



**ISLAMIC DEVELOPMENT BANK**

**CURRENT ISSUE PAPER**

**THE NORMALIZATION OF U.S. MONETARY POLICY: IMPLICATIONS  
FOR IDB MEMBER COUNTRIES**

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## Executive Summary

1. The highly accommodative monetary policies in advanced economies following the global financial crisis of 2008-09 have supported the recovery in the U.S. and other advanced economies. Different perspectives with regard to exiting from such policies create a challenge for financial stability, while recovery of the global economy is still to firm up.
2. Amid improving macroeconomic conditions in the U.S., the Federal Reserve is expected to start moving up policy rates at the end of 2015. In contrast, monetary policies in the Euro area and Japan are easing further. Consequently, the U.S. dollar has significantly appreciated against major currencies since the second half of 2014.
3. The normalization of U.S. monetary policy is likely to affect emerging market economies through capital outflows, exchange rate volatility and a tightening of domestic and external financing conditions (in form of bond yields and reduced liquidity). It will create different challenges to IDB member countries, depending on their exchange rate regime, reliance on commodity exports, and exposure to financial markets.
4. For oil exporters, the tightening of financial conditions could further compound the contractionary effects of reduced income resulting from the oil price slump. Additionally, countries with a U.S. dollar-pegged currency (GCC countries essentially) are recording a real appreciation, which erodes competitiveness in the non-oil sector. Other oil exporters face pressures over currency depreciation, as their external position weakens (Azerbaijan, Kazakhstan, Algeria, and Nigeria) or their currency anchor depreciates (Gabon).
5. Oil importers generally present a positive outlook. Countries with improved external position and relatively low debt levels (Pakistan, Cote d'Ivoire, and Morocco) have an opportunity to deepen reforms aimed at enhancing productivity and social inclusion. For countries with a relatively high external debt (Kyrgyz Republic, Jordan, Lebanon) or heavy dependence on other commodity exports (Indonesia, Malaysia, Uzbekistan), the tightening of financing conditions will probably outweigh the benefit of lower oil prices.
6. In the face of multiple external shocks, there is no "one-size-fits all" policy approach for IDB member countries. The resilience or capacity to adjust will depend on the structural features of each economy, including the degree of economic diversification, the exchange rate regime, the size of fiscal buffers, access to financial markets etc.
7. Fiscal consolidation is a key recommendation to adjust to lower income and tightening financing conditions. It is especially important for countries lacking flexibility in their monetary instruments, due to fixed exchange rate regimes. Over the medium term, member countries need to accelerate the implementation of diversification strategies, allowing the private sector to play an increasing role in the economic activity and jobs creation.
8. The drop of oil revenue and the potential decline in financial inflows in many of the IDB's high-income and upper-middle-income member countries imply some additional challenges for the Bank in mobilizing resources to address the clients' needs. Against this backdrop, there are opportunities for the IDB Group to enhance its catalyst role in providing development solutions to member countries. In this regard, it is critical to explore further innovative approaches based on blended finance and partnership with various stakeholders to leverage and catalyze public and private sources of financing.

## Introduction

The highly accommodative monetary policies in advanced economies following the global financial crisis of 2008-09 have supported the recovery in the United States and other advanced economies. Zero lower bound policies strengthened by quantitative easing programs have also contributed to an increase in capital inflows particularly in emerging market economies (EMEs). Different perspectives with regard to exiting from such accommodative policies create further challenge for financial stability, while recovery of the global economy is still to firm up (Caballero & al., 2015).

As the U.S. economy improves, the Federal Reserve (Fed) is expected to start normalizing its monetary policy through increasing policy rates. The anticipation of Fed's liftoff is putting substantial pressures on currency markets. Its possible spillovers on emerging market economies are a major source of concerns, as historically, periods of sharp U.S. dollar appreciation have been associated with an increased number of external crises in emerging markets (IMF, 2015a).

This policy brief explores the implications of U.S. monetary policy liftoff on IDB member countries, especially the EMEs. It firstly describes the uneven pace of recovery among advanced economies and discusses the resulting divergence of monetary policies, focusing on the Fed's anticipated liftoff.

