End of a long monetary tightening phase by US - Likely impact on India

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A long waiting period was over. The tight monetary policy stance pursued by the world's largest economy the United States (US) for about four years was reversed on 19 September 2024. The US consumer price index (CPI) based inflation, known as retail or headline inflation, was seen steadily slowing down to 3.10% in the first month of 2024 from a high 9.1% in June 2022. The first cut last month in the in the US policy interest rate, known as the Federal Funds rate by US Federal Reserve (the Fed), was by 50 basis points (bps). That was larger than the usual, routine size of 25 bps.

The background

In February, 2022, the range of the policy interest was at the lowest: 0%-0.25%. as the Fed was maintaining an expansionary policy to revive the battered economy by Covid-19 pandemic, resulting in loss of lives and livelihoods. However, when there were early signs of rising inflation in October 2021 and the global economy was recovering the post Covid-19 pandemic, the Fed dismissed them as "transitory and transient". The Fed took time to realize that the inflationary signs were real. It was soon clear they were from a shooting war between two neighbours, Russia and Ukraine causing disruptions in supply chains to Europe of and the rest of the world of wheat, and petroleum crude and natural gas.

The military conflict, developing into global economic and political uncertainties, forced the Fed to tighten the monetary policy. The policy interest rate which ranged at 0.25%-0.50%, from the first quarter of the calendar year 2022, went up to 5%-5.50%. **Table 1** indicates the upper limits of the policy rate changes in percent along with those of the advanced countries (the UK and the Europe) It is of interest to note that these countries followed US. They ignored the early signs like US. However, they changed the pattern in 2024. The Euro zone and the UK, have begun easing phase of monetary policy earlier in 2024, unlike the US.

The Fed's preferred Inflation

Although the US's the August CPI based inflation rate (2.50%) was higher than its target rate of 2%, the unemployment rate touched 4.4%,. That was above the target of 4.0%. As fears of recession began to loom large the Fed took the view that the time was ripe to ease the monetary policy and so, opted for a cut by 50 bps on September 19. The Fed's preferred measure of inflation, personal consumption expenditure index (PCE) based inflation was 2.50% for July. The PCE index based inflation is preferred as it captures inflation across a wide range of consumer expenditure and for reflecting changes in consumer behavior. For example, if the price of a given consumer good, shoppers may go for cheaper substitutes.

The August rate of inflation PCE based index was expected only on September 27. The Fed is keen on avoiding hard landing of the economy. In fact, a lone dissenter to the otherwise unanimous decision, Governor Bowman argued for a smaller cut by 25bps. She reminded the Board of Governors that the war against inflation was not still over, as the inflation target had yet to be reached.

Though the decision was widely welcomed by the economy, the markets were not convinced. The US 10 -year Treasury bond yield fell only to a small extent. It did not fall much as expected following a big bang cut of 50 bps in the policy interest rate. The yield fell to 3.62% in the next few days following the cut. By Tuesday, September 24 it climbed to 3.80%. The business and financial sectors were pessimistic., though, the Fed was trying to convince the markets that they would proceed with two cuts of 25 bps in November and in December, totaling in all in 2024 and two more cuts of 25 bps, each in 2025.

The Goldilocks Soup

The Fed Chair **Jerome Powell** reminded the economy in one of his subsequent comments, that the employment was at its peak, slightly higher than the desired rate of 4.0%. The Fed is keen that all caution is needed to have the "Goldilocks soup": neither too hot nor too cold. That is the soft-landing scenario, which is kind of "the best of all possible worlds with jobs back to normal, inflation back to normal, interest rates back to normal." The Fed was awaiting two more additional data by September 26 and on 27; first on economic growth news and second on PCE based inflation, Prior to these expectations, there was a welcome news on September 21. That was in regard to a decline in the number of new claims of unemployment benefits. The number is 218,000, the lowest since May. That would mean the recession fears are not that serious.

