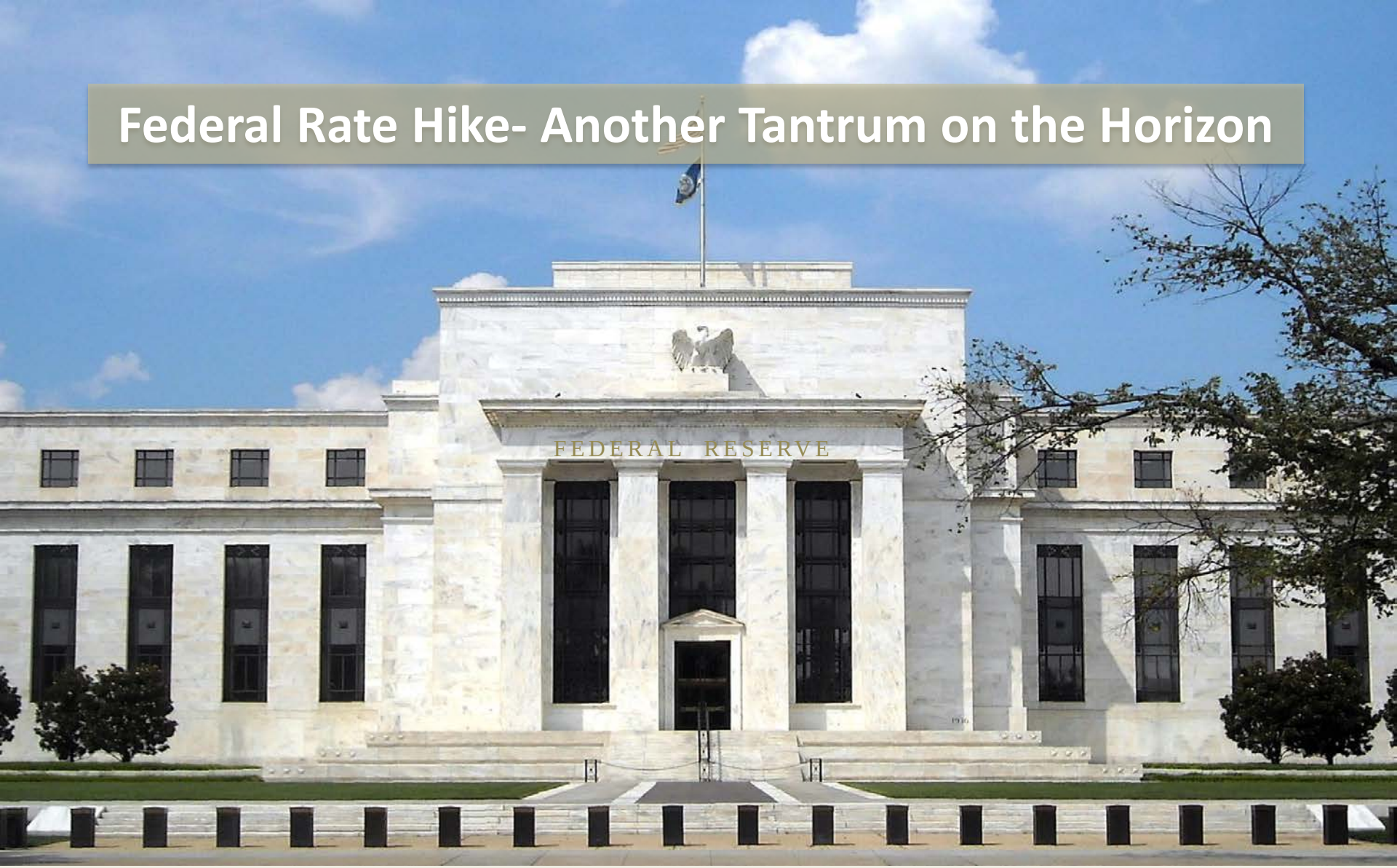
Federal Rate Hike- Another Tantrum on the Horizon



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MAY 2015

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FEDERAL RATE – SIGNIFICANCE

The Federal Funds rate (or fed funds rate) is the interest rate at which depository institutions (primarily banks) actively trade balances held at the Federal Reserve. The Federal Funds rate is one of the important interest rates in the U.S. Economy as can be read below :

Benchmark interest rates

- Interest rates are usually pegged to the Federal Funds rate
- E.g. Interest rates that banks pay on deposits (savings deposits, certificates of deposits, individual retirement accounts, Eurodollars, repurchase agreements, etc.)
- Interest rates that banks charge for loans (car loans, construction loans, mortgage loans, development loans, real estate loans, small business loans, etc.).

