US Fed rate hike

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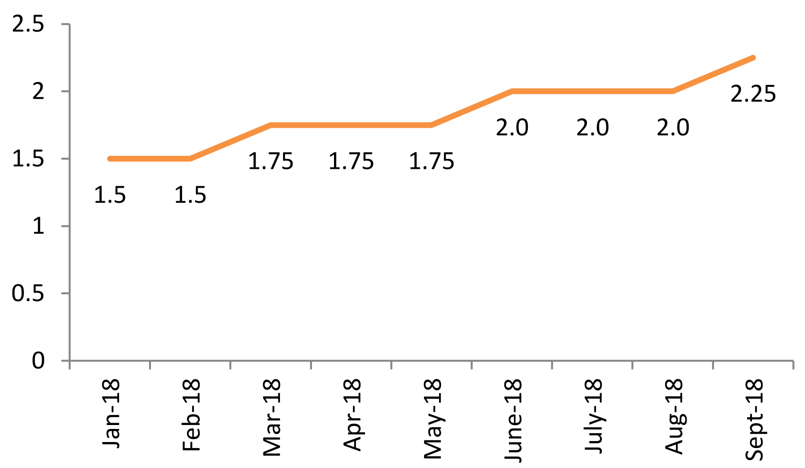
The US Federal Reserve raised the reference rate by 25 bps from 1.75-2% to 2-2.25% in its recently concluded Federal Open Market Committee (FOMC) meeting, in line with market expectations. The central bank signaled that it would adopt a gradual pace of monetary policy normalization and removed the "accommodative" monetary policy stance indicative of flexibility with future monetary policy actions. The US Fed still foresees another rate hike in December'2018, three more in the next year and one more rate hike in 2020. The FOMC has met for the 6th time during the calendar year and this was the third rate hike for 2018.

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

Chart 1: Movement of US interest rates (%)



Source: Federal Reserve

Federal Reserve Forecasts

- There was an upward revision in the GDP growth forecast for 2018 from 2.8% in the June projection to 3.1% and for 2019, the upward revision was from 2.4% to 2.5%. The forecast for 2020 was kept unchanged at 2%.
- The unemployment rate is projected to be higher at 3.7% in 2018, 0.1% higher than the June projections. The unemployment rate has been projected at 3.5% in 2019 and 2020 and remains unchanged from the previous projections.
- Inflation forecasts were kept steady at 2.1% for 2018 and 2020. However, inflation is projected to moderate from 2.1% to 2% in 2019.

