US Fed Interest Rates Hike

What is the issue?

\n\n

\n
- U.S. Federal Reserve again raised its benchmark short-term interest rate by 25 basis points to 1.75%, the highest in a decade.
\n
- This monetary tightening is driven by the confidence in the markets, but there are inherent risks which call for caution.
\n

\n\n

What is the trend in US monetary policy?

\n\n

\n
- The 2008 economic crisis pushed central banks worldwide to cut interest rates to historic lows in order to overcome recession.
\n
- These loans were facilitated by public borrowings and monetary policy easing and hence had to be serviced at some point in the future.
\n
- So, US Federal Reserve (which control's monetary policy), has been tapering liquidity lately, as the US economy seems to have recovered fully.
\n
- While the current increase is only the 6^{th} since the financial crisis of 2008, the trend ahead seems unambiguous for further increases.
\n
- Notably, US economy is projected to register strong growth ahead.
\n
- The resultant inflationary pressures might push Fed rates further for the next 2 years.
\n

\n\n

How has its impact been?

\n\n

\n

- To reverse the post-2008 liquidity easing, the Fed and other central banks have initiated normalisation of monetary policy.
  \n
- The impact of these on the wider credit markets is slowly beginning to show in the markets.
  \n
- The “interbank lending market” has been directly influenced.
  \n
- Significantly, the benchmark “London Interbank Offered Rate” (LIBOR), at which international banks lend to each other has also been increasing.
  \n
- LIBOR has risen for more than 30 consecutive sessions and is currently at its highest since the financial crisis.
  \n
- Also, the corporate debt market has clearly been impacted.
  \n
- The rising rates could adversely affect the capacity of private firms to service their debt.
  \n

\n\n

What are the challenges?

\n\n

\n

- **Debt Default -** The risk of default by private borrowers has been flagged by various organisations recently, including the IMF.
  \n
- Notably, private corporations attracted by ultra-low interest rates had heavily loaded up on debt over the last decade.
  \n
- Also, some companies borrowed heavily from across the borders, thus making them prone to exchange rate risks as well.
  \n
- Ironically, the 2004-2006 period saw the Fed raising rates to tackle inflation.
  \n
- But it ultimately led to a mass default of mortgage debt and precipitated the 2008 crisis.
  \n
- **Trade Protectionism -** US President Trump’s steep tariff raise against imports from China had recently forced down stock values across markets.
  \n
- These trade wars will clearly have a negative impact on global growth.

\n

- Corporate earnings and these policy uncertainties seem to be a long haul.
\n
- **Capital Flux -** Rising interest rates would also see capital outflow from emerging markets due to liquidity crunches.
\n
- This is particularly a concern for India.
\n

\n\n

\n\n

Source: The Hindu

\n