Key indicator of Economic activity

- The Federal Reserve System regularly targets the Federal funds rate when pursuing monetary policy--a lower rate to reduce unemployment and a higher rate to control inflation.
- Quantitative Easing : An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.

Important component of the costs of acquiring funds

- A key source of obtaining funds for the banks is the Federal funds market, making the Federal funds rate something of a baseline cost that banks can expect to pay for acquiring funds.
- Another seldom used source is discount borrowing from the Federal Reserve System.

FEDERAL RESERVE MECHANSIM

Reserve Requirement by Federal Reserve system

- Reserve maintenance requirements imposed on commercial banks by the Federal Reserve System (the Fed)

Purpose

- To ensure that all bank depository institutions keep enough reserves to back up customer deposits. The bank depository institutions have a two-week period to satisfy the requirements.

Short/excess Reserve

- Due to the normal fluctuation of banking activity, some banks have more reserves than needed to satisfy requirements and some have fewer

Interbank lending to remain compliant

- Banks that borrow reserves are able to satisfy reserve requirements and banks that lend reserves generate extra revenue for their trouble.

Inference : *Banks that borrow reserves are able to satisfy reserve requirements and banks that lend reserves generate extra revenue for their trouble.* ***This is a win-win exchange for both sides.*** *This inter bank lending is done at the federal fund rate*

KEY MONEY SUPPLY CONTROL TOOLS

The central bank in the United States is called the Federal Reserve. Its main objectives include full employment, stable prices and moderate interest rates, all of which tend to lead to long-run economic growth. These objectives are achieved using the three basic monetary tools as given below. These three tools enable the central bank to change the money supply and therefore stimulate the economy or slow it down.

Open Market Operations (OMO)

Open market operations are the purchases and sales of government securities (Treasury bills, bonds and notes) in the open market by the FOMC*.

Buying securities → Increase money supply in the economy.

Reserve Requirement

Reserve requirements are the portions of deposits that banks must maintain (typically over two weeks period) either in their vaults or on deposit at a Federal Reserve Bank.

Higher Reserve requirement → fewer loans to lend → smaller money supply → higher interest rates → lower economic output.

Discount Rate

The interest rate set by the Federal Reserve that is offered to eligible commercial banks or other depository institutions in an attempt to reduce liquidity problems and the pressures of reserve requirements.

Decrease in rate → Increase in borrowings by bank → increase in money supply in the economy.

*In US, the Federal Reserve System's top monetary policy-making body is Federal Reserve Open Market Committee (FOMC)

