

25 September 2021

Fed looks at tapering its bond purchase program

Key Highlights

- Fed has indicated that a **“tapering” in the pace of asset purchases** may begin as early as November and would conclude by about middle of 2022.
- Fed has indicated it **might even move up its timetable for raising interest rates to 2022**.
- For India the present situation of the **current account balance, short term foreign currency debt and forex cover** is substantially better than the 2013-2016 position.

What was the outcome of the FOMC meet?

- ❖ Fed has indicated that a **“tapering” in the pace of asset purchases** may begin as early as November and would conclude by about middle of 2022.
- ❖ The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest-rate lift off.
- ❖ Further, it **might even move up its timetable for raising interest rates to 2022**, reflecting a strong conviction the economy is on the path to full recovery.
- ❖ The **target interest rate** has been kept steady at in the **range of 0% to 0.25%**.
- ❖ The **accommodative policy will be maintained** till US economy achieves maximum employment and inflation at 2%.
- ❖ **Fed will continue purchases of treasuries and mortgage-backed securities at a pace of \$120 billion per month** which it has been buying to maintain accommodative financial conditions in order to support the flow of credit to households and businesses.

What Is the Taper Tantrum?

The phrase, “taper tantrum”, describes the **2013 surge in U.S. Treasury yields**, resulting from the Fed announcement of future tapering of its policy of quantitative easing (QE). The Fed announced that it would be **reducing the pace of its purchases of Treasury bonds**, to reduce the amount of money it was feeding into the economy. **The resultant rise in bond yields which triggered a wave of capital flight from emerging economies was referred to as a taper tantrum in financial media.**

The most affected countries were South Africa, Brazil, India, Indonesia and Turkey — due to their **high current account deficits and dependence on inflows of foreign capital.**

In India these capital outflows put pressure on the rupee, it depreciated by 15% in a couple of months.

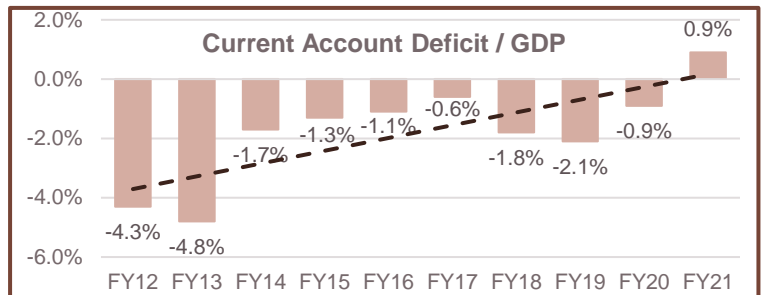
How this may impact India?

If the Fed starts tightening liquidity, **the impact on India will be felt like other emerging markets**. A part of the reason for massive flows to emerging markets have been easy liquidity conditions due to ultra-loose monetary policies of central banks. This may get impacted and some **money may shift back to developed markets causing correction in the Indian markets.**

However, **India is better placed this time than 2013**. The present situation of the current account balance, short term foreign currency debt and forex cover is substantially better than the 2013-2016 position. Also the **pool of domestic investors has increased** significantly which can cushion the markets in case of correction.

❖ Current Account

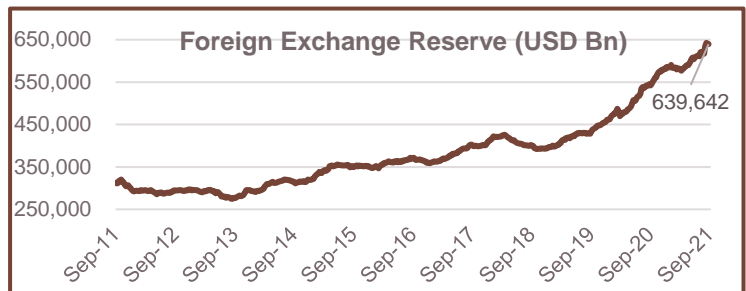
The **current account is in far better shape**, with India reporting a surplus last year. The current account balance recorded a surplus of 0.9% of GDP in 2020-21 as against a deficit of 1.7% in 2013-14.



Source: tradingeconomics.com

❖ Forex Reserves

As against \$275 billion in forex reserves in August 2013, India's forex currently stands at about \$640 billion.



Source: RBI - DBIE

However there are still some **pain points - higher inflation and a large fiscal deficit**. While inflation is transient, driven by supply side bottlenecks, as demand picks up, inflationary expectations would need to be anchored effectively. With respect to the fiscal deficit; India recorded a fiscal deficit of 9.4% of GDP in 2020-21 however with the pickup in economic activity this will tame down to 6.8% of GDP in 2021-22.

To Conclude

Due to the announcement there may be some outflows from Emerging Markets like India but RBI has prepared the economy well enough by accumulating sufficient foreign exchange reserves. The equity markets have risen to all-time highs and therefore some fall is imminent but with retail investors driving the markets and India's economy doing relatively well, the stock markets will bounce back soon enough. So **the effect of tapering should be relatively less this time for India**.

However, investors should **follow the desired asset allocation** to avoid unfavourable portfolio outcomes in case of any volatility that flows in the Indian markets due to tapering.

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