

## A Perspective on Fed Policy and Tapering

The monthly bond buying program of the Federal Reserve was further trimmed by \$ 10 bn as announced by Federal Chair Janet Yellen after the Review meeting on Wednesday 19<sup>th</sup> March 2014.

The highly awaited tapering of the US Federal Reserve's monthly \$ 85bn bond buying program since September '12 commenced in January '14 in light of the progress made by the country towards maximum employment and improvements in the labor market conditions juxtaposed with recovering growth. Accordingly the Fed decided to gradually trim down the stimulus plan. The bond buying was hence cut by \$ 10 bn in January '14 and by a further \$ 10 bn in February '14. With the cut of another \$ 10 bn announced by the Fed, the easing programme would now be \$ 55 per month.

This article aims to firstly put in perspective the Fed's position followed by an analysis of the impact tapering has had on the US and Indian economy based on the two earlier episodes of such action in January and February. The discussion then posits the possible scenario going ahead.

### **Highlights**

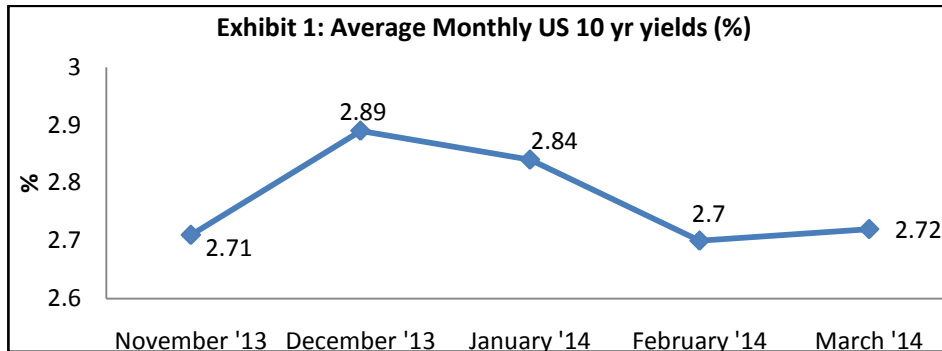
- **Position of Stimulus:** The cumulative monthly stimulus plan now stands at US \$ 55 billion following the \$ 10 billion cut announced in the Review meeting. The Fed will cut monthly mortgage bond purchases to \$25 billion from \$30 billion. Treasury purchases will drop to \$30 billion a month from \$35 billion. Ms. Yellen also suggested that the gradual scaling down of the stimulus would eventually exhaust the stimulus by fall 2014.
- **Interest rates:** Post the end of the tapering program, the Fed is likely to contemplate hiking the interest rates in 2015 which have been near zero since 2008 depending on the unemployment level in the economy. This has been a signal that was picked up by the market.
- **View on unemployment:** The Fed had looked at a threshold of 6.5% unemployment rate when the idea of tapering was discussed. The unemployment level presently is 6.7%. However, this was redefined when Ms. Yellen specified that the Fed would adopt a broader approach to unemployment whereby several qualitative factors such as "measures of labour market conditions, inflation expectations, and indicators of inflation pressures" would also be weighed before forming an opinion on unemployment.
- **US 10 year yields:** As a consequence of Ms. Yellen's statements about a likely interest rate hike in 2015, US 10 year yields spiked by 9 bps overnight from 2.68% on Tuesday 18<sup>th</sup> March 2014 to 2.77% on Wednesday 19<sup>th</sup> March 2014. The market has interpreted this move to mean stiffer rates going ahead – though admittedly, the rate hikes look possible only in 2015.

### **Impact of tapering in USA**

An overview of the impact of tapering on US 10 year yields, US markets and Dollar rate is given below. The time period is from November '13 to March '14 (as of 19<sup>th</sup> March 2014) to evaluate the performance of the indicators before and after the tapering.

- US 10 year yields**

Yields increased significantly in December '13 to 2.89% from 2.71% in November '13 driven by the Fed's announcement that it would begin the tapering of the stimulus program from January '14 given the improving economic conditions. 10 year yields on a monthly average stood at 2.84% in January '14 when tapering commenced formally. However, yields dropped to 2.7% in February '14 which was the second month of tapering and currently stand at 2.72% (up till 19<sup>th</sup> March 2014). However, market expectations are plenty that yields will inch up ahead in the current calendar year.

