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Fed increases rate as expected

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The Fed in its first meeting under Chairman Jerome Powell increased interest rates on Wednesday. It is a sign of confidence that the economy is growing stronger with low unemployment and rising wages. The Federal funds rate has been increased by 25 bps to a range of 1.5-1.75%.

The main motivations for doing so are:

- Recovery in the economy. GDP growth for the year is revised to 2.7% now (from 2.5% in December) and 2.4% in 2019 (from 2.1% in December). Growth will get moderated subsequently to 2% in 2020 and then move to the trend path of 1.8%.
- Potential build-up of inflationary forces. Presently inflation is expected to be 1.9% in 2018 and 2.0% in 2019.
- Unemployment is at 4.1% but is projected to go down to 3.8% this year and 3.6% in 2019. This will be one of the factors driving consumer spending leading to higher potential inflation.
- The recent $1.5 trillion tax cut and $300 bn spending bill will add to demand which in turn generate inflationary forces.

This is the sixth increase since December 2015, when the Fed started tightening monetary policy for the first time after the financial crisis. The market is expecting 4 rate hikes this year from the earlier forecast of 3. The Fed has spoken of another 2 rate hikes this year.

Impact on other interest rates

This will affect other interest rates like mortgages, credit cards and other borrowings. But ever since the rate has been increased in 2015 it was observed that interest rates on car loans and mortgages have changed only marginally. Credit card rates have however increased sharply.

Savers have not gained so far, though it is expected that the recent hike along with the tone which has accompanied the Fed may provide relief to savers in the form of higher deposit rates.

How does this affect us in India?

Changes in Fed rates normally have an indirect impact on our economy as it affects investment flows, exchange rate and at the periphery monetary policy decision. Also indications of further rate hikes in the year are indicative of the US economy doing well which augurs well for Indian exports at a time when the USA has already announced higher tariffs on steel and aluminum.

- In December 2015 when the Fed first increased the rate post rollback of the QE programme from zero, the repo rate in India was 6.75% and the difference was hence the same. Presently, at 6% repo rate the gap between the two rates has narrowed down significantly. Higher rates in the US would make Treasuries relatively more attractive and the flow of funds to emerging markets including India may be reconsidered. The 10 years treasury is presently at around 2.85-2.90% while it was lower in the range of 2.20% in December 2015. The comparable GSec rate for 10-years has come down during this period by around 20-30 bps.

- However with the RBI unlikely to lower rates – an increase is expected this year, Indian bonds may continue to remain attractive especially as the rupee has firmed up against the dollar in this period. The exchange rate was Rs 67.9/$ in December 2018.

- Monetary policy will be driven by domestic inflationary conditions and while the Fed action along with those of other central banks will be considered in the deliberations, the overriding consideration would be the CPI trajectory. With economic growth also to pick up in India and CARE forecast being 7.5% in FY19, there is the possibility of pick up in demand-pull forces which will get reflected in the core inflation number that will prompt such action.

- The higher regime of interest rates in the USA should normally translate into a stronger dollar as capital inflows increase which should in turn weaken other currencies. While this has not materialized in the past due to uncertainty on the US policy front, the appreciation of the rupee witnessed last year, may not be replicated in 2018.

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