## Uneven pace of recovery among advanced economies

After its rebound to 4 percent in 2010 from the recession of 2009, global growth has remained subdued over the last five years. In 2015, it is expected to decline to 3.1 percent from 3.4 percent in 2014<sup>1</sup>. This growth slow down reflects the declining trend in EMEs while in the advanced economies, activity is gradually firming up, though at an uneven pace (see Figure 1).

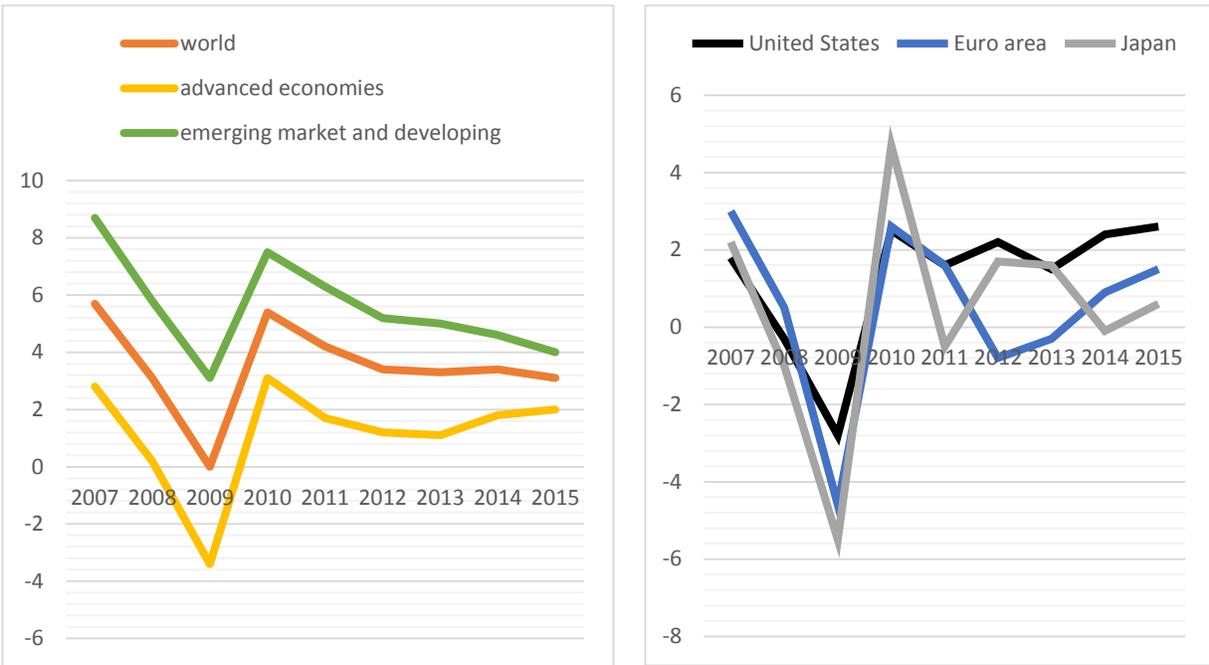
Among advanced economies, the United States experienced a relatively solid performance over the last five years, compared to the Euro area or Japan. U.S. growth is projected to firm up to 2.6 percent in 2015 from 2.4 percent in 2014; and to further accelerate to 2.8 percent in 2016. In the Euro area, growth increased to 0.9 percent in 2014 after a recession in 2012-13. It is expected to rise to 1.5 percent in 2015. Japan's real GDP growth remained weak and volatile over the last five year. The activity is expected to increase by only 0.6 percent in 2015<sup>2</sup>.

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<sup>1</sup> IMF World Economic Outlook (WEO) October 2015

<sup>2</sup> Ibid.

