US Federal Reserve's rate cut

Why in News?

- The US Federal Reserve's interest rate has had a quarter-percentage-point cut recently.
- This is the first time the rate has been cut since the 2008 financial crisis.

Why the rate was cut by the Fed?

- **The Fed** cited that the key reasons for the decision to cut rates are the concerns about the global economy and muted US inflation.
- This has also 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 6 months of the year.
- The rate cut has lowered the US central bank's benchmark overnight lending rate to a target range of 2%-2.25%.
- **The central bank** said that the cut will act as appropriate to sustain the record-long US economic expansion.
- However, the Fed Chairman underlined that the rate cut was merely a **mid-cycle adjustment** to policy.

Does the cut indicate a shift in policy?

- The rate cut follows months of pressure from US President, who has been pushing the American central bank for the cut.
- Fed Chairman has repeatedly pledged to follow economic data, and has resisted the nudges from the President — only to change course sharply now.
- The information from the Federal Open Market Committee's (FOMC) meeting indicates that the labour market remains strong and that economic activity has been rising at a moderate rate.
- **FOMC** – A panel within the Fed that is responsible for setting policy rates.
- The uncertainty in the Fed was reflected in the vote on the decision to cut rates, with 2 out of the 10-member FOMC opposing it.
- The decision failed to impress Trump, who has been calling for a big rate cut.

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

- Theoretically, a rate cut in the US should be positive for emerging market economies (EMEs), especially from a debt market view.
- Emerging economies tend to have higher inflation and, thereby, higher interest rates than those in developed countries.
- As a result, FIIs would want to **borrow money in the US** at low interest rates in dollar terms.
- Then, they **invest that money in bonds of EMEs** such as India in rupee terms to earn a higher rate of interest, thus making India more attractive for the currency carry trade.
- A rate cut by the Fed would also mean a **greater drive 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 EMEs** in a proportionate manner.

How did the stock markets react and why?

- Indian stocks tanked on the day after the rate cut announced.
- This may also be caused due to **domestic factors** such as dull July car sales data and slower GDP growth projections.
- But, one of the **major factors** was the characterisation of the rate cut as a mid-cycle adjustment.
- The markets have taken this as a sign that sharp further cuts were not forthcoming.
- The sell-off dragged benchmark indices to 5-month lows,
    1. BSE Sensex slipping below the 37,000 marks,
    2. Nifty50 breached the 11,000 marks in the intra-day trade.
- Bonds in India too, fell as investors trimmed bets on aggressive rate cuts in high-yield markets after the signal from the US Fed.
- A major 50 bps cut by the RBI expected next week will likely trigger a further rally in the bond market.

What is the impact globally?

- If Asian EMEs' currencies continue to weaken sharply against the dollar, this may result in Asian central banks 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 also which experienced some loss after the statement.
- Asian markets traded mostly lower. However, Japan's Nikkei bucked the trend. Britain's FTSE 100 and Germany's DAX also dropped. But France's CAC 40 rose.

Source: The Indian Express, The Hindu.