US Federal Reserve Keeps Rates Steady as Inflation Persists

For Prelims: US Federal Reserve**,** Retail Inflation**,** Reserve Bank of India**,** Monetary Policy Committee**,** Wholesale Price Index (WPI)**, C**onsumer Price Index**,** Core Inflation**,** Headline Inflation,

For Mains: US Fed Rate Hike's impact on Indian Economy

Source: IE

Why in News?

Recently, the **US Federal Reserve** maintained interest rates in a target range between **5.25%-5.5%** and indicated that borrowing costs are likely to stay higher. Annual inflation in the US is currently at 3.5%, compared to 3.2% in the UK and 2.4% in the eurozone.

What are the Reasons Behind the Recent US Federal Reserve Decision?

- **Inflationary Pressures:**
  - The US inflation rate peaked in 2021 and 2022 at 7.0% and 6.5% respectively, and then declined at the end of 2023 but it still remains stubbornly **high at 3.5%.**
    - This is significantly above the **US Fed's target of 2%.**
  - This persistent inflation suggests that previous measures, like raising interest rates, haven't brought inflation down as quickly as hoped.
- **The Wait-and-See Approach:**
  - Earlier in the year, the **fed anticipated** inflation **would decline** and projected rate cuts. However, the current situation has forced them to reconsider.
  - By holding rates, the **US Fed** buys itself time to gather more data. They'll be closely monitoring inflation metrics, employment figures, and consumer spending patterns.
  - This data will guide their future decisions on whether to raise rates to combat inflation or leave them unchanged to support economic growth.

Why do Central Banks Resort to a Rate Hike?

- The central bank **may increase interest rates** to control **inflation.**
- This is being done **to reduce the amount of money available for borrowing,** which can help to cool down the economy and prevent prices from rising too quickly.
- With **higher borrowing costs,** people and companies may be less willing to borrow, which can slow down economic activity and growth.
  - Businesses may take fewer loans, hire fewer people, and **reduce production** in response to the increased costs of borrowing.

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How do US Fed Rates Impact the Indian Economy?

- **Capital Outflows:**
  - The **Fed's rate hikes make US dollar-denominated assets** (bonds, treasuries) more attractive. This triggers a phenomenon called the **"carry trade."**
  - Investors borrow money in low-interest-rate countries like India and invest it in the US to earn higher returns. This outflow of capital (capital flight) from other countries can:
    - **Slow Economic Growth**: Reduced foreign investment can hinder the growth of Indian companies and the overall economy.
    - **Impact on stock markets:** The sudden withdrawal of foreign investment can lead to stock market volatility and potentially decreased valuations.
- **Inflation**:

    - Changes in **the US Fed rates** can have significant effects on capital flows and the exchange rate which can result in inflation.
    - By **adjusting domestic interest rates** and liquidity measures, the RBI can try to mitigate the inflationary impacts of a weaker rupee.
- **Weaker Rupee**:
    - When **foreign investors pull their money** out of India due to the higher US returns, it reduces the supply of USD in India and increases the supply of INR. This imbalance **weakens the** Indian rupee.
    - This has a **double-edged effect:**
        - **Imported Inflation**: Cheaper rupees make **imports more expensive,** especially for crucial resources like oil. This can push up the overall cost of living in India.
        - **Potential Export Boost:** A weaker rupee can **make Indian exports cheaper** in the global market, potentially increasing their competitiveness.
- **Higher Borrowing Costs:**
    - The **Reserve Bank of India (RBI)** might raise interest rates in India to match the Fed's move to:
        - **Control Inflation:** Higher interest rates **discourage borrowing** and spending, potentially helping to curb inflation.
        - **Stem Capital Flight:** The RBI aims to prevent further **outflow of capital** from India by making domestic investments more attractive
- **Stock Market Fluctuations:**
    - As **investors chase higher US returns,** the Stock Indian stock market might experience:
        - **Decreased Demand:** Reduced foreign investment can lead to lower demand for Indian stocks, potentially causing a decline in their prices.
- **Increased Debt Burden:**
    - A **weaker rupee** can make it more expensive for India to service its external debt, which is mostly denominated in US dollars. This can:
        - **Strain Public Finances**: The government may need to spend more to pay off its debts, impacting other crucial developmental plans.
- **Benefits for Banks:**
    - The **banking industry gets benefits** from the interest rates rise, as banks re-price their loan portfolio much quicker than their deposit rates, which helps them to increase their net interest margin.

