The US Fed's Biggest Interest Rate Hike

Why in news?

The U.S. Federal Reserve implemented its steepest interest rate increase in 28 years in an attempt to control inflation.

What is the US Fed's rate hike about?

- The United States Federal Reserve increased its interest rate by 75 basis points to 1.75% to control the runaway inflation.
- The need for rate hike comes with the U.S. Consumer Price Index based inflation quickening to a four-decade high of 8.6% in May.
- The U.S. central bank was determined to continue raising interest rates till it saw compelling evidence that inflation was slowing towards its 2% goal.

How do rate cycles work?

- **In controlling inflation**- When interest rates go up in an economy, it becomes more expensive to borrow. So,
  - households are less inclined to buy goods and services
  - businesses have a disincentive to borrow funds to expand, buy equipment or to invest in new projects
- A subsequent lowering of demand for goods and services.
- This ends up depressing wages and other costs, in turn bringing runaway inflation under control.
- **In investing in foreign countries**- Emerging economies such as India tend to have higher inflation and, therefore, higher interest rates than in developed countries.
- So, investors, including Foreign Portfolio Investors, tend to borrow in the US at lower interest rates in dollar terms, and invest that money in the bonds of countries such as India in rupee terms to earn a higher rate of interest.

What are the concerns for the U.S. at this stage?

- **Inflation beyond the target**- The Fed's announcement has come amid criticism that the US central bank has fallen behind the curve on inflation.
- The Fed, which cut rates to support the economy when the pandemic hit in 2020, has already hiked rates twice this year.
- **Supply side factors**- But the current efforts might have very little control over supply side factors, including Russia's invasion of Ukraine and COVID-related lockdowns in China.
- **Job cuts-** As the Fed tries to dent inflation, rising rates will also spark a period of slower economic growth, which could result in layoffs.
- **Cost of borrowing-** When the Fed raises the target interest rate, the cost of borrowing increases.
- This means banks will have to pay more to borrow money, but they will charge individuals and

businesses more interest.
- As a result, mortgage rates will rise, and fewer people will be able to buy homes and businesses will bring down capital expenditure.

How does this impact global markets and India?

- **Less attractive markets**- When the Fed raises its rates, the difference between the interest rates of the two countries narrows, thus making India less attractive for the currency carry trade.
- There will be institutional outflow of capital from foreign investors as they abandon riskier assets like Indian stocks and securities for US treasury bonds.
- **Low global growth**- It would also mean a lower impetus to growth in the US could be negative for global growth, especially when China is reeling under the impact of a real estate crisis.
- **Affect emerging market equities**- Higher returns in the US debt markets could also agitate emerging market equities, reducing the foreign investor enthusiasm.
- **High cost for raising fund** - Fed rate hikes will also make it costlier for the emerging economies, including the Indian government to raise funds from the bond markets.
- **Soar in gold prices-** A rise in the short-term interest rates in the US and bond yields increase the opportunity cost of holding gold, which yields no interest.
- As a result, gold prices could be on the rise as more people look to diversify their money and not park their money in bank deposits.
- **Pressure on the rupee-** In the Indian economy, the rate hike could further weaken the domestic currency.
- **Imported inflation-** Inflation could gather steam in India through the currency route.
- The rupee has been on a downhill even though the RBI has been intervening in the forex market to reduce volatility.
- The rising cost of imports is likely to widen the current account deficit (CAD).

References

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