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Source: *The Business Times*, p19
Date: 18 October 2022

The long shadow of the Fed's rate hike on emerging Asia

By Xie Taojun and Liu Jingting

THE US Federal Reserve raised benchmark interest rates by 0.75 percentage points in September – the highest increase in decades. Other countries followed suit. The Monetary Authority of Singapore announced its fifth straight monetary policy tightening to curb inflation on Friday (Oct 14).

Recently, the United Nations warned against the risk of a recession induced by excessive monetary tightening.

How has the US monetary policy stance evolved and why may other countries worry about US rate hikes? The impacts on emerging economies are particularly relevant for Asia.

Recent episodes of QE

US monetary policy after the global financial crisis (GFC) has been largely accommodating. Between 2008 and 2015, the Fed kept its policy rate at a level close to zero. To stimulate the economy, the Fed actively engaged in quantitative easing (QE) to inject liquidity into the economy.

That was a honeymoon period for many emerging economies, including emerging Asia. Cash-rich investors looked to the region for higher returns. Cross-border investments rebounded to pre-GFC levels. Asian stock markets rallied. Such buoyant sentiment lasted until Q2 2013 when the Fed announced a slowdown of QE.

When Covid-19 hit in March 2020, the financial markets were again short of liquidity, just as in 2008. The Fed soon purchased US$1 trillion worth of treasuries in Q1 2020. The effective federal funds rate fell sharply from about 1 per cent to zero again. Policymakers of emerging countries followed, synchronously lowering interest rates to boost the economy.

This round of QE lasted until December 2021, when the Fed announced a tapering as inflation risks loomed large. While the world recovers from a pandemic-induced recession, emerging economies are particularly vulnerable to capital flights. Indonesia, the current G20 president, called in December 2021 for coordination in the new monetary policy tightening cycle, so as not to impede the post-pandemic recovery.

As US interest rate hikes reach fresh highs, it is worth taking a closer look at the key challenges to the emerging economies and the differences from past experience.

Liquidity contraction in emerging economies

US interest rate hikes and global financial market volatility often go hand in hand. Researchers have documented a "global financial cycle" in which US interest rate hikes trigger financial market volatility and depress asset prices globally.

Traditionally, a country can choose two out of the three options of free capital mobility, fixed exchange rate or monetary autonomy. This is the well-known macroeconomic trilemma that central banks have to deal with.

However, as global financial market integration deepens, most countries have chosen to keep their capital markets open. This means that investors are free to reallocate their funds to places with higher returns. Among the emerging economies, it is not uncommon that central banks try to strike a balance between monetary autonomy and exchange rate stability.

With an interest rate hike in the US, investors' flight to the dollar will tighten the liquidity conditions of emerging economies. For countries favouring stable exchange rates, the central banks have to let interest rates move in tandem with the US'.

The real economy will see slower growth as a result. With higher borrowing costs, firms will be discouraged from expanding production. Households will consume less as they reallocate their funds to various savings vehicles.

Dollar-debt servicing burden

What is different this time compared to the GFC period is perhaps the growing size of the corporate sector's dollar liability. In the years leading up to the GFC, dollar bank loans were the major source of emerging economies' dollar liabilities.

In the post-GFC years, low world interest rates encouraged companies to issue foreign currency bonds. Until now, dollar debt securities issuance by non-banks in the emerging and developing countries have exceeded dollar bank loans. As the US raises its interest rate and the dollar appreciates, the burden of servicing debt would be heavier on the corporates that issued dollar bonds.

Even with the local currency bonds issuance by the emerging economies' governments, the risk of volatile capital outflow when the dollar appreciates does not go away. Global investors who hold local currency bonds may still choose to sell these bonds for dollar assets, leaving the emerging economies with a plunge in bond price and a reduction of liquidity still.

Heightened inflation risks

For countries trying to maintain monetary autonomy, currency depreciation is inevitable. Prices of imports will rise, adding pressure to the already heated inflation. Oil-importing emerging economies will feel the pain more keenly as commodity prices reach fresh highs recently.

Singapore posted a headline inflation rate of 7.5 per cent year on year for August, Thailand's was 7.86 per cent, while Indonesia's annual inflation stood at 5.95 per cent in September – all at record highs over recent years.

Such inflationary pressure was not seen in the Fed's tapering in the past: After the Fed's tapering of QE at end-2013, oil prices plunged in mid-2014 as US shale oil production boomed.

Policy options

The Fed has hinted at keeping its policy rate high. As central banks simultaneously tighten monetary policy to contain inflation, interest rates will likely remain high for longer outside of the US as well.

Higher interest rates curb demand-driven inflation but hamper economic growth. Relying on fiscal stimulus to boost the economy would be countervailing as it contributes to inflation. Emerging economies may need to look elsewhere for post-pandemic growth.

To sustain investments, fostering the growth of promising emerging industries would be strategic. The drive for sustainability and green finance that took off in 2015 offers good opportunities for many. Artificial intelligence, virtual reality, and cybersecurity are among some of the other hot emerging industries of the day.

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