Will the Fed increase interest rates today?

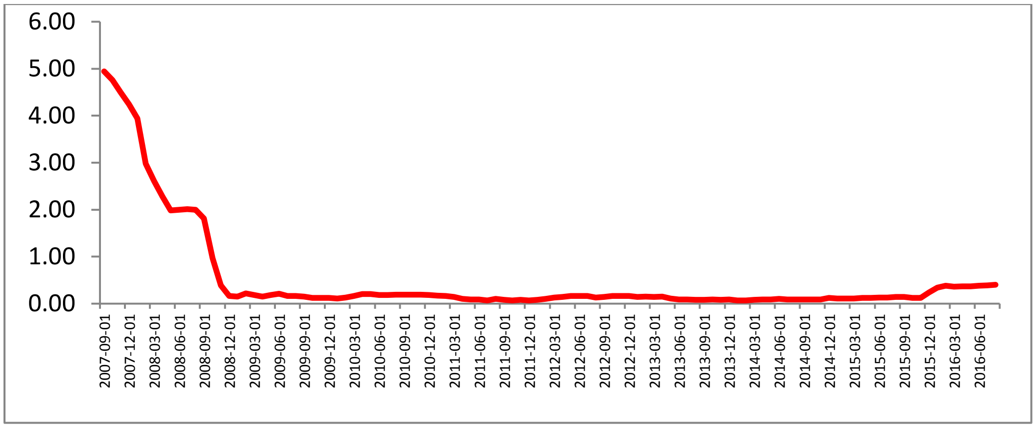
The Federal Reserve has commenced its meeting for the sixth time this year to discuss whether or not to increase interest rates. This issue has been high on the mind of the markets as it will set the tone for the coming months. The Bank of Japan has maintained status quo in its policy today. However it has been announced that it will be introducing a new long-term interest rate target of around zero. The use of aggressive monetary policy measures has not had the desired impact and it does look like that the central bank is running short of tools for reviving the economy. The heavy purchase of bonds could lead to a situation where there are fewer such offering by banks. Inflation is still well below the bank's target and the yen has strengthened significantly against the dollar this year, thus hurting exporters.

Prima facie, the Fed has two main jobs: to maximize employment and keep prices stable (the Fed has targeted an inflation rate of 2%). In the FOMC's June 2016 Summary of Economic Projections, the Committee participants' estimates of the longer-run normal rate of unemployment ranged from 4.6 to 5.0% with a median value of 4.8%.

The market expectations are that the Fed would stay put on its policy with not more than 15% of the respondents in various Surveys pitching for an increase in rates this time.

How has the Fed rate moved?

Chart1: Effective Fed rate (Sep-2007 to Aug-2016)



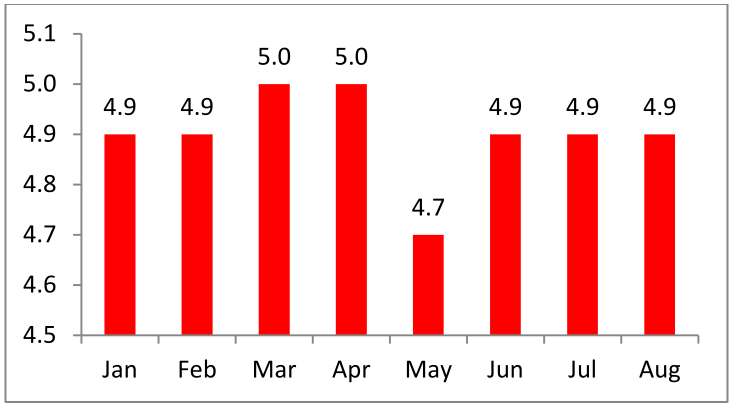
The Fed target rate was 25 bps until December 2015, after which it was increased to a range of 25-50 bps. The effective Fed rate increased from 24 to 40 bps between December 2015 and September 2016.

Expectation on Fed Policy

The Federal Reserve would be assessing the movement in the labor market, economic activity, household spending and inflation before taking a call on interest rates.