U.S DIRECT INVESTMENT ABROAD VIS - A - VIS FEDERAL RATE

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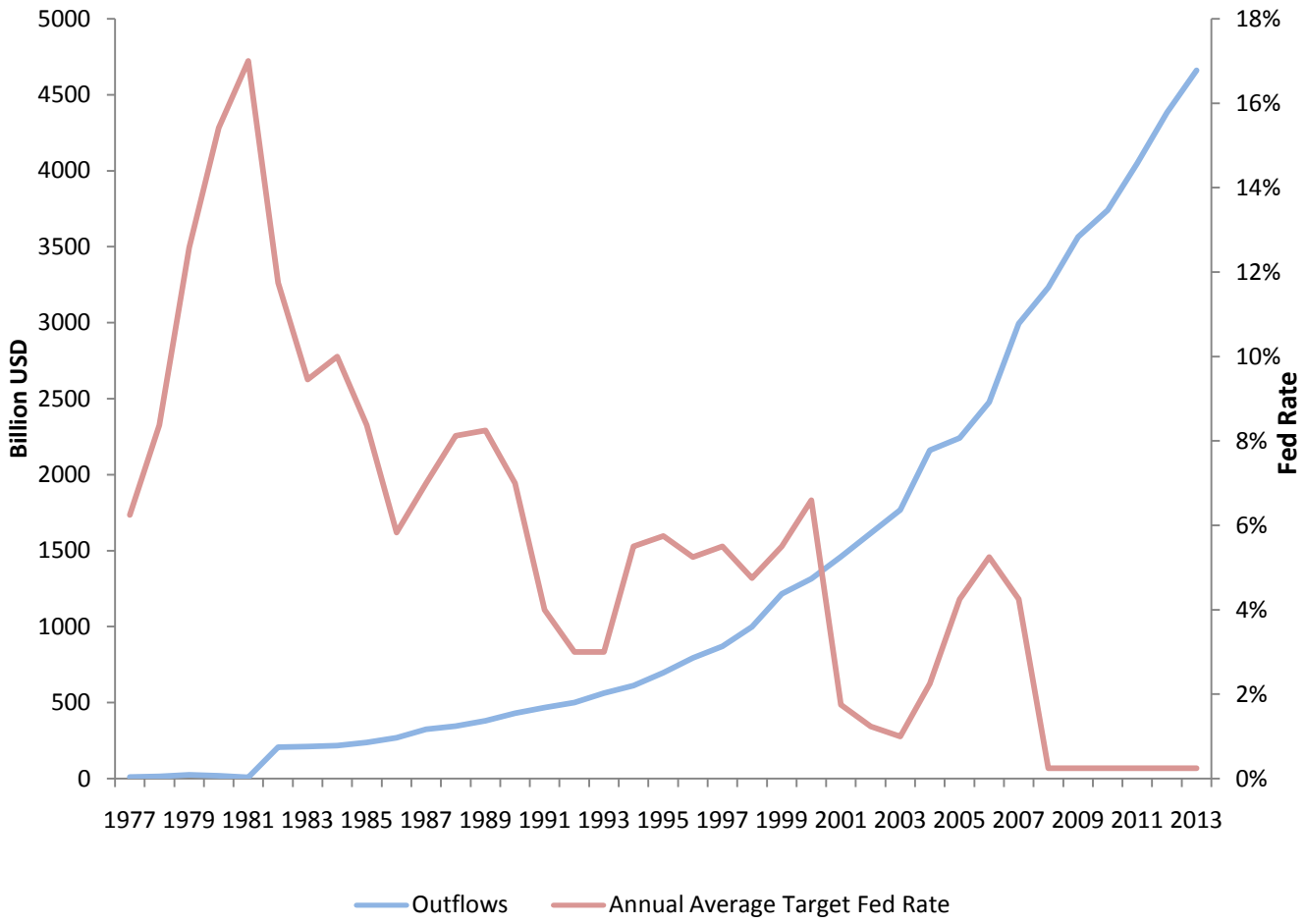

Correlation

between U.S. direct investments abroad and federal target rate is -0.74 which indicates that they are inversely related.

Source : Bureau of Economic Analysis

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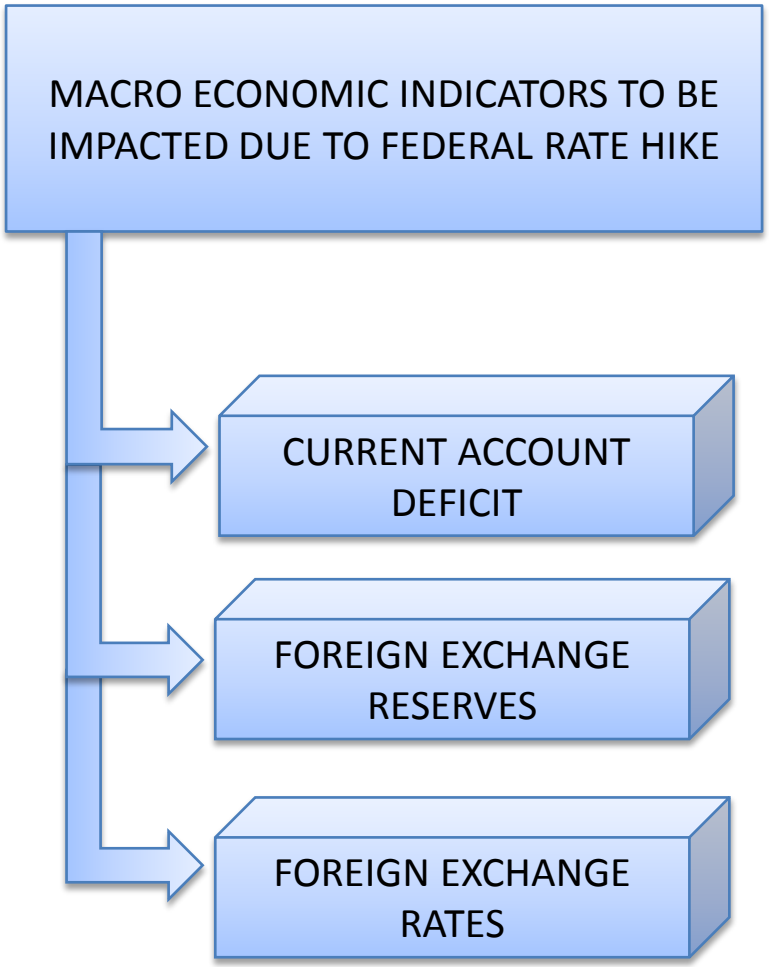
IMPACT OF FED RATE HIKE ON EMERGING MARKETS

