US Fed’s Policy - Fears of a ‘taper tantrum’

Why in news?

The manner in which the US Federal Reserve (Fed) is easing the financial market is suggestive of the taper tantrum trends of 2013.

What is the taper tantrum of 2013?

Quantitative easing involves

1. central bank purchasing longer-term securities from the open market in order to increase the money supply,
2. encouraging lending and investment by interest rate cuts.

- After the 2008 global financial crisis, to increase money supply in the economy, the US Fed introduced Quantitative easing programmes.
- All of them aimed at increasing lending by commercial banks and spending by consumers.
- US economy and labour market conditions recovered well after 2010.
- Eventually, the Fed began considering exit from the easy money policy by the end of 2013.
- So, the Fed followed Tapering i.e a system of slowly reducing the amount of money the Fed puts into the economy.

What was the impact?

- The US Fed’s announcement in 2013 led to a sudden sell-off in global stocks and bonds.
- Because, when yields on the ultra-safe US treasuries rise, investors have reduced incentive to invest in riskier assets such as equity. [Click here to know more on bond yield-price relation.]
- US stock market dropped around 4% immediately after the announcement.
- Bond yields surged.
- The impact was felt globally as foreign investors pulled money out of bonds of emerging economies, creating.
- This triggered capital outflows and currency depreciation in many emerging market economies including India.
- The subsequent widening of current account deficit (CAD) eroded the forex

reserves that the RBI had built till then.

What is the apprehension now?

- In the wake of the pandemic and its economic implications, U.S. Fed started massive bond-buying programmes in 2020 to infuse liquidity.
- It also pushed down the interest rates, to allow banks to offer cheaper loans, thereby stimulating economic activity.
- Now, with economic recovery, the US Fed is aiming for a gradual reduction of this quantitative easing programme.
- This has led to fears that the move could resemble the "taper tantrum" of 2013.

What is the likely impact?

- **Global Investments -** Almost half of the global investor funds originate in the US.
- So, the Fed funds rate is critical for global investors due to the asset buying sentiment fuelled by the ultra-low interest rates in the US.
- Once rates begin moving up, investors who have borrowed in dollars to invest in assets globally will sell these assets to pay back the dollar loans.
- This can, in turn,de-stabilise markets.
- **India -** The biggest impact will be seen in FPI flows.

    1. FPI flows shrunk from 2015 to 2018 when the Fed was tightening its monetary policy.
    2. In contrast, the net inflow was more than Rs.1,70,000 crore in 2020, linked largely to Fed funds rate being close to zero.
    3. Now, again, FPI money is likely to move back to US treasury securities.

- Also, the Indian G-secs and the rupee could witness volatility once the Fed rate hike cycle begins.
- Nevertheless, the impact on Indian equities may be negligent, as seen during the first taper (2013).
- That's because domestic institutional investors such as mutual, insurance and pension funds can step up the buying.
- Also, with retail investors in place, large FPI outflows may not hurt the market much.

- The Fed officials have also said that they were trying to be as transparent as possible about their plans to avoid a repeat of the 2013 event.

Source: Business Line, Bloomberg