**Figure 1: Recent Trends in Global Growth**



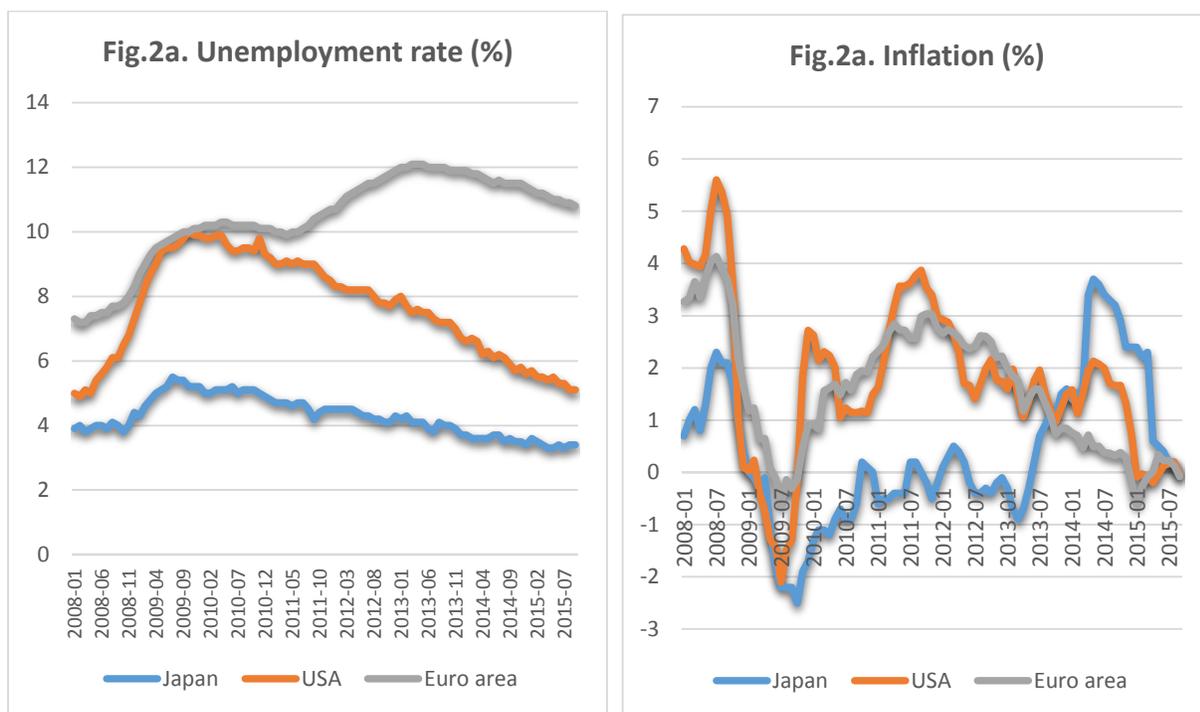
Source: data from the IMF World Economic Outlook, October 2015.

The U.S. labor market also gained momentum in recent months. U.S. unemployment rate declined to 5.4 percent in April 2015, the lowest since May 2008. It further slumped to 5.1 percent in September and was essentially unchanged at 5.0 percent in October<sup>3</sup>. The unemployment rate was stable in the euro area, at 10.8 percent in September 2015, down by 0.6 percentage point year-on-year. Despite a weak growth performance, unemployment remained low in Japan, below 3.5 percent since February 2015 (Fig. 2a).

Inflation is projected to decline from 1.3 percent in 2014 to 0.3 percent in 2015 in advanced economies, reflecting primarily the impact of lower oil prices. It is projected to rise in 2016 and thereafter, but to remain generally below central bank targets. In the U.S., inflation declined sharply in late 2014 and early 2015 (Fig.2b). Annual inflation is projected to decline to 0.1 percent in 2015 from 1.6 percent in 2014. In the euro area, inflation remained below 1 percent since end-2014. It is expected to be 0.2 percent in 2015, slightly lower than in 2014. In Japan, inflation came in roughly flat since April 2015, amid spending slump. Annual inflation is expected to decline to 0.7 percent in 2015 from 2.7 percent in 2014.

<sup>3</sup> U.S. Bureau of Labor Statistics ([www.bls.gov](http://www.bls.gov)).

