US Federal Reserve Policy Tightens Global Liquidity

What is the issue?

The Federal Reserve has made it clear that the federal funds rate will be moving higher soon and the surplus liquidity that was fuelling the asset price boom in global markets will be withdrawn early.

What will be the major policy moves of Fed Reserve?

- Tightening the global liquidity
- Aggressive rate hikes
- Stopping the net asset purchases in early March
- Shrinking the balance sheet once policy rate hikes commence

What possible ramifications will it have on global financial markets?

- **Pulling out of stocks**- The MSCI World Equity Index is down 7% since the beginning of this year with investors pulling money out of overheated stocks in all regions.
- **Bond market**- Bond markets have turned turbulent with 10-year US treasury security yield rising to 1.87%, hardening 36 basis points over the past month.
- **Bond yields**- Sovereign bond yields in other countries are also rising as the world is ready for the rate hike cycle to begin in the US.
- **Reallocation of funds**- Institutional investors have begun reallocating funds out of risky assets such as emerging market equity, bonds and cryptocurrencies into safer havens of dollar denominated securities.
- **Weakening of currencies-** This is causing currencies of emerging economies to weaken, further accelerating fund outflows.
- **Taper Tandrum-** This has led to fears that the move could resemble the "taper tantrum" of 2013.
- Tapering means gradual slowing down of purchases of securities and bonds.
- Once the tapering is complete, the Fed may go for reduction in the size of the balance sheet to slowly remove the monetary stimulus.

To know more about US Federal Policy, click [here]

What is the status in India?

- Indian benchmark equity indices are down around 6% from recent highs
- The 10-year government security yield has hardened over 40 basis points since December 2021.
- Foreign portfolio investors have turned net sellers this fiscal year, pulling out almost Rs. 45,000 crore.

What is the need of the hour?

- There is a need to support domestic investor participation in equity markets to strengthen prices in such times.
- The RBI needs to act fast to include government securities in the global bond indices so that the G-sec yields get some support at a time when FPIs pull money out of government bonds.
- Retail participation in government bond markets should be promoted to create demand for these securities at a time when government borrowing is set to rise sharply.
- In case of increase in volatility, the forex reserves built over the last two years will be useful to support the currency.
- The RBI should keep up with its attempt to add to its reserves in periods when foreign funds pour money into the country.

References

1. https://www.thehindubusinessline.com/opinion/fed-tightens/article64942084.ece