US Monetary Policy Decision and impact on India

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The US Federal Reserve in its recently concluded Federal Open Market Committee (FOMC) meeting unanimously decided to maintain its current level of reference rate at 2-2.25%. However, signalled that it would continue with its interest rate hikes going forward amid a strong economic backdrop.

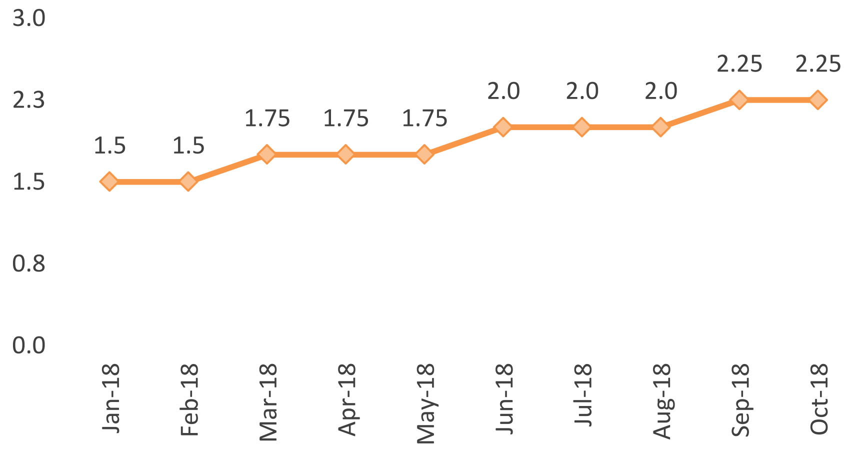
The policy has detailed various factors that will enable US Federal Reserve to continue with the rate hikes path going forward:

- Continued strength in the labor market.
- Reduction in the unemployment rate from 4.1% in Jan'18 to 3.7% in Oct'18 (a 49-year low).This will be one of the factors driving consumer spending leading to higher potential inflation.
- Increase in economic activity, growing at an annual pace of 3.5% in Q3- 2018, higher than the 3% target.
- Rise in consumer spending.
- Inflation near the committee's target of 2%.

The policy, however, pointed towards moderation in business fixed investment that would have likely restricted the Federal Reserve officials from increasing interest rates in this meeting.

Exhibit 1 depicts the trend of the US interest rate (upper point in the range) during the calendar year 2018.

Exhibit 1: Movement of US interest rates (%)



Source: US Federal Reserve

The US Federal Reserve raised the interest rates 3 times in this calendar year.

Comparison of US rates with other economies

Table 1 below elucidates the policy rates announced by major central banks of United Kingdom, Japan, and Euro area and details the risks surrounding the economic growth, inflation forecasts or plan of action wherever was available.

Table 1: Policy rates of major central banks

Major Central Banks	Rates	Risks/plan of action/Inflation forecasts
Bank of England	0.75% (unchanged)	Risks to economic activity : Decline in business investment , uncertainties regarding Brexit , moderation in inflation , trade tensions Plan of Action BoE to maintain the stock of sterling non-financial investment grade corporate bonds at £ 10 billion and UK government bond purchases at £ 435 billion.
Bank of Japan	Around 0% (unchanged)	Risks to economic activity : Cited protectionism, vulnerabilities in the emerging markets as threat to the economy. Plan of Action : Bank to continue with its monetary easing programme until the inflation reaches 2% target Inflation Forecasts: Lowered its inflation targets from 1.1% to 0.9% for FY19 and from 2% to 1.5% for FY21.
European Central Bank	0% (unchanged)	Risks to economic activity : Cited protectionism, vulnerabilities in emerging markets and financial markets volatility as risks to Eurozone Inflation Forecasts : Underlying inflation to move upwards due to rising activity and wage growth, Plan of Action : Plans to end monetary easing by the end of year remains on track.

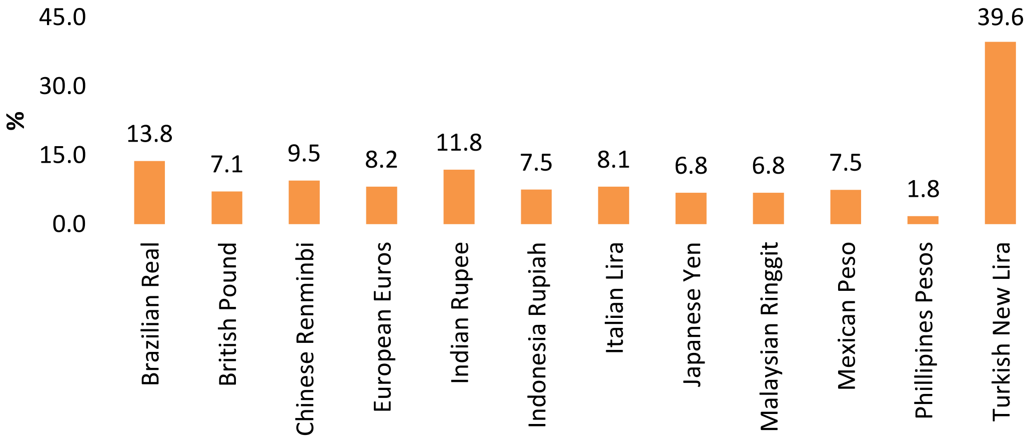
What does higher US interest rates mean for India?