- For the first time since 2006, the United States will raise short-term interest rates later this year, as the first country to start the process of normalizing its monetary policy. Even if this process is well managed, the likely volatility in financial markets could give rise to potential stability risks.

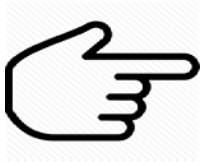
- While the market and US Federal Reserve watchers are still uncertain, how patient Fed President Janet Yellen will be – i.e. when will be the proposed rate hike, in **June or in September**, it is foreseeable that Emerging Market stocks (among other risky assets) will suffer.

- Even though the Fed has not yet started raising interest rates, the well-established US economic recovery and the prospect of monetary tightening have, over the last year, caused the dollar to appreciate sharply against most currencies, those of emerging markets and advanced countries alike.

- If the Fed tightens as expected by the mid of this year, it will impact various macro economic factors of the developing economies, for e.g. current account and trade deficit, foreign exchange reserves, foreign exchange rates, etc.

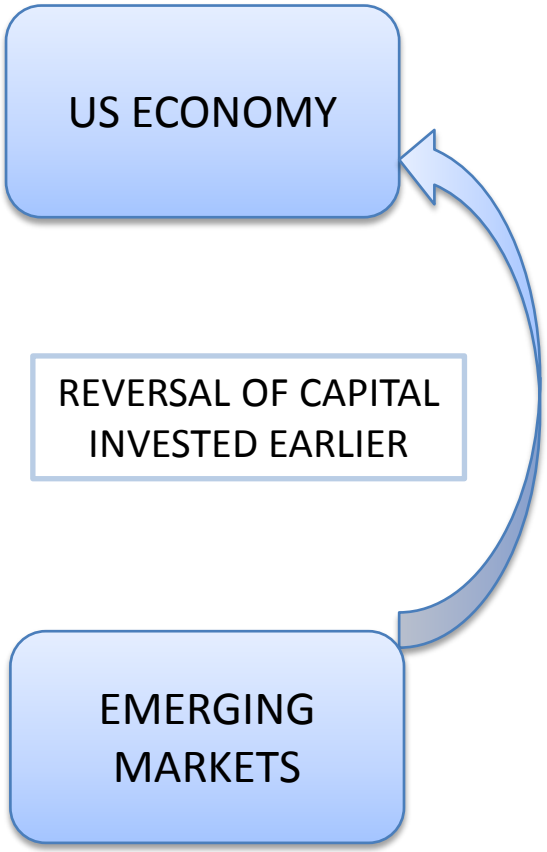


Emerging Markets endure two Threats with the Proposed Fed Rate Hike



REVERSAL OF CAPITAL INVESTED EARLIER

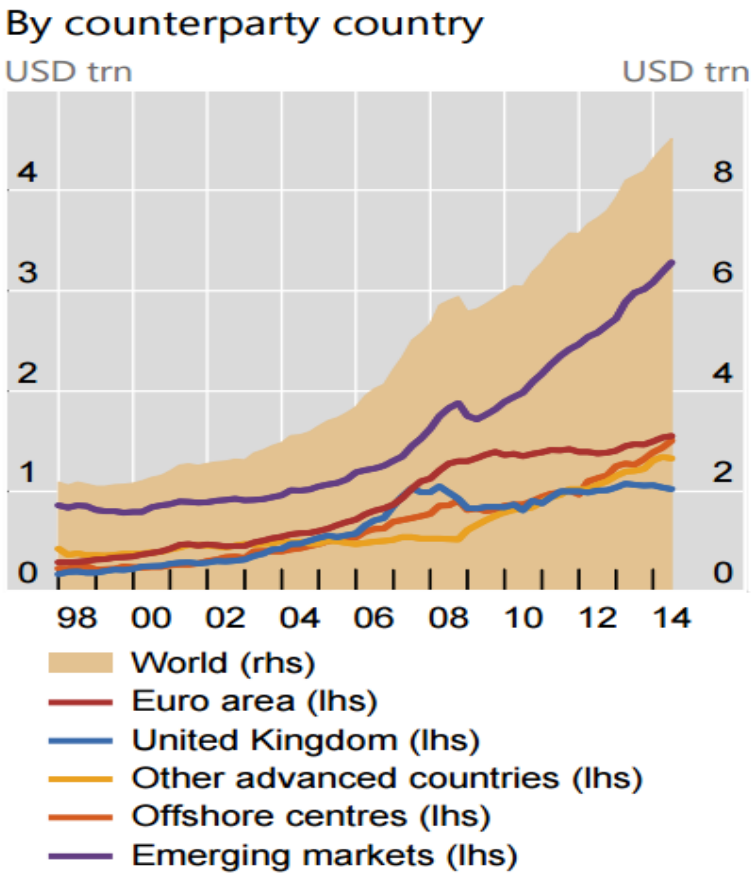
- Some emerging markets are heavily reliant on foreign inflows to fund fiscal or current account deficits.
- As per IMF data, between 2009 and 2013, emerging markets received about **US$ 4.5 trillion** of gross capital inflows, representing roughly half of all global capital flows in that period.
- If investment returns rise in the U.S., international capital flows away from emerging markets could accelerate and make funding the "twin deficits" (i.e. simultaneous occurrence of Fiscal deficit and Current Account deficit) more difficult.



IMPACT OF FED RATE HIKE ON EMERGING MARKETS

REPAYMENT OF US DOLLAR DENOMINATED DEBT

- Emerging market governments, corporations and banks took advantage of low cost dollar finance to shore up their finances.