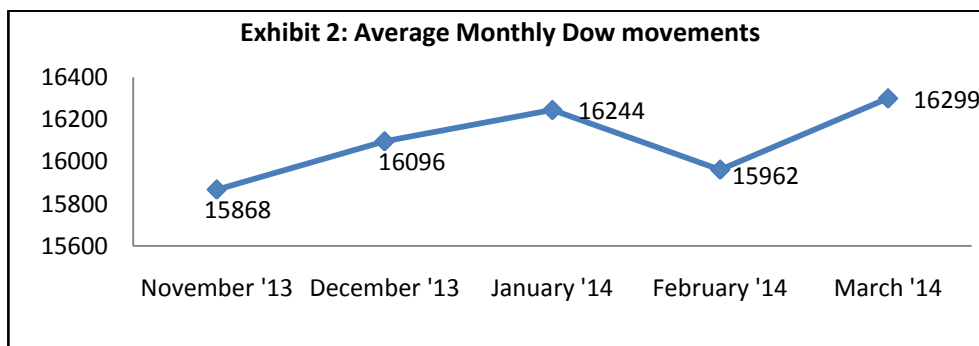


Source: CNN

- Stock Market response**

The monthly average movement in the Dow Jones Index is considered as being representative of the overall US markets. Dow was on an upward trend from November '13 upto January '14. The commencement of tapering which was interpreted as a recovery in the economy was viewed positively by markets and improved the overall sentiments. However, February '14 witnessed a fall on account of unprecedented weather conditions in the USA which resulted in slow growth in employment and relatively poor corporate performance.

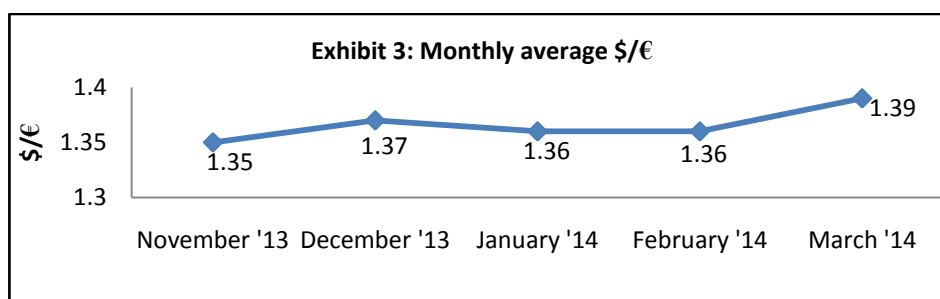
Going ahead while the Dow is significantly higher so far in the month of March, it is important to note that Ms Yellen's statements regarding hiking of the near zero interest rates (against the market expectations) as early as 2015 is likely to cause concern among investors as far as rising interest rates are concerned. In fact, the Dow took to her announcement strongly as it fell by over 100 points at close on 19<sup>th</sup> March 2014. But future direction is likely to be driven more by economic conditions and hence the decline witnessed on announcement may be considered to be temporary.



Source: CNN

- **US Dollar vs Euro**

The US Dollar depreciated to 1.37 against the Euro in December '13 compared with the exchange rate of 1.35 in November '13. However, subsequently, dollar was steady at 1.36 against the Euro in January and February '14. In March '14, the USD has witnessed significant depreciation with the rate standing at 1.39 USD against a Euro. There has been a limited temporary effect of tapering on the USD with several other domestic and global factors at play.