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. The higher regime of interest rates in the USA backed by strong economic backdrop has translated into a stronger dollar that in turn has result in weakening of other currencies.

As can be seen from the Exhibit 2, that dollar has strengthened against all the major currencies during March'18-November'18. It is not only rupee which is depreciating, but other currencies have also been depreciating against dollar. With a set of 12 countries chosen here, the Turkish lira has depreciated the most (39.6%), followed by Brazilian Real (13.8%) and Indian Rupee (11.8%).

The dollar has roughly gained by around 7-8% when compared with UK, Japan and Euro zone. Given the decline of around 12% in the rupee, it could be said *broadly* that around 3.5% - 5% depreciation in Indian currency could be explained by fundamental factors including widening of trade deficit (on account of higher oil prices) and FPIs outflows and the rest to strengthening of the US dollar.

Exhibit 2: Changes in Exchange rate vis-à-vis dollar (November'18 over March'18)

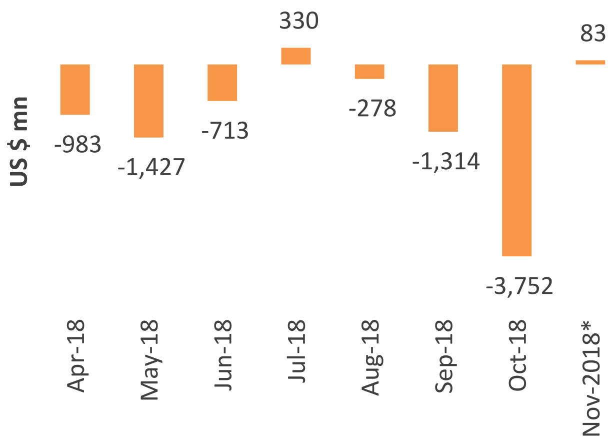


Source: Pacific Exchange Rate Service.

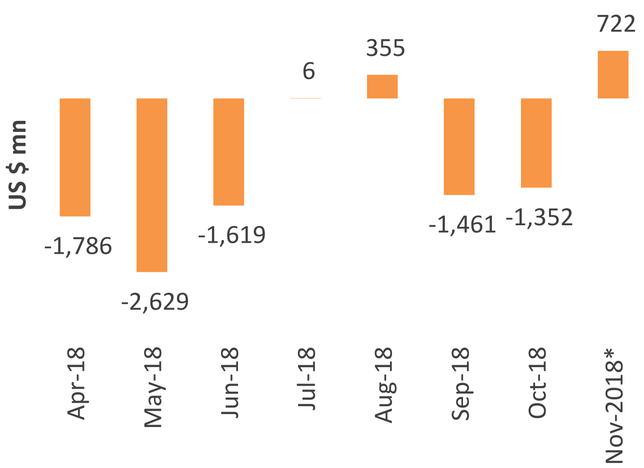
What about the FPIs flows?

Indian economy has been witnessing capital outflows in both the debt and equity segment since the start of this financial year. It was only in the month of July where both equity and debt segment witnessed positive flows and only debt segment witnessed positive flows in the month of August'18. The FPIs have again turned positive in the month of November'18.

FPIs in Equity



FPIs in Debt



Source: NSDL; *upto 7th Nov'18

The future direction of FPI flows will be critical for India as the picture so far this year has tended to be unfavourable. The picture so far in November is positive for both debt and equity but the important question is whether or not this can be sustained. With rates going up in the USA backed by strong growth, we may not expect significant inflows and hence the balance of payments has to be supported by a lower CAD, which is possible with oil prices coming down as well as better invisible receipts. FDI would be more dependable and the recent easing of ECB norms could increase such flows.

Concluding Remarks:

- Going forward, monetary policy decision 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 given that the RBI's governor is to focus only on the inflation numbers while deciding the interest rates.
- With the recent decline in oil prices, there is a high possibility of moderation in inflation which will provide some respite to the markets and the currency. In addition, the lower print for inflation in October'18 further is suggestive of RBI maintaining a status quo in its monetary policy in December.