SOCIO-ECONOMIC VOICES

Impact of Fed Rate Reduction on Emerging Economies

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The Fed rate cut was not exactly unanticipated, the quantum of it was uncertain before 18th September. How the 50 basis points (half a per cent) rate reduction by the Fed affects emerging economies including India is the question that confronts us today. Before we attempt to develop a plausible scenario for the future it could be useful to examine the current context. FOMC has lowered the benchmark rate to a target range of 4.75 to 5%, this is the first rate cut in more than four years. Projections by decision makers or dot plots tend to suggest it could come down by another 50 basis points (half per cent) by the end of this year and 100 basis points (one per cent) next year. In other words, this is the beginning of the process. This is one aspect the Central Banks of emerging economies need to consider. The Fed statement focuses on improving employment and stable inflation rate. It anticipates that inflation will slide down to two per cent in the near future. With elections being six to seven weeks away from the announcement by the Fed, the possibility of a change in future policies cannot be ruled out. However, the basic thrust of policy is expected to remain the same. This is a policy which has been announced at a time when the US economic growth is expected to touch 3% in quarter three and for the entire 2024 it is projected to be around 2.5%; at the same time, inflation is expected to come down from 2.5% to 2%. In other words, the economy is not facing any major apprehension about recession or inflation, economic conditions are somewhat stable. So the current context is a bit different from many of the past rate reductions prompted by recessionary pressures and economic instability. The implicit emphasis is on borrowing and spending by businesses and consumers. Possibly it is an attempt to prevent any economic growth downslide. In some sense demand revival is the key, which is being encouraged while keeping inflation within limits.

The response to the Fed rate cut amongst emerging countries would be determined by the respective macroeconomic conditions of these economies in relation to growth and inflation. Many of the economies have large slack and un-utilised capacity, e.g. China which needs stimulus measures. China has announced some measures recently which include a repo rate cut, a reduction in the reserve ratio and higher government spending to meet the 5% growth target. Indonesia has already front-loaded the rate cut. It came just before the US announcement which was wildly anticipated. Some of the other countries in the ASEAN region are in the process of reducing the rate too, for example, South Korea. One notable exception among the emerging countries is Brazil which has increased the rate by 25 basis points, this has been attributed to a pick in domestic inflationary expectations due to droughts and floods in certain regions.

In the case of India, the seasonally adjusted quarterly capacity utilisation has been 74.6% for a number of quarters. Inflation, both combined CPI and core inflation are coming down. From February 2023 to August 2024 the policy repo rate has been constant at 6.5%, whereas the core inflation (I.e., inflation without food and fuel, which are the volatility components) has come down from 6.1% to 3.3% during the same period. Hence adjusted for inflation the real policy rates are quite elevated. When one looks at the policy rates through the prism of overall inflation (rural, urban and combined) then too the broad picture remains the same, CPI inflation from February 2023 to August 2024 has come down from 6.44% to 3.65%. Given the possibility of an excellent kharif crop, overall inflationary expectations are somewhat muted. However, given the fact that several State elections are around the corner and inflationary perceptions stay anchored in earlier experiences, RBI may not tweak the policy rate immediately. It could possibly try to reduce the rate only early next year. On the other hand, industries particularly MSMEs expect the rate cuts to happen sooner. Demand revival in the economy has to go hand in hand with a rate reduction to encourage investment and consumption, particularly in sectors like manufacturing, housing and consumer durables. Rate cuts are also necessary for supply chain cost reduction across the value chain.

Apart from the domestic macroeconomic developments every emerging country will also be confronted by a weakening dollar. The dollar index during the last fifty-two weeks has come down by 5.47%. The impact of a weakening dollar can be multi-dimensional for emerging economies. Firstly it affects the flow of funds as investors and institutions move their money in search of higher yields to emerging economies that are on a growth trajectory. India will be a front-runner for attracting such funds; selected equities and bonds provide considerable opportunity. However, India may have to compete with ASEAN countries as our earnings multiple at 25 times is higher than that of Malaysia, Vietnam, Indonesia, South Korea and Singapore. Obviously, growth both at overall and sectoral levels along with company performances help India to overcome higher priceearnings ratio issues.

However, untamed inflow of funds which always searches for arbitrage opportunities can lead to undue strengthening of the rupee, this is an area of concern for RBI. The problem with a strong rupee is- that it will make Indian exports uncompetitive, at the same time the imports would be cheaper. Unless RBI prevents the overvaluation of the rupee, this can lead to a widening of the current account deficit. Further, it can have a damaging impact on export-orientated industries like IT, Pharma, engineering projects, chemicals, readymade garments etc.

Another impact of the Fed rate cut will be in the area of non-interest-bearing assets like gold. A wobbly dollar along with global volatility due to Middle-east and Ukraine conflicts accentuates the demand for gold which is considered to be a safe haven. Secondly, a decline in interest rate brings down the opportunity cost of holding gold, and leveraging becomes widespread leading to an escalation in gold demand; consequently, prices could go up further. This is true of global markets as well as India. The Fed rate cut has provided space for emerging economies like India to reconsider their policy rate. Given the macroeconomic stability and the desire to step up the overall economic growth and employment, a reduction in rate sooner than later would be useful.

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