Source: CNN

### Impact on India

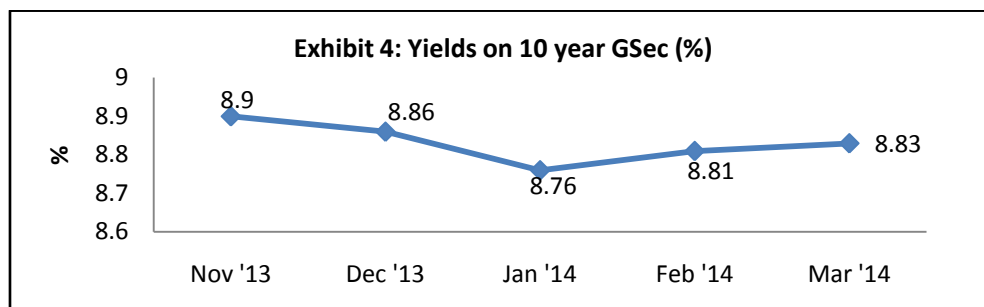
It may be recollected that when the news of tapering first hit the headlines in May '13, there was significant turmoil in the markets with the rupee being affected sharply which was compounded by an already existing high CAD. However, with the trade deficit being controlled and the exchange rate steadied by a series of measures announced by RBI and the government, the act of tapering in January was less potent than the initial panic caused across markets.

An analysis of the movements in FII inflows, interest rates, stocks and the rupee to dollar exchange rate is done below in order to gauge the impact of tapering on India. The time period as stated earlier is from November '13 to March '14 for purpose of comparison.

- **Interest rates (10 yr.GSec yields)**

Yields on 10 year Government Securities have been high since Nov '13. They have moved from 8.9% in November to 8.86% in December. Rates fell in January to 8.76% but have steadied to near 8.8% in February and March. A major factor contributing to the yields can be the high repo rates maintained by the RBI and also the expectation that rates will not be lowered until inflation comes down. The RBI has indicated that it would be targeting the CPI inflation number.

Further, liquidity has also been under pressure as evidenced by the higher flow of funds through the term repo windows. The advance tax payments pressures in mid-March as well as redemption of mutual funds towards the end of the month along with the ALM adjustments made by banks to shore of resources would tend to keep rates at elevated levels. Hence, the impact of tapering on interest rates would be minimal as they would be driven by domestic factors.

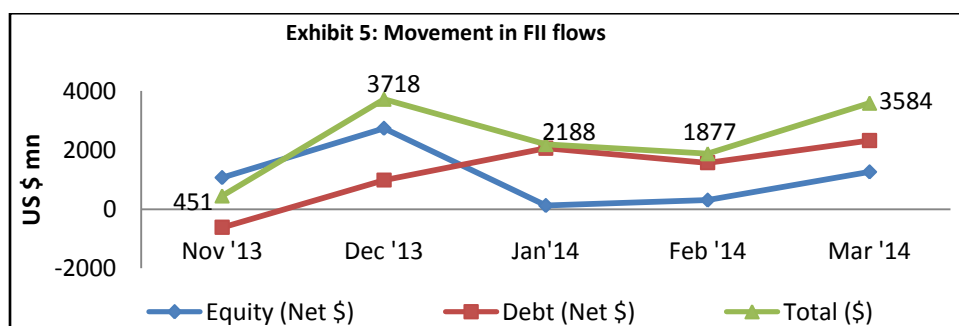


Source: FIMMDA

• **FII inflows**

Total FII inflows in India have picked up from US \$ 451 mn in November 2013 to \$ 3,584 mn in March '14 so far. With the commencement of tapering, FII inflows in January '14 dropped to \$ 2,188 mn compared with \$ 3,718 mn in December '13. There was a further reduction in February with total FIIs accumulating to \$ 1,877 mn. However, FIIs have gained momentum in March '14.

Interestingly, FIIs inflows in debt have been significantly larger than inflows in equities since January '14. Hence, unlike the fear of capital flight when the Fed tapering was first announced in May '13, the FII inflows to India have been positive clearly indicating that they are not vulnerable to the Fed's decisions alone. The RBI has also maintained a tight monetary policy which would have helped at the margin. Also there could be the feeling that the economy has bottomed out and can only improve going ahead.



