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## **Impact of US Fed's monetary policy rate change on India**

**Professor T.K. Jayaraman**

Earlier this week on Dec 14, the US Federal Reserve (the Fed) raised its policy rate known as the Federal Funds Rate from the range 0.25% - 0.50% to 0.50% - 0.75%.

This increase comes after 12 months.

All along, there were expectations that the recession which broke out after the 2008 financial crisis could be fought with loose monetary policy. It is widely known that the Fed and the Democrat President could not succeed in persuading the Republican dominated legislature to agree to expansionary fiscal policy measures of public expenditures. The neo-liberalism of less government, no budget deficits and less public debt combined with monetarism was ruling the roost. It was left to the Fed to be the Lone Ranger to fight recession.

Quantitative easing by pumping several trillions of dollars debased the currency. Steady outflows of US capital to emerging economies depreciated the US dollar, no doubt contributing to reduction in its own annual trade deficits by making its exports cheaper to the rest of the world.

### **Short-lived optimism**

With recovery in sight in early 2015, though painfully slow with small monthly increments in job numbers, the Fed was finally able to get the economy out of a low interest environment in December last year, 2015. The Fed was keen to return to days of “normal” interest rate regime, as soon as there were some signs of recovery, reflected in the rising price level as well as fall in unemployment rate.

It announced its first rate increase in December 2015, with indications that it might consider two to three increases in 2016, if the recovery is firmed up, reflected in consumer price index and unemployment rate.

The optimism was a short-lived one. The BREXIT decision came as a jolt. Fears of another phase of recession discouraged any further efforts towards further tightening monetary measures. Uncertainties continued, although jobs were growing, but no steady trend. The time for any more increase in the policy rate had not yet arrived.

### **Return of Keynes**

The November US Presidential election results altered the scene. With the Republican President-elect announcing that he would embark on fiscal policy measures of one trillion dollar in infrastructure projects, tax cuts for encouraging corporate investment and regulatory rollbacks, all with an eye on job creation, the US economy began to see the emergence of “animal spirits”.

Indeed, it heralded the return of Keynes in a Republican garb, much to the dislike of the hardcore party members, as it meant a higher public debt, from the current ratio of debt to GDP ratio of 77%. Though inflation is still low below the targeted 2% per annum, market signals are much clear. The unemployment rate is just around 4.5%, below the targeted rate of 5%. The signs of heating-up were firming up. Bond yields of different maturities were rising. The average rate on a 30-year mortgage loan went up to 4.13% from 3.54% before the election.

The Fed’s Open Market Committee in its scheduled meeting on Wednesday, December 14 decided to go unanimous. It is a modest increase, but a significant step.

### **Impact on India**

India, one of the emerging economies will no doubt be affected. Though the rise in interest rate differential as of now is low, indications of possibilities further rise in the differential due to two more expected cuts in policy rate, there are fears of increasing outflows of capital. That would weaken the rupee further from the current rate of Rs 67.79 to around Rs 69 per US\$.

Depreciation of the currency would increase the rupee value of the imports of petroleum crude whose price is quoted in US dollars. The latest reports show India’s oil demand went up in November 2016 by 12.1% from November 2015, with petrol by 14.3% reaching 2.03 million tons; LPG sales by 16.5% to 1.88 million tons; naphtha sales by 6.9% : 1.08 million tons and fuel oil by 12.6% in November.

The trade deficit would naturally bulge from the current 5.7 % of GDP and if capital inflows dry up, the balance of payments may deteriorate further. However, the reserves remaining at a healthy figure of US\$ 363,870 million is a comforting situation. .

Other emerging economies are likely to suffer more due to very high external debt denominated in US dollars. The deprecation of currencies of Mexico and Brazil will have a very heavy toll on their budgets, as they have to set aside more savings for debt servicing. India on the other hand has smaller external debt ratio (22.7 % of gross national income) and a relatively low debt

servicing ratio (8.1 % of total exports of goods and services) compared to major emerging economies.

### **India's current situation**

With cash-starved rural and informal sector affecting growth prospects in the last quarter and a likely extended impact in the first quarter of 2017, there is no possibility of any demand pull inflation. Asian Development Bank has just revised India's growth rate in 2016 to 7% from the earlier forecasted figure of 7.4%.

Inflation in November 2016 is reported to be lower (3.63% annualized) as against 4.2% in October 2016. The fears of inflation stem only, as noted by Reserve Bank of India recently, from a possible decline in winter crop output and rise in crude oil prices (presently hovering around US\$55.16 per barrel) leading to rise in transport costs.

In these circumstances, Reserve Bank of India may not need to consider any step in regard to the already announced monetary policy action of December 7: the unchanged rate at 6.25%. The withdrawal of 100 cash reserve ratio would enable banks to disburse credit to the needy sectors. Already some commercial banks have reduced their benchmark interest rates for encouraging use of their liquidity.

No immediate action on the part of RBI itself would be an appropriate monetary policy response at this stage.

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*Professor T.K. Jayaraman teaches at Fiji National University.*