**Figure 2: Monthly Unemployment and Inflation rates for the U.S., Japan and the Euro area**



Source: OECD data, October 2015

## The normalization of U.S. monetary policy

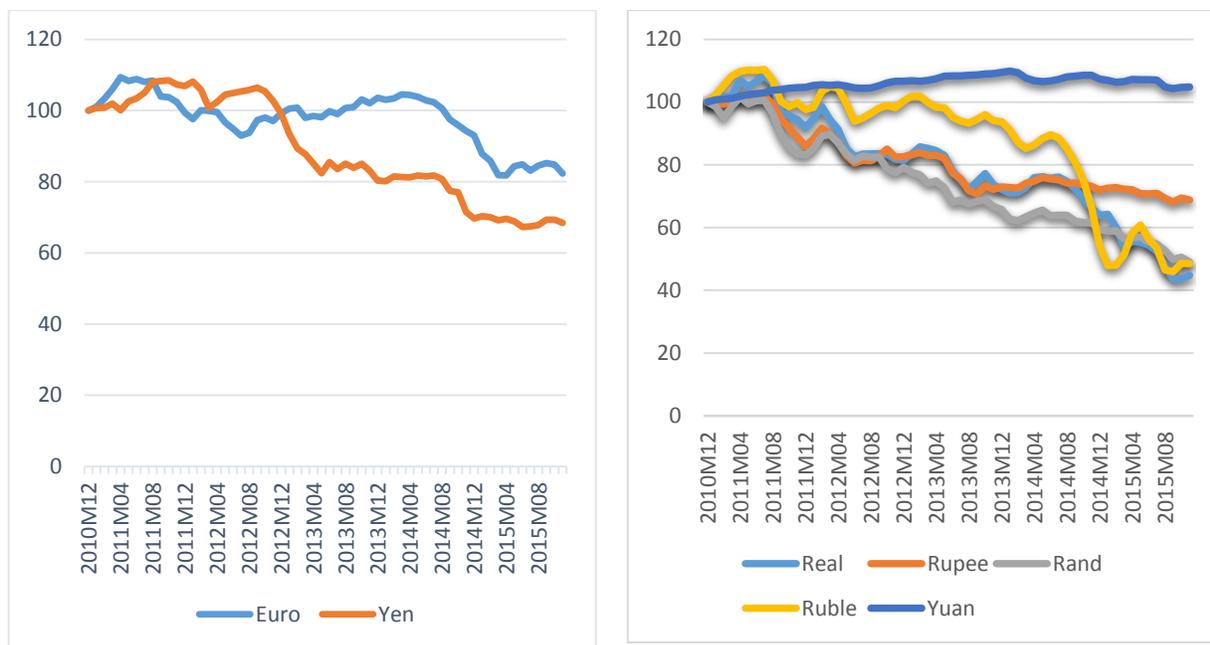
Amid improving macroeconomic conditions, monetary authorities in the United States have begun to withdraw unconventional monetary policy stimulus—with the Federal Reserve concluding its asset purchase program in late 2014. The Fed had maintained the target range of the federal funds rate unchanged at 0-0.25 percent since the end of 2008, in response to the global crisis. Current expectations, supported notably by the labor market data, are that policy rates in the US are likely to start moving up at the end of 2015 (Arteta & al., 2015).

In contrast, monetary policies in the Euro area and Japan are easing further. In October 2014, the Bank of Japan announced its decision to expand its quantitative easing (QE) program through purchase of government bonds worth 80 trillion yen per year. Starting from March 2015, the European central bank (ECB), has embarked into an ambitious QE program, the ECB is committing to a QE program worth 1.1 trillion euros. Its monthly purchases will rise from around €13 billion (\$14 billion) to €60 billion, and last until at least September 2016<sup>4</sup>.

<sup>4</sup> World Bank, Global Economic Monitor.

Reflecting these divergences in the outlook and expected monetary policies, the U.S. dollar has significantly appreciated against major currencies, especially the euro and the yen, since the second half of 2014. As for EMEs, China and to a less extent India managed to maintain a stable exchange rate. The currencies of other major emerging economies (including the Russian ruble, the South African rand, and the Brazilian real)<sup>5</sup> fell to multi-year lows against the U.S. dollar (Figure 3).

