will tend to appreciate which will put pressure on other currencies. The present tone of a weak dollar will get reversed over time. This will also have an impact on the US trade balance. In particular, the weakness of the Euro will help improve EU competitiveness and provide a welcome boost to EU growth, though trade to US is only small share of EU economy. On the other side, several developing countries have debt in dollars. The appreciation in the dollar will increase the cost of dollar repayments and increase the share of debt paid for by emerging economies.

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