Significance of US Federal Reserves rate cut and its impact on India

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"The cut in interest rates on Wednesday is the first time since the 2008 financial crisis. What is ironic is that this move comes despite a strong US economy and indicators such as job market data showing renewed buoyancy."

Late Wednesday evening India time, the United States Federal Reserve announced a quarter-percentage-point cut in interest rates — the first rate cut in 11 years.

What makes this rate-cut action — the first since the global financial crisis broke in 2008 — more significant is that barely six months previously, the US Fed was on a hawkish rate-hike trajectory, moving in the direction of bolstering the debt-laden American economy.

Why the rate cut by the Fed?

The Fed has cited concerns about the global economy and muted US inflation among the key reasons for the decision to cut rates, and signalled a readiness to lower borrowing costs further if needed. At the same time, the central bank has underlined that the US economy grew "at a healthy pace" over the first six months of the year.

Financial markets had expected the quarter-percentage-point rate cut, which lowered the US central bank's benchmark overnight lending rate to a target range of 2%-2.25%.

In a statement issued at the end of its two-day policy meeting, the Fed said it had decided to cut rates "in light of the implications of global developments for the economic outlook as well as muted inflation pressures". It "will act as appropriate to sustain" the record-long US economic expansion, the central bank said.

A cut up to at least 75 basis points in the Fed funds rate had been expected by the end of the year, with the rate-cut cycle beginning from August. (One bps is equivalent to one-hundredth of a percentage point.) Fed Chairman Jerome Powell, however, underlined that the rate cut was merely a "mid-cycle adjustment to policy", thus ruling out multiple sequenced cuts in rates.

Does the cut indicate a shift in policy?

The cut in policy rates follows months of pressure from US President Donald Trump, who has been pushing the American central bank for a cut in rates to stoke growth. Powell has repeatedly pledged to follow economic data, and has resisted the nudges from the President — only to change course sharply now.

"Information received since the Federal Open Market Committee met in June indicates that the labour market remains strong and that economic activity has been rising at a moderate rate," the Fed said in its statement. "Job gains have been solid, on average, in recent months, and the unemployment rate has remained low."

The Federal Open Market Committee (FOMC) is a panel within the Fed that is responsible for setting policy rates. The ambiguity in the Fed was reflected somewhat in the vote on the decision, with two members of the 10-member FOMC opposing the decision to cut rates.

The decision failed to impress Trump, who has been calling for a big rate cut. The President scoffed at Powell, posting on Twitter: “What the Market wanted to hear from Jay Powell and the Federal Reserve was that this was the beginning of a lengthy and aggressive rate-cutting cycle which would keep pace with China, The European Union and other countries around the world… As usual, Powell let us down… We are winning anyway, but I am certainly not getting much help from the Federal Reserve!”

What will be the impact on emerging market economies, including India?

Theoretically, a rate cut in the US should be positive for emerging market economies (EMEs), especially from a debt market perspective. Emerging economies such as India tend to have higher inflation and, thereby, higher interest rates than those in developed countries such as the US and Europe. As a result, FIIs would want to borrow money in the US at low interest rates in dollar terms, and then invest that money in bonds of emerging countries such as India in rupee terms to earn a higher rate of interest.

When the US Fed cuts its interest rates, the difference between the interest rates of the two countries increases, thus making India more attractive for the currency carry trade.

A rate cut by the Fed would also mean a greater impetus to growth in the US, which could be positive news for global growth. But this could also translate into more equity investments in the US, which could temper investor enthusiasm for emerging market economies in a proportionate manner.

How did the stock markets react; why?

Indian stocks tanked on Thursday. While domestic factors such as dismal July car sales data and slower GDP growth projections played a role in the selloff, one of the major factors was Powell’s characterisation of the rate cut as a mid-cycle adjustment. Markets have taken this as a sign that sharp further cuts were not imminent.

Thursday’s sell-off dragged benchmark indices to fresh five-month lows, with the BSE Sensex slipping below the 37,000 mark. The broader Nifty50, too, breached the 11,000 mark in the intra-day trade. Bonds in India too, fell as investors trimmed bets on aggressive interest-rate cuts in high-yield markets after the signal from the US Fed.

The sharp fall in yields of government securities over the past month have already priced in the Fed’s action. A major 50 bps cut by the RBI expected next week will likely trigger a further rally in the bond market. (As investors buy government bonds, prices increase, and yields fall. A lower yield indicates lesser risk, but if the yield offered by a bond is higher than what it was when issued, there is a chance that the government that issued the instrument could be financially stressed and may be unable to repay the capital).

According to analysts, there are also concerns that if Asian emerging market currencies such as the rupee continue to weaken sharply against the dollar, that may result in central banks such as the RBI turning more cautious about cutting the policy rate too aggressively.

The Fed’s tempered outlook on rate cuts found a reflection in the US markets. The Dow Jones Industrial Average and the S&P 500 lost over 1% after the statement.

Asian markets traded mostly lower Thursday, with Hong Kong’s Hang Seng falling 0.7% and the Shanghai Composite 0.8%. Japan’s Nikkei, however, bucked the trend. Britain’s FTSE 100 fell 0.2% and Germany’s DAX dropped 0.1%. But France’s CAC 40 rose 0.4%.

American Federal Reserve

Why in the discussion?

- Recently the Federal Reserve has cut interest rates for the first time since 2008. The Fed has cut rates in more than a decade.
- This step by the Federal Reserve has been done to avoid the fear of a downside in the economy.
- This cut is the highest in the last decade. The Federal Reserve has indicated the need to reduce the borrowing cost further.
- Prior to the Federal meeting, it was already expected in the financial markets that a cut would be made in the quarter-rate, such as the US Central Bank, which reduced the debt rate from 2.00 per cent to 2.25 percent overnight.
- On the completion of its two-day policy meeting, the federal said in a statement that with the economic perspective, along with the silence inflation pressures, decision has been taken to cut rates, considering global growth.
- The Federal also said that its monitoring will continue. It will be seen how it is affecting the economy and how appropriate it will be to maintain the expansion of the US economy.
- After this announcement of the Federal Reserve, the price of crude oil and gold has seen a decline in the international market.
- Following the decision, crude oil prices have dropped to $ 63.69 a barrel by $ 1.06 a barrel. At the same time, the settlement of gold futures for October has dropped 0.4 percent in the US.
- This has become $ 1,431.80 per ounce after the federal decision.

Federal Open Market Committee

- FOMC, which is the Federal Open Market Committee. is a committee under the Federal Reserve System.
- It has been set up under the US law to oversee the operation of the country's open market, with interest rates and important decisions about the provision of currency supply in the US economy.

Expected Questions (Prelims Exams)

1. Recently American Federal Reserve Bank has cut the interest rate, in this context, consider the following statements-

1. It has negetive effect on the capital market of the world.
2. It has negetive effect on the global capital market ecomomies.

Which of the above statements is/are correct?

(a) Only 1 (b) Only 2

(c) Both 1 and 2 (d) Neither 1 nor 2

Expected Questions (Mains Exams)

Q. Discuss the effect on the other emerging market economies along with India after the interest rate cut by American Federal Reserve Bank recently. **(250 Words)**

Note: Answer of Prelims Expected Question given on 1 Aug. is 1(b).