

Impact of Fed rate on the Economy

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In news- The Federal Reserve System, the central banking system of the United States has raised the interest rate by 25 basis points recently.

What is the Fed rate?

- In the United States, the federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.
- Reserve balances are amounts held at the Federal Reserve to maintain depository institutions' reserve requirements.
- Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.
- The federal funds rate is an important benchmark in financial markets.
- The federal funds target range is determined by a meeting of the members of the Federal Open Market Committee (FOMC) which normally occurs eight times a year about seven weeks apart.
- The Federal Reserve uses open market operations to bring the effective rate into the target range.
- The target range is chosen in part to influence the money supply in the U.S. economy.

Its impact on economy-

- The actions of the Fed will likely **drive the decisions of central banks around the world, as they seek to strike a delicate balance among growth, inflation, and**

currency volatility.

- **When interest rates rise in the US and other developed markets, foreign investors, especially from the US, go for investments in US debt and other avenues, which impacts the flow of funds into Indian equity markets.**
- Since the beginning of January 2023, foreign portfolio investors (FPIs) have pulled out a net of more than Rs 27,000 crore from Indian equities.
- As for debt investors, as interest rates are expected to rise further before stabilising and moving on a downward trajectory, investment advisors say they should look to invest in medium- to long-term debt investment products as interest rates peak in the coming months.
- When the Fed is tightening, interest rates tend to rise more for emerging markets, including India, which see a **sharp currency depreciation.**
- While it is **not necessary that the RBI will blindly follow the Fed and other central banks in hiking rates,** interest rates in India have, in fact, moved in tandem with rates in the US.
- While most central banks, including the RBI, have been raising rates to tame inflation, the RBI considers domestic factors, especially retail inflation, while reviewing interest rates.
- As price pressures wane, several central banks have opted for slower rate hikes or pauses.

The Federal Reserve System-

- The Federal Reserve System (often shortened to the Federal Reserve, or simply the Fed) **is the central banking system of the United States.**
- It was **created on December 23, 1913,** with the enactment of the Federal Reserve Act, after a series of financial panics (particularly the panic of 1907) led to the desire for central control of the monetary system in order to alleviate financial crises.

- Over the years, events such as the Great Depression in the 1930s and the Great Recession during the 2000s have led to the expansion of the roles and responsibilities of the Federal Reserve System.
- Congress established three key objectives for monetary policy in the Federal Reserve Act: maximizing employment, stabilizing prices, and moderating long-term interest rates.