- Data from the Bank of International Settlements supports similar figures reported by the IMF that emerging market borrowing has doubled in the past five years to more than US$ 6 trillion.
- This is problematic because local currency devaluation caused by a reversal of capital flows can make servicing this dollar debt more difficult.
- Furthermore, corporations and banks that borrowed in dollars could be facing additional pressure if they don't have matching revenues or assets.



Source: IMF

- Emerging Markets have collectively borrowed more than $6 trillion in US dollars till 2014, a currency they cannot print and do not control. This hard-currency debt has tripled in a decade, split between $3.1 trillion in bank loans and $2.9 trillion in bonds.

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FRAGILE FIVE

Rating agencies and institutions evaluate the economies to identify the risk exposures attributable due to changes in Macro economics. Estimates of exactly which countries are most exposed to risk due to Fed rate hike vary widely, but some countries seem to consistently appear on the lists of the U.S. Fed, international banks and rating agencies. The chart below shows the countries that seem to have the largest external financing challenges with Fed rate hike

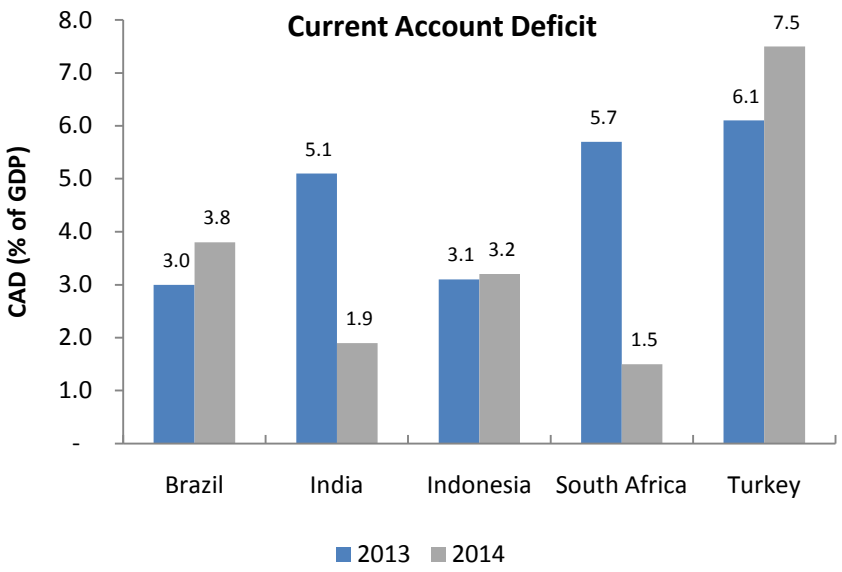
- Fragile Five together make up 14% of the world's GDP, larger than France and China combined.
- Free money from the US Fed allowed Turkey, South Africa, India, Brazil, and Indonesia and others to run deficits as their higher interest rates created a demand for their bonds and currencies. Now that has reversed.
- The Fragile Five have problems not necessarily related to their economic situation. Their financial markets are relatively large compared to other emerging markets. So when US interest rates rise and investors move capital back to the US, they sell developing countries with large liquid markets where exiting without large losses is easier.

