Indian Economy · GS - III

Analyse the transmission of US Federal Reserve monetary tightening to emerging market economies. What policy measures can improve their resilience to external financial shocks?

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 20/10/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
10	~150 words

Answer Hint

Interest-rate differential, capital outflows, currency depreciation, foreign exchange reserves, external debt, inflation, fiscal discipline, monetary credibility, capital markets.

Model Answer

Introduction

The US Federal Reserve influences global financial conditions because the US dollar is the dominant international reserve and transaction currency. Changes in US interest rates can significantly affect emerging market economies.

Transmission Mechanisms

- **Capital flows:** Higher US yields may attract investment away from emerging markets, increasing financing costs.
- **Exchange rates:** Capital outflows can weaken domestic currencies, making dollar-denominated imports and debt repayments more expensive.

- **Inflation:** Currency depreciation can raise imported inflation, particularly for energy and essential commodities.
- **Borrowing costs:** Tighter global credit conditions can increase government and corporate refinancing risks.

Factors Supporting Resilience

Adequate foreign exchange reserves, manageable external debt, credible monetary policy, diversified exports and sound fiscal management can reduce vulnerability. Domestic capital markets also provide alternative sources of financing.

Way Forward

Emerging economies should maintain prudent fiscal policies, strengthen export competitiveness, diversify financing sources and improve financial-sector supervision. Central banks must balance inflation control with growth, while allowing exchange rates to adjust in an orderly manner.

Conclusion

US monetary tightening creates external risks, but its effects depend on domestic fundamentals and policy responses. Strong institutions and macroeconomic stability help emerging markets withstand global financial volatility.

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