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Opinion Paper

US Interest Rate Lift-off: Macroeconomic Implications for Emerging Market and African Economies[1]

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Introduction

After several months of anticipation, the US Federal Reserve Bank raised its benchmark short term interest rate - the Federal Funds rate – from a 0-0.25 percent target range to a 0.25-0.5 percent range on 16 December, 2015. The decision was shaped by two economic developments, which signaled a recovery of the US economy: favorable labour market conditions and the inflation developments. The US economy expanded at a moderate pace of 2.1 percent in 2015, while labour market conditions have improved considerably. Unemployment was estimated at 5 percent in 2015 and is expected to decline to 4.7 percent by 2018[2]. Inflation has continued to run below the Fed's 2 percent long-run objective, partly reflecting declines in energy prices and non-energy imports, but is expected to rise to the target objective over the medium term. The rise in interest rates is the first monetary policy tightening since 2006 and if part of a sustained tightening cycle, it could have strong effects on emerging market and African economies.

The US interest rate hike came at a time when many emerging markets were already reeling from the slowdown in China, sharply lower commodity prices, depreciating currencies and increasing geopolitical risks. Other major central banks such as the European Central Bank (ECB) and Bank of Japan are easing their monetary policy positions, and the move by the US reflects divergence of monetary policies. The Fed believes that the overall stance of its monetary policy remains accommodative and future moves will be prudent and more gradual than in the previous tightening cycles, but each decision will depend on market conditions affecting inflation and employment.

Comparing the current interest rate hike with the monetary policy tapering of 2013 when the US exited from the unconventional monetary frameworks (quantitative easing), the main difference is that there was much greater uncertainty in 2013 than there was in the run-up to the recent rate hike, which was well communicated over a long time. The initial talk of tapering in May 2013 led to a surge in U.S. 10-year Treasury yields by 100 basis points, followed by a spike in financial market volatility in emerging economies. Equity markets dropped sharply, coupled with significant capital outflows, currency depreciations, and a steep rise in bond spreads in emerging markets.[3] The impact of the current hike could be more muted than during the tapering.

[1] Prepared by Seedwell Hove, with contributions from Jeremy Wakeford
[2] Federal Reserve Bank Board projections
[3] World Bank, Global Economic Prospects, June 2015, Special Feature 1

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Implications for emerging market economies

The rise in interest rates could dampen capital flows to emerging markets as US markets become more attractive for global investors looking for stable and safe returns. The most vulnerable countries are those with large external financing needs, large stocks of inward foreign portfolio investments (shares and bonds), high foreign currency debt levels, small foreign exchange buffers, and low monetary policy credibility. A number of emerging market economies such as Brazil, Indonesia, Colombia, South Africa and Turkey[4] are relying heavily on foreign capital inflows to fund fiscal or current account deficits. Between 2009 and 2013, emerging market economies received about US$4.5 trillion of gross capital inflows, representing about half of all global capital flows in that period.[5] As during the 2013 tapering, the mere talk of a U.S. rate hike earlier in 2015 started to drain capital from emerging market economies well before the rate hike, putting depreciation pressures on currencies and further increasing costs of finance.[6] Oil exporting countries with large current account deficits such as Colombia, Nigeria and Russia, which are already affected by the oil price decline, are likely also to experience sharp drops in capital inflows and disruptions in financial markets. World Bank estimates suggest that a 50 basis point jump in global long term interest rates could temporarily reduce capital flows to developing countries by 0.9 percent of their combined GDP.

Although the current rise in interest rates has been priced in by the markets, and the impact on long term interest rates has been rather muted thus far, the expectation of subsequent rate increases could steepen the US yield curve as the long term interest rates increase, if this is the beginning of a new tightening cycle. This could result in a surge in borrowing costs in emerging markets. Compounded by the slump in commodity prices, this may further strain corporate balance sheets and lead to non-performing loans for many firms (especially commodity firms) operating in shrinking economies. The impact is likely to be more acute in countries that have large borrowings denominated in US dollars, such as Brazil, Mexico, Russia and Turkey. The impact will depend heavily on gross external financing needs and debt repayment conditions.

The Fed rate hike has also induced further appreciation of the US dollar, affecting emerging market economies with large amounts of dollar-denominated debt, such as Brazil, Turkey and South Africa. Since the discussion of the interest rate hike began 12 months ago, the US dollar has rallied substantially against major currencies in anticipation of the lift-off and given the loose monetary policy elsewhere. Most commodity exporters have already suffered from the slump in commodity prices, which has compressed export revenues. Now, with the rise in US interest rates, there is increased risk of currency depreciation as the US dollar appreciates further. For example, the Brazilian Real depreciated by 1.5 percent, while the Columbian Peso, the Russian Rubble and the South African Rand depreciated 4.1 percent, 3.7 percent and 3.7 percent respectively following the hike in the US interest rate. Rising cost of borrowing could blight economic growth in emerging markets. However, in countries that trade more with the United States, such as Mexico and others in Central America, the negative impact will be

[4] Atradius Economic Research
[5] IMF World Economic Outlook, October 2015
[6] SRR advisors

partially offset by an increase in their exports emanating from the depreciation of their currencies.