Unemployment rate

Chart 1: Unemployment Rate for 2016 (%)

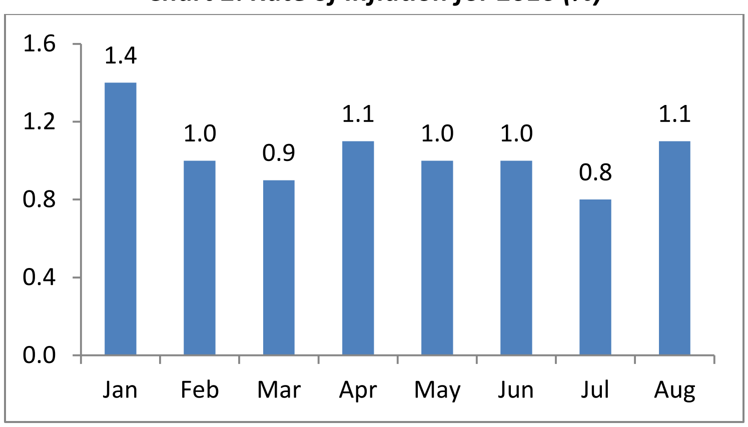


Source: Bureau of Labor Statistics

The national unemployment rate remained steady at 4.9% in August. The unemployment rate has been maintained below 5% for 2016 so far indicating strengthening of labor market. Also, payrolls and other labor market indicators point to some increase in labor utilization in recent months. This is a positive signal for the Fed and hence the labour market data does make a case for the Fed to raise interest rates in its coming meeting. Besides, the Federal Reserve had suggested that with sustained improvements in the economy, interest rates would likely go up.

Inflation

Chart 2: Rate of Inflation for 2016 (%)



Source: US Labor Department

US consumer prices rose more than expected in August as healthcare costs recorded their biggest gain, pointing to a steady build-up of inflation that could allow the Federal Reserve to raise interest rates this year. However, as can be seen, the inflation rate has been well below 2% and hovered around 1% during the year.

While the conditions do look appropriate for a rate cut, the fact that inflation has been virtually unchanged may be the factor that will hold back any rate action at this stage. Also to the extent that the Elections are around the corner, there could be this factor to also consider, though the Fed is autonomous/independent on this score. The clue to watch out for would be the statement relating to risk- if it is 'balanced', then one could expect it to come sooner.

When then will rates be raised?

There are two other meetings this year, November 1-2 and the last one in December 13-14. The November meeting will not probably witness an increase as this will be just before the Elections. It is more likely to be in December. Moreover the decision to freeze rates would put Fed on the same lines with Bank of England and the European Central Bank, where both kept interest rates at historic low levels in their recent meetings.

Implications for India

Assuming no change in interest rates today, the following would be the implications for us.

- **FII inflows:** This will be positive for them as the flows would continue in the normal course. Higher interest rates will cause a reversal of such flows in the short run, though the Indian market is still attractive and would continue to receive equity inflows. Debt would more likely be affected as the tendency for lower rates in India and higher rates in the US could lower the spread which can cause a slowdown in inflows.
- **Stock market:** The stock market is expected to stabilize and remain less volatile, as the markets currently largely anticipate no change in interest rates by the Fed.
- **Exchange rate:** The rupee is expected to revert to normal and remain steady against the US dollar, consistent with steady FII inflows thus ironing out volatility in the market. However, some volatility can be expected before all Fed meetings as future rate hikes have been kept open-ended. Fundamentals like outflow of FCNR deposits would tend to be the driving factor for us.
- **Monetary Policy:** RBI is closely monitoring the Fed movements given the possible effect on the exchange rate. Assuredly the RBI will put more weight on domestic inflation and the FCNR outflows. However, no change in the rates by the Fed would offer some space on interest rates to the extent that FPI flows would remain unaffected. Otherwise, this factor would also play at the back of the mind.

Contact:

Madan Sabnavis	Anuja Shah	Anushka Sawarkar
Chief Economist	Economist	Associate Economist
madan.sabnavis@careratings.com	anuja.jaripatke@careratings.com	anushka.sawarkar@careratings.com
91-022-67543489	91-022-67543568	91-022-67543609