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OPINION | COMMENTARY

## How U.S. Interest Rates Influence the World Economy

Advanced economies welcome the Fed's move, but many emerging markets may face trouble.

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After keeping financial markets in suspense for months, the U.S. Federal Reserve finally acted on Wednesday by raising its benchmark interest rate by a quarter percentage point.

Financial markets world-wide, including in Asia, not only took the move in stride but were buoyed by it. After all, the move was widely anticipated, signaled the Fed's confidence in the durability of the U.S. economic recovery and came with the assurance that U.S. monetary policy would remain accommodative. Yet there are reasons to worry about the fallout.

It's not because the Fed's action is likely to cause any emerging-market economies to tip over into balance of payments or currency crises. Most of these economies now have lower external-debt levels compared to the levels they experienced prior to past crises. Many also have more flexible exchange rates, which act as shock absorbers, and larger stashes of foreign-exchange reserves than they did in the past.

The Fed's action is a net positive for emerging markets in Asia and elsewhere. It erases some uncertainty that had added to short-term volatility in capital flows and currencies, and cushions the blow with a dovish statement about future rate hikes.

But for all its power and influence, the Fed isn't the only central bank that matters. While the Fed's move removes one source of short-term uncertainty, it highlights the stark divergence in business-cycle conditions and monetary



New York Stock Exchange building. PHOTO: SPENCER PLATT/GETTY IMAGES

policies between the U.S. and virtually every other major advanced and emerging-market economy. This portends further volatility in global currency markets and international capital flows, which could have whiplash effects for countries exposed to these crosswinds.

The Fed's move is likely to be welcomed by central banks in other advanced economies, particularly the European Central Bank and the Bank of Japan, which are eager to weaken their currencies in order to boost their flagging economies and push up domestic inflation. This will exacerbate the asymmetry in global exchange rates, leading to further and more persistent strength in the U.S. dollar relative to every other major currency.

Concerns about a massive pullback of capital from emerging markets are probably overblown. After all, this was just a quarter percent hike in U.S. short-term interest rates. Once the dust settles, the Fed's action alone is unlikely to cause major portfolio rebalancing among international investors.

However, this rate hike reminds emerging-market economies with weak fundamentals that their room for maneuvering has been reduced even more, leaving them with little choice but to push through essential reforms. A surging dollar could create macroeconomic stress in countries that have accumulated high levels of dollar-denominated corporate debt. And it will certainly add to the difficulties that economies such as Brazil, Russia, Turkey and Venezuela are already facing as a result of economic mismanagement, weak commodity prices and political instability.

Among the Asian emerging market economies, India is well positioned to weather the effects of the Fed rate hike. Its economy still has growth momentum and room to tolerate some currency depreciation without adverse domestic consequences.

What will the Fed's actions do to China? Last week, the People's Bank of China

signaled that it was preparing to put into practice what it has been doing in principle since its currency was depegged from the dollar in 2005: manage the yuan's value against a basket of currencies. In reality, the yuan has remained tightly managed relative to the dollar. This has created complications for domestic macroeconomic management as the dollar strengthened against other currencies over the past year, lifting along the yuan, even while the Chinese economy was losing momentum.

Managing the yuan's value relative to a basket of currencies rather than just the U.S. dollar makes good economic sense and would allow China a smoother transition to a more market-determined exchange rate. It would also provide cover for the PBOC to orchestrate an orderly depreciation of the yuan without spooking markets by appearing to devalue the currency to prop up growth.

The risk is that domestic and foreign investors may not buy this, since they still lack confidence in the Chinese government's economic management. This could trigger another wave of capital outflows, adding to instability in the region.

For China and other emerging market economies, the right response isn't to recalibrate monetary policy or instituting capital controls to fend off volatility. Rather, it is to rebuild confidence by delivering on financial-market reforms to improve resource allocation, as well as implementing supply-side reforms to boost productivity and promote more balanced growth. The Fed's action warns policy makers in these countries that time is short.

Now that the Fed has acted, attention will quickly turn to the next pressing question: What will China do? That may be the more consequential question for Asia, if not the world.

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