The tightening of borrowing costs and financial conditions could also exacerbate preexisting vulnerabilities in EME and developing countries, heightening risk aversion and worsening credit worthiness. Also, considering that market liquidity is still fragile, the impact of the initial shock may be amplified and propagated to other market segments, such as sovereign bonds markets, which increases risks of spikes in U.S. long-term yields and of financial market and exchange rate volatility.[7]

The appreciation of the dollar due to the interest rate hike also affects the oil market. The Brent crude oil price fell by 3.2 percent on the announcement of the rate hike, pushing the oil price to the lowest levels in 7 years. The dollar is closely linked to the oil market in two ways. First, oil is priced in US dollars, such that appreciation of the US dollar would reduce the purchasing power of oil importing countries and, at the same time, impact revenues for exporters. Secondly, due to the interconnectedness of the currency and commodity markets, a stronger dollar prompts speculative traders to sell oil futures and other commodities and buy more of the U.S. currency, thus effectively dampening oil prices. The stronger dollar which has rallied for more than a year has contributed to the decline in oil prices in 2014/2015, affecting oil exporters such as Russia, Nigeria, and Venezuela.

As in the previous episodes of monetary policy tightening, the current wave of monetary policy tightening has heightened volatility in financial markets. Bond spreads have widened, while equity markets remain volatile in many emerging market economies. Most equity markets initially rallied on the policy decision, reflecting confidence in the US economy and the global economy in general. The MSCI emerging markets index firmed up by 0.6 percent while the Shanghai composite index climbed 1.8 percent on the Fed's announcement. However, many stock markets across the world have seen sell-offs early in early January.

Implications for African countries

The impact of the US interest rate hike on African countries - especially if it is followed by further rate hikes - could be severe. Many African countries such as Zambia, Ethiopia, Rwanda, Kenya, Ghana, Senegal and Ivory Coast, have borrowed in international capital markets in recent years through sovereign bonds. As such, further tightening of financial conditions could make financing more expensive, depending on the extent of debt that is denominated in US dollars.

Most African countries are already reeling under the effects of the decline in oil and other commodity prices. The US interest rate hike has further dampened oil prices, which has fallen to less than US$40 per barrel in December 2015 and further to less than $32 per barrel early January 2016. Oil exporters such as Nigeria, Angola, Cameroon, Equatorial Guinea, Congo Republic and others will feel the pinch, as export revenues are compressed, budgets are squeezed and current account deficits widen. Capital flows which have been affected in the run-

[7] World Bank, Global economic prospects, January 2015.

up to the rate hike could be weakened further. Combined with weaknesses in commodity prices, a gradual rise in global interest rates could affect FDI decisions especially in mining and exploration in some African countries.

Further strengthening of the US dollar emanating from the rise in US interest rates would further weaken African currencies. A lot of African currencies are already weak following the slump in oil and other commodity prices. Countries with ballooning debt and high exposure to global markets, such as Ghana, South Africa and Angola, will be most vulnerable, while other countries including Ethiopia and Kenya, which have some buffers, may cope somewhat better. Cote d'Ivoire's cost of debt could increase following the US interest rate increase, given that it has issued some foreign exchange denominated sovereign bonds in recent years.

Ghana, which has an unsustainable domestic- and foreign-debt burden could be most affected. Its debt-to-GDP level was over 71 percent as at June 2015, with much of the debt being short-term dollar-denominated bonds acquired over the past few years. The weakening of the Ghana Cedi could raise the real cost of servicing the debt. South Africa is also reeling from its own crises, compounded by lower commodities, energy constraints, weak investor sentiment, agricultural contraction and fiscal pressures. South Africa's credit rating was downgraded in December 2015 after the sudden change of finance minister. Gross government debt is projected to increase from 47.4 percent of GDP in 2015 to 49 percent in 2016, as growth is forecast to remain subdued at 1.3 percent in 2016. The South African rand has lost more than 45 percent of its value since January 2015, of which 3.7 percent was lost after the US interest rate hike. In Angola, the U.S. rate hike will compound a number of factors already dampening the economy, including the oil price slump and subsequent decline in exports and fiscal revenues. The current account deficit could widen to -5.6% of GDP in 2016[8]. Angola issued a US$1.5 billion sovereign bond in November 2015, and with the lift-off of US interest rates, the cost of refinancing could rise.

Conclusions and policy implications

The hike in US interest rates could spark financial market volatility, exacerbate capital outflows from emerging markets, weaken other currencies, and increase borrowing costs in the short-term. The most vulnerable countries are those with large external financing needs, high foreign currency debt levels, low foreign exchange reserves, and low monetary policy credibility. However, the impact could be limited compared with the taper turbulence of 2013 for several reasons: the current rate hike was well communicated and widely anticipated for some time and is in line with market expectations; the tightening is taking place at a time when other major central banks such as ECB and Bank of Japan are easing their monetary policy stances, such that global liquidity is less affected; and the Fed highlighted that further rate adjustments will be gradual.

Emerging and African economies may need some policy interventions to contain the effects of the rate hike. For commodity exporters which have already been affected by the decline in commodity prices, and have high foreign currency vulnerabilities, close monitoring of

[8] IMF World Economic Outlook, October 2015

prudential requirements and measures to restore confidence may be warranted. For countries that rely on capital inflows such as South Africa, Malaysia and Ghana, depending on the available policy leverage, could increase interest rates. Emerging market economies which are concerned about the balance sheet effects of currency depreciations may raise policy interest rates to stem depreciations, stock market declines and bond yield jumps, but this would require credibility of monetary policies. If the ensuing financial stress threatens financial stability, maybe due to large foreign currency liabilities, intervention in foreign currency markets through the use of international reserve or swap market operations may be necessary.

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