These five countries got their name in 2013, as hints emerged that the US Federal Reserve would end its easy-money policy. Bound together by sizeable current account deficits and reliance on foreign capital, they looked vulnerable to shocks such as a strong dollar and rising U.S. interest rates.

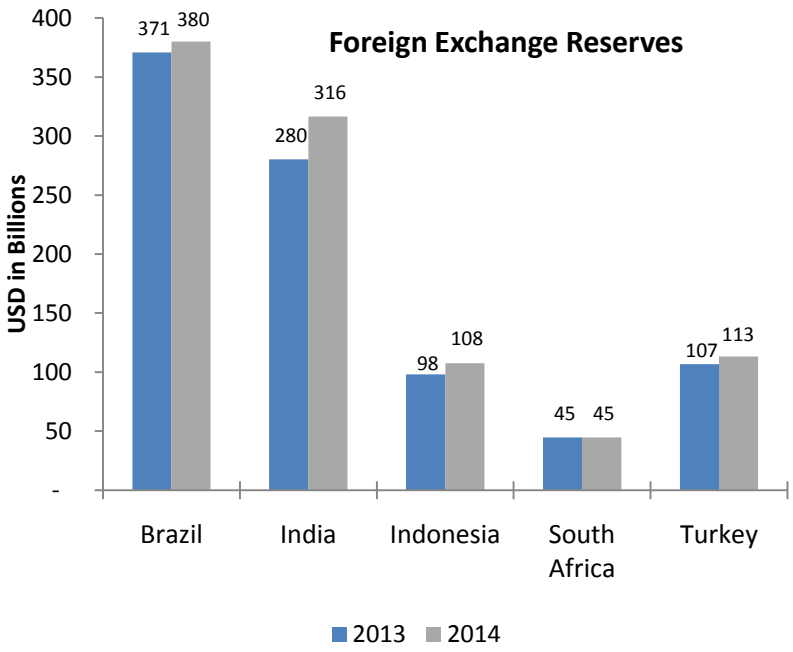
Source: Federal Reserve

CURRENT ACCOUNT BALANCE

Amongst the five countries listed, India has improved its current account deficits, as compared to 2013, becoming less reliant on foreign funds to prop up its economy. Indonesia also looks in better shape than Brazil, Turkey and South Africa, as shown in the graph below:



