The immediate causality of Fed rate hike has been the correction of asset prices in most EMEs. Is this a flight to safety? Or is this due to drying up of the source of global liquidity, which fostered speculative rise in asset prices around the globe earlier? It may be a combination of both, which would hamper capital flows to EMEs.

The United States Federal Reserve is on a rate hike cycle. Eight years after the onset of the global financial crisis, the US Fed announced the first hike in Fed rate on December 16, 2015. It took 12 months for the second Fed rate hike on December 14, 2016. During 2017, the US Fed raised the policy rate thrice. And while the Fed rate has been hiked twice in 2018 so far, at least two more hikes are anticipated during this year. The current Fed rate stands in the range of 1.75% to 2%. To put this in perspective, a few critical data are analysed to understand the compulsion before the Fed to continue the tightening cycle. The US unemployment rate has come down progressively to an 18-year low of 3.8% in May 2018, as against 10% in October 2009. The US GDP, which grew by 1.5% in 2016, accelerated to 2.3% in 2017, and is projected to rise further to 2.9% in 2018. The US annual consumer price inflation (December over December), which was 0.73% in 2015, surpassed the tolerable level of 2% and stood at 2.07% by December 2016 and 2.11% in December 2017.

The latest CPI inflation in the country was as high as 2.8% in May 2018—the highest inflation rate since February 2012. From these data, one can very well anticipate the direction of the US monetary policy, going forward. The withdrawal of monetary accommodation in the US was predictably gradual in the initial period. Now, the pace of monetary tightening in the US has gathered momentum. The US Fed is no more pumping global liquidity. On the contrary, it is sucking global liquidity through open market sale of securities from its portfolio to reduce its balance sheet size, which grew unusually during the period of quantitative easing. The US fiscal policy is currently accommodative, which is unusual during the upswing phase of a business cycle. Hence, the US Fed may be extra cautious and pursue monetary tightening at a rapid pace to offset the inflationary pressure in the economy arising out of the accommodative fiscal policy.

Global financial markets have factored in these developments. The six-month US dollar LIBOR, which was below 1% at the end of December 2015, rose to over 1.3% in December 2016, 1.8% in December 2017, and to around 2.5% in June 2018. The 10-year US bond yield also rose from 2.4% in December 2017 to 3.1% in May 2018, before softening a bit to 2.96% in June 2018. The turnaround in the interest rate cycle in the US is a major source of concern for the emerging market economies (EMEs). The recovery in the US economy seems to be on a firm footing after a prolonged sluggishness. Therefore, EMEs are expected to benefit from the US recovery. Global trade volume is also on a steady increase. Nevertheless, EMEs are somewhat uncomfortable with the normalisation of the US monetary policy for several reasons. The interest rate differential between the US and EMEs has narrowed down significantly.

Moreover, exchange rates of most of the EME currencies have depreciated, following the normalisation of the US monetary policy. This has led to withdrawal of portfolio investments by the foreign institution investors (FIIs) from EMEs, particularly from the debt segment, despite continued strength of their medium-term fundamentals. The immediate causality of the Fed rate hike has been the correction of asset prices in most EMEs. Is this a flight to safety? Or is this due to drying up of the source of global liquidity, which fostered speculative rise in asset prices around the globe earlier? It may be a combination of both these factors, which would hamper capital flows to EMEs, going forward. Asset price correction in EMEs has been factored in by the market participants.

But the problem in EMEs is not limited to asset price correction only. In order to maintain interest rate differential between the US and EMEs, many EME central banks have raised policy rates. The interest rate defence to protect exchange rate typically does not work in EMEs, which have cut their policy rates aggressively earlier with the Fed, and may be in a better position to match the hikes in the US Fed rate now. EMEs, which did not do so, may find it difficult to fine-tune their policy rates. In fact, a premature hike in the policy rate in EMEs may hamper incipient recovery in the investment cycle. The deeper problem lies in servicing the corporate debt, particularly in foreign currency, negotiated by EME firms at variable rates from the international market when the LIBOR rate was low. Exporters may somehow manage to service their external debt as they have a natural hedge in terms of earning in foreign currency.

But non-exporters, who had borrowed from the global market in foreign currency, would face serious debt servicing problem, going forward, due to the rise in LIBOR rates and depreciation of the home currency. How is India prepared for the global uncertainty arising out of normalisation of the US monetary policy? Up to June 13, 2018, FIIs have withdrawn `32,844 crore (nearly $5 billion) from the Indian debt market and `4,006 crore (about $600 million) from the equity market. As the rupee was under pressure, the Reserve Bank of India (RBI) recently intervened in the forex market to impart stability to the exchange rate. Moreover, RBI, by hiking the repo rate by 25 basis points on June 6, 2018, wanted to kill two birds with one stone—i.e. to keep inflation expectations under check, around 4% on a medium-term basis, and provide stability to the rupee exchange rate. Despite high volatility, the correction in the equity market has been, by and large, prevented due to large investment by mutual funds. However, the 10-year sovereign yield in India has touched 8% despite mutual fund investments.

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