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Federal Reserve action and impact on India

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The Federal Reserve left its key benchmark rate unchanged on May 1st despite renewed calls by President Donald Trump to cut interest rates. It was decided to keep the Federal Funds rate between 2.25% and 2.5%.

The Fed unanimously agreed to leave rates alone, sticking with the wait-and-watch approach outlined earlier this year amid uncertainty about where the US economy is headed. The Chairman had remarked that the Fed did not see a strong case for rates moving in either direction and was comfortable with the current policy stance.

Some pointers

- Fears of a slowdown in the wake of positive news from China and trade tensions between Washington and Beijing appear to be easing
- Global cross-currents apparent at the start of the year have moderated including the extension of Brexit negotiations between the United Kingdom and the European Union.
- On a 12-month basis, overall inflation and inflation for items other than food and energy have declined and are running below 2%.
- Job gains have been solid, on average, in recent months, and the unemployment rate has remained low.
- There has however been a slowdown in household spending and business investment in the first quarter.

Fed thoughts so far

- Since the start of the year Mr Powell has said the US economy remains steady and the Fed was in "no hurry" to raise rates amid a number of risks to the global economy.
- In March, the Fed took its patient approach even further, suggesting it would abandon plans to slowly continue raising rates this year and instead hold off on raising rates indefinitely until it has a better handle on where the economy is going for the rest of the year.

Mr Powell said he anticipates inflation to reach the Fed's target ‘over time’ and that the recent weakness is transitory. The Chairman had said that if inflation were to persistently stay below 2%, the Fed would be concerned and would take it into account in setting policy, which can be indicative of rate cuts.

What have other central banks done?

ECB

In April the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.40% respectively. The Governing Council expects the key ECB interest rates to remain at their present levels at least through the end of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.

The Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Bank of England

The Monetary Policy Committee in their last meeting in March had voted unanimously to maintain Bank Rate at 0.75%. The Committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion. The Committee also voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

The Committee had highlighted the shifting expectations about the potential nature and timing of the United Kingdom's withdrawal from the European Union which had generated volatility in UK asset prices, particularly the sterling exchange rate. Brexit uncertainties also continue to weigh on confidence and short-term economic activity, notably business investment. Employment growth has been strong, although Survey indicators suggest that the outlook has softened. Most indicators of consumer spending are consistent with ongoing modest growth. As the Committee has previously noted, short-term economic data may provide less of a signal than usual about the medium-term growth outlook.

Bank of Japan

In the last policy announcement on April 25th it was stated that The Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020, taking into account uncertainties regarding economic activity and prices including developments in overseas economies and the effects of the scheduled consumption tax hike.

***Short-term policy interest rate**:* The Bank will apply a negative interest rate of minus 0.1% to the Policy-Rate Balances in current accounts held by financial institutions at the Bank.

Long-term interest rate: The Bank will purchase Japanese government bonds (JGBs) so that 10-year JGB yields will remain at around zero percent. While doing so, the yields may move upward and downward to some extent mainly depending on developments in economic activity and prices.

With regard to the amount of JGBs to be purchased, the Bank will conduct purchases in a flexible manner so that their amount outstanding will increase at an annual pace of about 80 trillion yen.

The Bank will continue with 'Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control' aiming to achieve the price stability target of 2% as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2% and stays above the target in a stable manner.

Implications for India

1. No change in interest rates for the present and possible rate cuts if inflation remains very weak in the USA can be a positive for FPI flows to the emerging markets including India. This will help to boost our capital account and counter the higher CAD due to higher oil prices.
2. Slower growth in the USA would however have a negative impact on India's exports as a slowing economy can impact global trade flows and Indian exports are driven more by demand forces than price for most products. IMF expects global growth to slow down to 3.3% in 2019 from 3.6% in 2018 with advanced economies slowing down from 2.2% to 1.8%. USA, UK and Euro region are to witness significantly lower growth rates this year.
3. Dollar will remain stable and not likely to appreciate too much which is good for the rupee which is under pressure presently due to the oil factor.
4. RBI policy unlikely to be influenced overtly as the MPC looks more at the CPI inflation number and the US action is more a secondary concern which is discussed carefully though not decisive in taking rating action.

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