FOREIGN EXCHANGE RESERVES

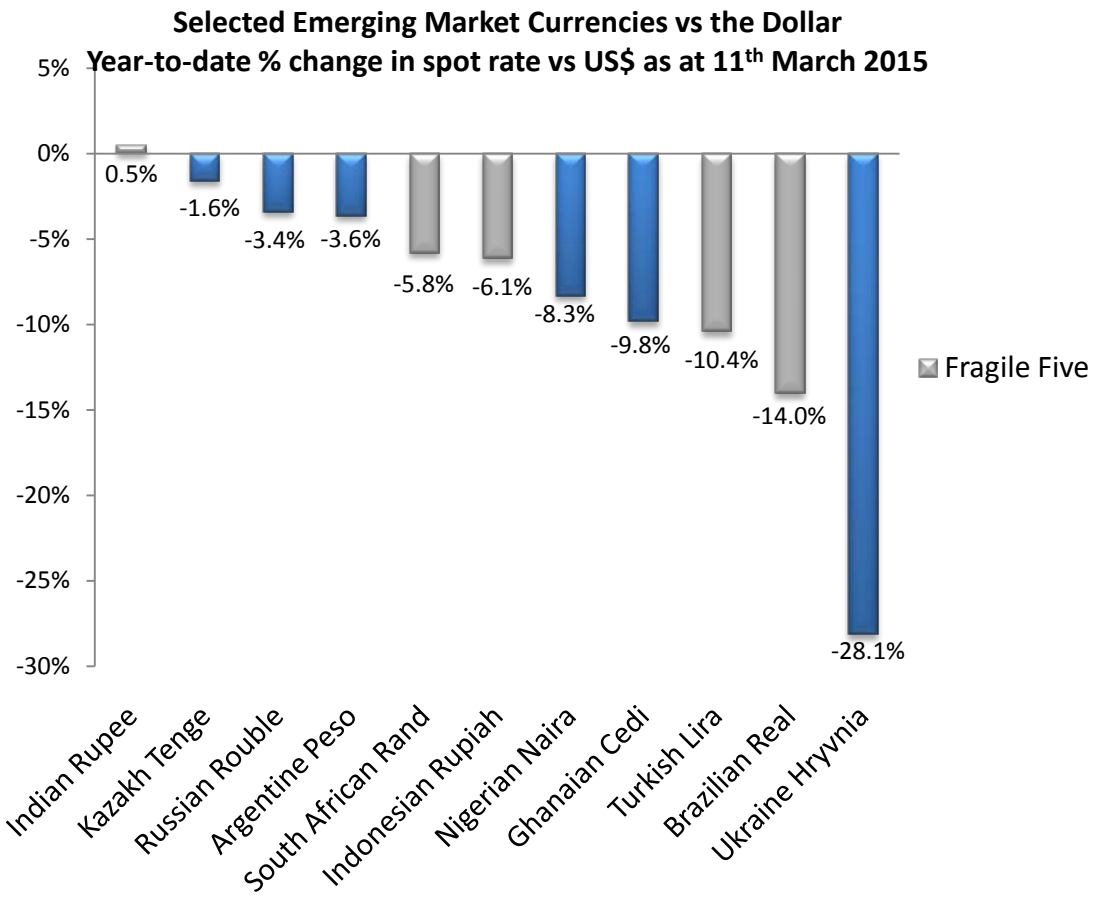


In the past one year, India has stocked up on its foreign exchange reserves at a pace second only to Indonesia's among the Fragile Five. The improvement in the trade balance plus capital inflows owing to a pick-up in investor confidence has allowed the central bank to add $36 billion to forex reserves in the past year.

Source: Mint

FOREIGN EXCHANGE RATES

In the latest emerging-market sell-off, Brazil has lost as much as 14 percent and Turkey 10.4 per cent since the start of the year, as this graph shows:



Source: CNBC

INFERENCE:

- It is believed by the global economists that India has taken sufficient efforts to be out of the Fragile Five.
- India has enacted enough reforms to have passed "the point of Inflexion away from their old growth models" by tackling inflation by the central banks, cutting the current account deficits, reducing with the intention of finally removing costly government sponsored fuel subsidies, etc.

IMPACT ON INDIA

India seemingly is in better position as compared to other emerging markets, as indicated below:

- As of last week of March 2015, INR was the only emerging markets currency which appreciated in the past year against the dollar, despite the dollar index hitting new highs every day in anticipation of a Fed Rate hike.
- The inherent strength of Indian economy, supported by steady reforms being brought in by the government and strong Foreign Investment Inflows are the reasons why Indian economy is insulated against the Fed Tantrum.
- It seems that the INR will most likely outperform its peers when the Fed eventually hikes rates. This will prevent Foreign Investment Outflows from India and will support the currency and markets.

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Why India looks geared up to face Fed Rate Hike

- Curbs on gold imports, such as higher duties, helped dramatically narrow India's current account deficit to $32.4 billion in the fiscal year that ended in March 15 from $87.8 billion a year earlier.
- Falling global crude prices have helped improve the health of public finances by drastically slashing the government's fuel subsidy bill.
- The decline in the rupee vis-a-vis other global currencies against the US dollar has been less severe
- India's benchmark index BSE Sensex has returned 7% in the year 2014-15 so far and has been among the leading gainers in the emerging market basket. China's Shanghai Composite Index has declined 1.9% in the same period.
- International events are having a less of an impact as investors focus on government steps to revive the economy and the RBI's policies, based on macro data such as inflation, GDP growth rates etc.

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