Indian Economy · GS - III

“Monetary policy decisions of the US Federal Reserve have significant implications for emerging economies like India.” Explain the transmission channels through which US interest rate hikes affect the Indian economy. How can India reduce its vulnerability to external financial shocks?

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 16/10/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
10	~150 words

Answer Hint

Macroeconomic stability, adequate foreign exchange reserves, export competitiveness, diversified capital flows, domestic investor participation, prudent monetary policy, fiscal discipline, deeper domestic financial markets

Model Answer

Introduction

The US Federal Reserve influences global financial conditions through its monetary policy. Changes in US interest rates affect capital flows, exchange rates and financial markets, including those of emerging economies such as India.

Impact on the Indian Economy

1. Capital Outflows: Higher US interest rates can make American assets more attractive, encouraging foreign investors to withdraw funds from Indian equity and debt markets.

2. Currency Depreciation: Capital outflows may increase demand for dollars and put pressure on the rupee. A weaker rupee raises the domestic cost of dollar-denominated imports, particularly crude oil.

3. Inflationary Pressure: Costlier imports can increase production, transportation and consumer prices, potentially complicating the RBI's inflation-management efforts.

4. Financial Market Volatility: FII selling can pressure the Sensex and Nifty. Higher borrowing costs may also affect investment and consumption.

Measures to Reduce Vulnerability

India should maintain macroeconomic stability, strengthen foreign exchange reserves, improve export competitiveness, deepen domestic financial markets and encourage long-term investment. The RBI must balance inflation control with growth.

Conclusion

India cannot control global interest rates, but sound economic fundamentals and coordinated policies can reduce their adverse effects.