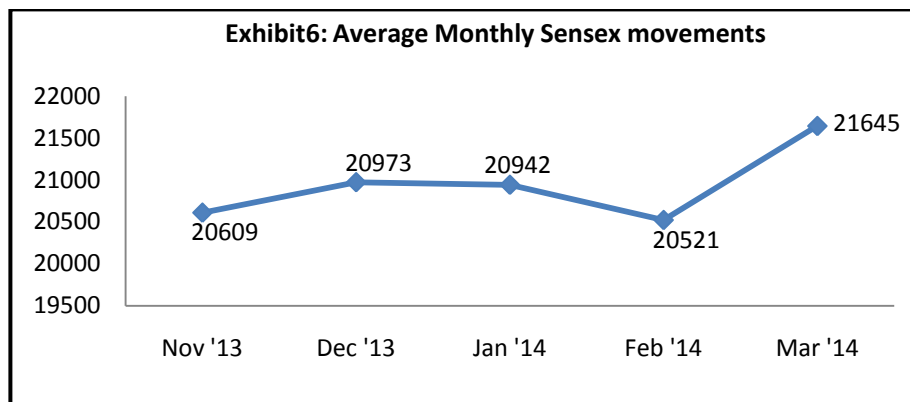
Source: SEBI

• **Stock Market response**

Movements in Sensex from November '13 to March '14 are considered below as a representative of the overall sentiment in the economy. Average monthly movement in Sensex stood at 20,942 in January '14 (marginally lower than December '13) which was the first month of tapering. Subsequently it fell in February '14 to 20,521 before rising to 21,645 in March '14. FII flows had declined in January and moved up only gradually in February.

With the Sensex being largely range-bound it is possible to conclude that domestic markets do not appear to be deterred significantly by the tapering of the Fed. Even during the period May-September, it was range bound between 19,000-20,000 with August being the only exception when it slid to 18,641. On the other hand, the

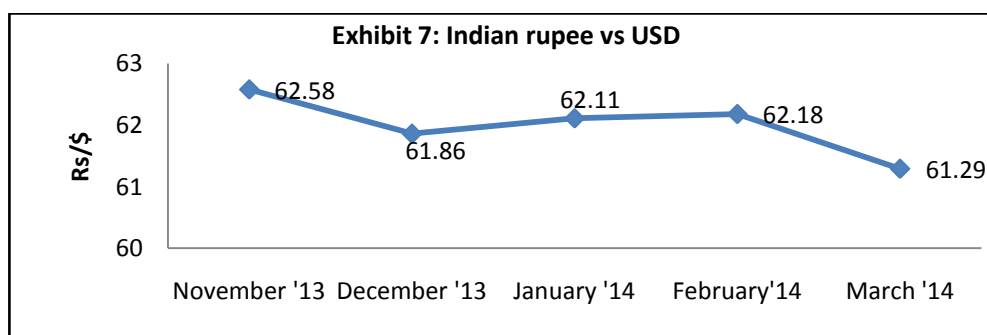
stock market has been influenced more by domestic factors as market sentiments have become positive in India owing to the upcoming Elections in the country and recent control over inflation.



Source: BSE

#### • Rupee vs US Dollar

The exchange rate was at Rs 62.11 in January '14 and Rs 62.18 in February '14 indicating no major response to the tapering. In recent times (Rs 61.29 as of March '14) Rupee has recorded appreciation against the USD owing to the positive FII inflows in India along with a strengthening CAD which is now expected to be less than \$ 40 bn for the year. Also the RBI had announced a swap facility for FCNR deposits for banks which brought in over \$ 30 bn which helped to shore up the forex reserves.



Source: RBI

#### **Forward Outlook in the light of the tapering programme**

- Interest rates are more likely to be driven by domestic considerations with RBI action being the guiding factor.
- FII inflows in India are likely to remain buoyant with no major threat otherwise. Forming of a strong and progressive government will work as a catalyst for future foreign inflows. However, once the Fed increases rates, then funds would certainly reconsider options.
- Domestic stocks are driven by internal factors of Elections, performance of economy; trade flows, FII movement etc. and the tapering impact would be limited.

- Rupee against the USD will remain driven by fundamentals and trade numbers and as long as FII funds are stable, would be unlikely to be affected significantly.

**Clearly then, it does appear that India is influenced majorly by domestic factors as opposed to external. Hence, India is expected to remain largely unaffected by the ongoing tapering program of the Fed.**

### **Concluding Remarks**

India has covered some distance from May '13 when a statement of possible tapering by Bernanke, the then Chairperson of the Federal Reserve triggered unrest in the country to today when even though the tapering program enters its third month, the economy is resilient. **The threat of tapering was more potent than the actual implementation.** It can also be argued, that the Government and RBI prepared the economy for the eventual tapering.

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