How can India Reduce the Impact of the US Federal Reserve Decisions on its Economy?

- **Balancing Interest Rates:**
    - **Raising Rates:** The **Reserve Bank of India (RBI)** can replicate the US Fed's hike to:
        - **Attract Foreign Investment:** Higher interest rates can make Indian bonds and other investments more attractive to foreign investors, potentially increasing demand for the rupee and stabilizing its value.
        - **Control Inflation:** Increased interest rates can deter borrowing and spending, potentially aiding in the control of inflation, particularly when coupled with a depreciating rupee.
- **Diversifying the Reserve Basket**:
    - **Reducing Dollar Dependence:** India can **diversify its foreign exchange reserves** by increasing holdings of other major currencies like the Euro, Yen, or Yuan.
        - This **reduces India's vulnerability** to **US dollar fluctuations**. However, managing a diversified reserve basket can be complex.
- **Expanding Trade Horizons:**
    - **Exploring Export Markets:** Identifying and entering new markets for Indian exports can help diversify India's trade base and reduce its reliance on US markets.
        - **Trade Agreements**: Negotiating bilateral trade agreements with other countries can reduce trade barriers and boost trade flows with non-US countries.
            - This reduces dependence on the US Dollar.
- **Stimulating Domestic Consumption:**
    - **Boosting Demand:** If the **US Fed** hike slows down the economy, the government can implement measures to encourage domestic consumption:

- **Tax Cuts:** Reducing taxes can put more money in people's pockets, potentially increasing spending and stimulating economic activity.
  - In 2020, the Indian government increased the tax rebate for income tax payers in the lower tax brackets. This aimed to boost consumption spending during the COVID-19 pandemic.
- **Subsidies**: Targeted subsidies for essential goods and services can help ease the burden on consumers and maintain purchasing power. Public Distribution System (PDS), Pradhan Mantri Ujjwala Yojana (PMUY) are examples of such governmental initiatives.

- **Reducing Reliance on Oil:**
  - **Embracing Renewables**: A strong dollar often leads to higher oil prices. India can mitigate this by investing in solar, wind, and other renewable energy sources. It can reduce dependence on imported oil and shield the economy from oil price fluctuations.
    - **Exploring Biofuels**: Developing biofuels like ethanol can provide an alternative fuel source, reducing reliance on imported oil.

Drishti Mains Question:

Q. Discuss about the US Fed Rate Hike's impact on the Indian Economy. How can India tackle the impact of the US Federal Reserve decisions on its economy?

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims

Q. Indian Government Bond Yields are influenced by which of the following? (2021)

1. Actions of the United States Federal Reserve
2. Actions of the Reserve Bank of India
3. Inflation and short-term interest rates

Select the correct answer using the code given below.

(a) 1 and 2 only

(b) 2 only

(c) 3 only

(d) 1, 2 and 3

Ans: (d)

Q. Consider the following statements: (2022)

1. Tight monetary policy of US Federal Reserve could lead to capital flight.
2. Capital flight may increase cost of firms with existing External Commercial Borrowings (ECBs)
3. Devaluation of domestic currency decreases the currency risk associated with ECBs

Which of the statements given above are correct?

(a) 1, 2 and 3

(b) 1 and 2 only

(c) 2 and 3 only

(d) 1, 2 and 3

Ans: (b)

Mains

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. **(2019)**