On September 26, data on economic growth showed that the latest second quarter gross domestic product (GDP) estimate was an 3% annualized growth in the US economy. The rise is higher than the 1.4% growth in the first quarter. The data on

TABLE : 1 — Major Advanced Countries : Post Covid Pandemic Inflation and Central Banks Response (Inflation and interest rates in percent)

Year and Month	USA			UK		Eurozone	
	Inflation	PCE based Inflation	Interest	Inflation	Interest	Inflation	Interest
2021							
Jan	1.40	1.61	0.25	0.70	0.10	0.90	0.25
April	4.20	3.72	0.25	1.50	0.10	1.60	0.25
July	5.40	4.53	0.25	2.00	0.10	2.20	0.25
Oct	6.20	5.41	0.25	4.20	0.10	4.10	0.25
Dec	7.10	6.18	0.25	5.40	0.25	5.00	0.25
2022							
Jan	7.50	6.30	0.25	4.40	0.50	5.11	0.25
April	8.30	6.62	0.50	7.80	0.75	7.44	0.25
July	8.50	6.62	2.50	10.10	1.25	8.87	0.25
Oct	7.70	6.35	3.25	11.10	3.00	10.62	1.50
Dec	6.50	5.44	4.00	10.50	3.50	9.20	2.25
2023							
Jan	6.40	5.48	4.25	10.10	3.50	8.64	2.75
April	4.90	4.45	5.00	8.70	4.25	6.96	4.00
July	3.20	3.30	5.50	6.80	5.00	5.30	4.25
Oct	3.20	2.95	5.50	4.60	5.25	2.90	4.75
Dec	3.40	2.62	5.50	4.60	5.25	2.90	4.75
2024							
Jan	3.10	2.50	5.50	4.00	5.25	2.80	4.70
April	3.40	2.70	5.50	2.00	5.00	2.40	4.50
July	2.90	2.50	5.50	2.20	5.25	2.60	4.50
Aug	2.50	2.20	5.50	2.20	5.00	2.20	4.50
Sept	TBA	TBA	5.00	TBA	5.00	TBA	3.90

TBA: To be announced Source: Trading Economics

n PCE index based inflation in August revealed inflation was lower than CPI based. It was just 2.2%. It is now clear that the trend is not only firm, but it is much closer to the inflation target of the Fed rate of 2%.

The former Fed Chairman **Ben Bernanke** said in a talk show on September 25 that the Fed could cut by interest rate 50 to 75 basis points more this year, implying indicating that the central bank could cut by a larger 50 basis points in one of the remaining meetings of the year". That made some section of the US press to react that the next cut would as sizeable as the first, any time soon, possibly in October. With another 100 bps rate cuts next year, which would bring the Fed funds rate to around 3%. That is 5% as of now minus 2%. That might be the so-called neutral rate. Bernanke, became his usual cautious, when he concluded:

"That's, in some sense, the target. Now, whether they'll get there or whether they'll be derailed by new information, new shocks, remains to be seen. But that's where they hope to end up, I think, as this process continues."

What would Reserve Bank of India do?

Now turning to Indian scene, we know very well that RBI would watch and would not be swayed by external happenings. There is no urgency either, The Fed's jumbo cut has proved well for India. The interest rate differential has gone up in favour of India. The Fed cut has widened the spread between the yields of the US and Indian government bonds, which will help attract more foreign portfolio flows into debt. As the macroeconomic indicators are robust, the long term foreign domestic investment inflows would also increase. NRI inward remittance would go up. These inflows would strengthen the rupee. The lingering concerns are around food inflation and the domestic inflation is a more of a food supply issue. Food production depends more on uncertain factors, including weather. That will be a challenge. ■

TABLE –2 : INDIA: Post Covid Pandemic Years — Food and retail Inflation rates and RBI Policy Interest Rates (in percent)

Year and Month	Food Inflation	Retail Inflation	Policy Interest Rate (REP0
2021			
Jan	1.81	4.06	4.00
Apr	2.02	4.23	4.00
Jul	3.96	5.59	4.00
Oct	0.85	4.48	4.00
Dec	4.87	5.66	4.00
2022			
Jan	5.43	6.01	4.00
April	8.38	7.79	4.00
July	6.75	6.71	4.90
Oct	7.01	5.88	5.90
Dec	4.19	5.72	6.25
2023			
Jan	5.94	6.52	6.25
Apr	3.84	4.70	6.50
July	11.51	7.44	6.50
Oct	6.61	4.87	6.50
Dec	9.53	5.69	6.50
2024			
Jan	8.34	5.10	6.50
Apr	8.74	4.83	6.50
July	5.42	3.60	6.50
Aug	5.66	3.65	6.50
Sept	TBA	TBA	6.50

Source : Reserve Bank of India

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