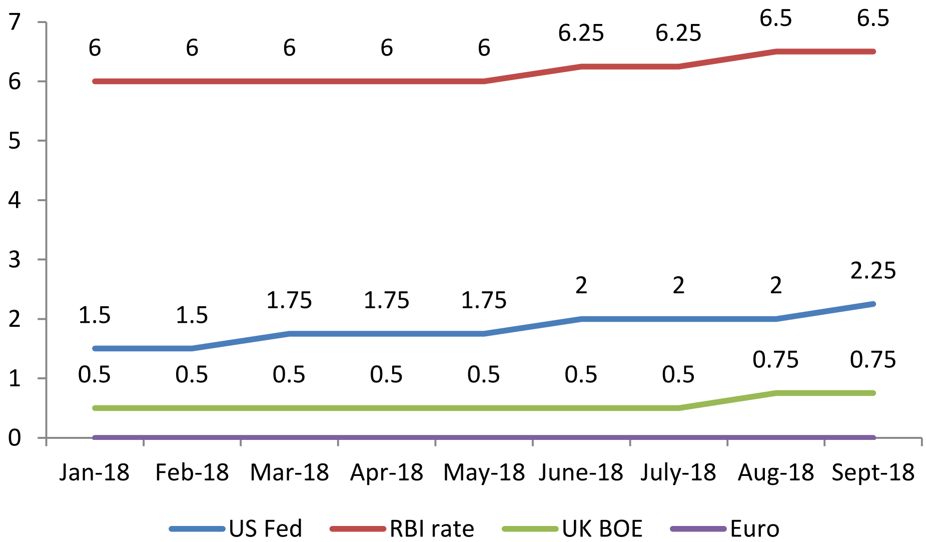
Factors driving the decision

- The FOMC indicated that the economic activity has been rising at a strong pace since the previous meeting. There was an upward revision in the GDP growth for Q2 to 4.2%, which stands out to be the strongest period of growth since 2014. The growth in Q2 is 2% higher than the growth estimated in Q1 of 2018.
- Strengthening labor market as data on employment depicted easing of concerns in the job market. Unemployment rate has moderate from 4% in June’18 to 3.9% in both July and Aug’18. The unemployment rate is lower than 4.1% witnessed during Jan-March’18. The unemployment rate at 3.9% is at 18-years low.
- Fueled by tax and regulation cuts, there were job gains to the tune of 2,01,000 workers, which were added in the month of Aug’18.
- Faster pace of wage growth as average hourly wage growth rose by 2.9%, which stands at a 9 year high.
- On a 12-month basis, both overall inflation and core inflation remained near 2%. The overall inflation has moderated from 2.9% in June’18 to 2.7% in Aug’18, while the core inflation has slowed down to 2.2% in Aug’18.
- Indicators of longer term inflation expectations are little changed.
- US consumer confidence index has surged to a 18-year high. Household spending and business fixed investments have seen a robust growth.

Comparison of US rates with other economies

Chart 2 plots the comparison of the policy rates announced by the central bank of USA (upper rnage), India, United Kingdom and Euro Area during the current financial year.

Chart 2: Comparison US rates vs India, UK and Euro area (%)



Source: RBI, Federal Reserve, BoE and ECB

- The above chart shows that the US Fed has increased the interest rates 3 times during the calendar year 2018 and has increased from 1.5% to 2.25%. The European Central Bank (ECB) has kept their interest rates unchanged while Bank of England (BoE) has hiked rates once during the year.

- The Reserve Bank of India, which has met thrice during the current financial year (FY19) has hiked rates twice by 50 bps from 6% to 6.5%.

- Unlike RBI, the ECB and BoE have not tracked the monetary policy announcements of the US Fed.

- ECB, in its recent meeting in the month of September'18 has kept the interest rates unchanged at 0% but have planned to halt the quantitative easing (QE) program from the end of this calendar year. The ECB believes that the monetary policy stimulus is needed to build up domestic price pressures over the medium term, before going for an interest rate hike.

Impact on India

- The changes in Fed rates normally have an indirect impact on the economy as it affects foreign investment flows, exchange rate and monetary policy decision (depending on the impact on inflation).

- RBI has tracked the rising interest rate scenario in the US economy during the calendar year 2018 by having interest rate hikes (2 times) equivalent to the US Fed, prior to the US Fed meeting yesterday. The gap between the US interest rates and RBI rates has narrowed from 4.5% in January'18 to 4.25% in Aug'18. If the RBI hikes interest rates in the scheduled meeting on 4 October, 2018, the gap will widen again to 4.5%. The gap has significantly declined from 6.25% since the beginning of Jan'2016.

- The Fed rate hike will strengthen the dollar and a higher interest rate along with elevated crude oil prices will lead to an outflow of foreign capital, weakening the Indian rupee further in the short term.

- However, in addition to the US rate hike, domestic forces in the form of inflationary concerns on account of weakness in the Indian rupee and higher oil prices will drive RBI for a rate hike. There is a growing expectation of an interest rate hike by the RBI in the forthcoming monetary policy committee (MPC) meeting. A hike in the interest rate by RBI would keep the gap stable between the two interest rates, which will augur well for the foreign investors.

- A higher interest rate in India will in turn lead to rising yields and higher cost of borrowings for the corporates, adversely affecting the investment scenario and growth prospects of the country.

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