Macroeconomic impact series

US monetary policy in focus

Investment, rather than inflation, a key risk for emerging economies

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Key messages

- This autumn, US monetary policy could be significant for emerging economies. The Federal Open Market Committee could raise rates as soon as September.
- Near-term economic risks from a US rate rise could be offset, in part, by US dollar-denominated reserves increasing in value, leaving room for currency intervention.
- Developing and emerging economies with external financing gaps, high dollar debt and those that are undiversified, could face increasing difficulty attracting investment.

An autumn rate rise

This autumn, US monetary policy will be worth watching, given its potential to affect developing economies' economic outlook.[1] The Federal Open Market Committee (FOMC) is split on the timing of rate rises.[2] Some committee members deem it necessary to raise the policy rate as soon as next month, as indicated by New York Fed President Dudley,[3] or even twice by the end of the year, as Atlanta Fed President Lockhart has suggested.[4] According to the financial markets, a December rise in the target range for the federal funds rate is most likely – one year after the 2015 increase and just over one month after the US presidential election.

US monetary policy typically garners attention because it responds to underlying changes in the US economy, which are often a harbinger of global economic developments. Additionally, changes in the US policy rate influence longer-term rates in emerging and developing economies, a correlation that has increased since the 2008 financial crisis.[5] US interest rates also affect the US dollar, which has a special role as a global reserve currency, and influences global trade balances, as a result of its use in trade invoicing. Given this, we consider groups of developing and emerging economies that could face increased difficulty in attracting inward investment.

Near-term risks are manageable

Emerging and developing countries' currency reactions to a change in US monetary policy are unlikely to be big enough to noticeably shift domestic inflation. On the one hand, as the US dollar appreciates with a US rate rise, risk aversion may mean that currencies perceived as riskier will weaken as funds are repatriated to the US. In floating exchange rate regimes, this can lead to inflation. However, only currency depreciations that surpass 10–20% typically trigger significant exchange rate pass-through inflation effects.[6]

Emerging market currency weakness in response to dollar strength would largely help exporters through a more competitive exchange rate. However, dollarised or US-dollar pegged economies, such as those of Hong Kong, Venezuela and Saudi Arabia, could see export competitiveness decline as a result of US dollar strength. An offsetting factor is that economies with large US dollar reserves would see the value of those reserves increase. This allows for extra spending power for potential currency intervention, if necessary.

The harder challenge: attracting investment

As US interest rates rise, and the US dollar strengthens, certain countries could face increasing difficulty in attracting investment finance. This is because the rise in US interest rates will catalyse investment flows back to the US as a result of risk aversion or home bias for US-based investments. There are two groups of economies that could face this challenge.

Countries with high US dollar-denominated debt are vulnerable to abrupt changes in investment inflows as the dollar rises. This includes larger emerging economies, such as China, India and Brazil, which saw dollar-denominated loans rise exponentially[7] during US quantitative easing. Sub-Saharan African economies are already seeing a significant credit slowdown given recent growth dynamics.[8] Those with high dollar debt, such as Ghana's, are vulnerable. Equally, economies with large financial sectors, and large external financing gaps, such as Kenya and South Africa, with current account deficits of around 7% and 5%, are exposed to rising domestic borrowing costs as US rates rise.

Additionally, economies most in need of investment to facilitate structural change could face increased difficulty. Largely undiversified resource exporters, such as Nigeria, Angola and the Democratic Republic of Congo, look particularly at risk. To start, US dollar strength typically has a dampening impact on oil and commodity prices.[9] Added concern that real interest rates (the nominal rate deflated by the inflation rate) are rising prematurely in response to US developments, in relation to low productivity in these economies, could hurt the inward foreign direct investment that would help diversification.

Endnotes

1 The FOMC meetings with new economic projections and a press conference by the chair are on 20–21 September and 13–14 December 2016: http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm#24561
2 Hilsenrath, J. (2016) 'Fed's July minutes show a split Central Bank seeking to keep options open', *Wall Street Journal*, 16 August. http://www.wsj.com/articles/feds-july-minutes-show-a-split-central-bank-seeking-to-keep-options-open-1471457347
3 Sivabalan, S. (2016) 'Emerging-market rally fades as Dudley comments spur Fed concern', *Bloomberg*, 16 August. http://www.bloomberg.com/news/articles/2016-08-16/emerging-stocks-head-for-longest-rally-in-16-months-as-won-gains
4 Reuters (2016) 'Two Fed rate hikes "conceivable" in 2016, September in play: Lockhart', 16 August. http://www.reuters.com/article/us-usa-fed-lockhart-idUSKCN10R1TB
5 Takáts, E. and Vela, A. (2016) International monetary policy transmission. Paper 78. Basel: BIS.
6 Caselli, F.G. and Roitman, A. (2016) *Non-linear exchange rate pass-through in emerging markets*. Working Paper 16/1. Washington, DC: IMF.
7 McCauley, R.N., McGuire, P. and Sushko, V. (2015) *Global dollar credit: Links to US monetary policy and leverage*. Working Papers 483. Basel: BIS.
8 Tyson, J. (2016) *Sub-Saharan Africa's economic downturn and its impact on financial development*. Shockwatch Report. London: ODI.
9 Druck, P., Magud, N. and Mariscal, R. (2015) Collateral damage: Dollar strength and emerging markets' growth. Working Paper 15/179. Washington, DC: IMF.

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