

# LEARNING CURVE ON FED RATE

## Fed Rate Cut: Impact on Indian Market

### US Federal Reserve Action on 19<sup>th</sup> Sep' 07

- Cut Fed Rate by 50bps to 4.75%
- Discount Rate by 50bps to 5.25%

### What are “Fed Rate”/”Target Rate” and Discount Rate?

#### Fed Rate / Target Rate

(similar to “Call Rates” in Indian Context)

This is the interest rate at which banks in US borrow overnight federal fund from each other. Federal fund is held with US central bank “Federal Reserve”. The rate at which banks borrow from each other is market determined and fed tries to keep the rate aligned with target rate by adding and subtracting from or through open market operations. It is much similar to our banking structure; where RBI fixes reverse-repo rate and around this rate the call rate.

Call rate is the rate at which banks borrow overnight funds.

#### Discount Rate

(similar to “repo rate” in Indian Context)

“Discount rate” is the interest rate at which Federal Reserve provide money to banks in the system which is equivalent to repo-rate in the Indian context. Discount rate is always kept few bps higher to fed rate (target rate). In the past it has been kept 100bps higher to fed rate, but recently it has been slashed by 50bps twice owing to the subprime crisis in the economy, which had brought down the spread to 50bps.

### Does it indicate the start of a long drawn easing of interest rates in the US?

The US economy has shown moderations in the first half of this year. Housing activity continued to worsen and employment slackened. Though retail sales showed a pick up last month, the general trend was one of a slowdown. Consumer confidence has been shaky. The after effects of the sub-prime mess threatened to derail the economic activity further. Credit conditions remain tight and mortgage-lending activity has slowed down. The Housing industry is crucial to the US economy and the Fed sees a major risk to the economy on its deteriorating state. Foreclosures are bound to be higher at a time when house prices are falling and the EMI's are increasing. This cut in interest rates would lead to lenders lowering their PLR's and thus softening the relative impact of interest rate reset. The lower lending rate could also spur purchasing of new houses thereby stabilizing the house prices.

### Impact of Fed Rate Cut in the Indian Capital Market

#### Equity Market

- The impact thereafter

Equity Market rose more than 4% as indicated by leading equity indices following the fed rate cut announcement. Market participants were expecting fed rate cut by 25bps but Federal Reserve had made it 50bps, which provided the additional boost to the market.

- What lies ahead for Indian Equity Markets?
  - Overall positive for emerging equity market due to increase in foreign institutional flows
    - Liquidity concerns that arised due to sub prime crisis will get offset.
  - India to be among the out performers in emerging markets
    - Lower dependency on exports
    - Domestic consumption growth remains intact (more so backed by good monsoon).
    - High real interest rates.( as the inflation is under check)
    - RBI is under good position to counter any adverse developments with contained inflation.
  - Rupee to strengthen following dollar weakness
    - Positive for FII's to invest in India in view of high dollar return.
    - Negative for export oriented sectors.
- Fed action more aggressive than the expectation highlights risk of US slowdown, which will **adversely** affect global demand.
- Positive for Sectors
  - Industrial/ Infrastructure
  - Financial Services
  - Real Estate
  - Telecom
- Negative for sectors
  - IT
  - Textiles
  - Auto components
  - Metals

### **Debt Market**

It's too early to think off Benchmark interest rate cut. The growth is strong, credit is picking up and concerns remain on inflation. Depending upon the liquidity and credit off take situation the RBI has legroom to alter the CRR ratio and SLR ratio in the coming months.