**Figure 3: Exchange Rates (monthly average, US\$ per national currency (2010Dec=100))**



Source: The World Bank, Global Economic Monitor data (November 2015), and author's calculations.

## Implications for IDB Member Countries

The normalization of U.S. monetary policy is likely to affect emerging market economies through exchange rate volatility and a tightening of domestic and external financing conditions -- in form of bond yields and reduced liquidity -- (IMF, 2015b). It will create different challenges to IDB member countries<sup>6</sup>, depending on their exchange rate regime, reliance on commodity exports -- especially oil-- and exposure to financial markets.

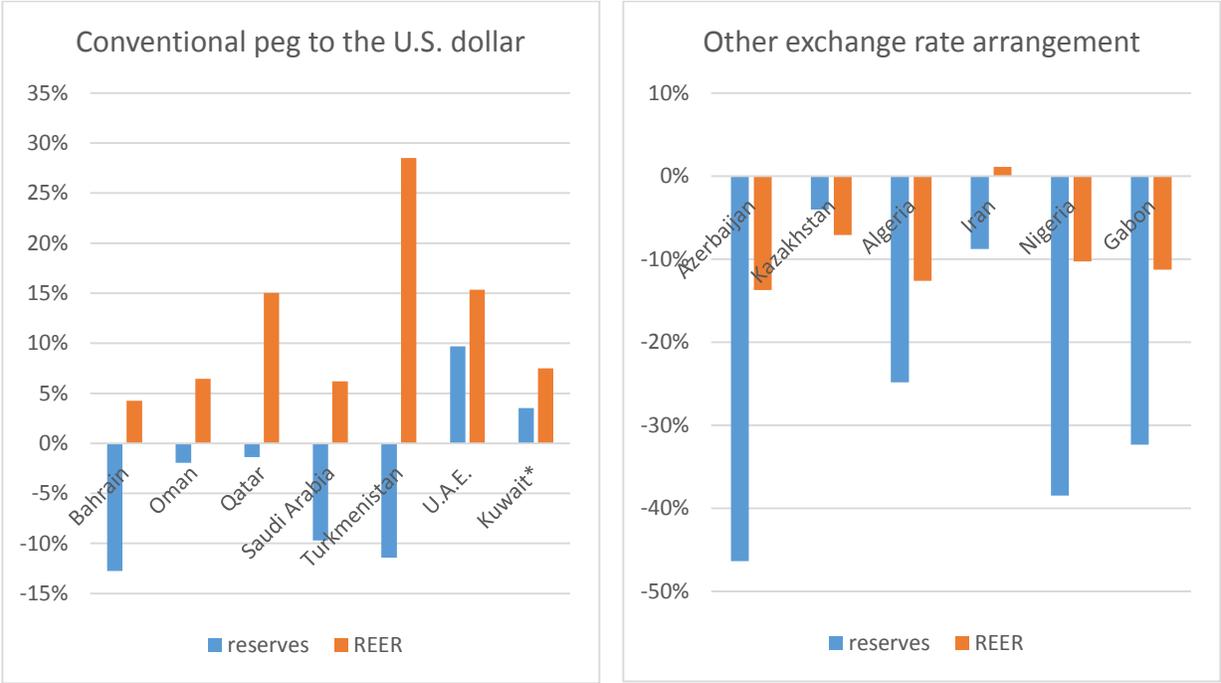
<sup>5</sup> The five EMEs mentioned are referred to as the BRICS. Other large EMEs like Turkey and Indonesia also experienced significant depreciation of their currency.

<sup>6</sup> As the focus is on emerging market economies, the analysis will mainly concern the 31 Non Least Developed Member Countries (Non-LDMC-31) among which 16 are Oil-Exporters according to IMF classification. Brunei, Iraq, Libya, Suriname and Syria are excluded for data issues.

The tightening of financial conditions is expected to be more challenging for oil exporters to the extent that it further compounds the deterioration of the current account balance due to the oil price slump (Husain & al., 2015). As a result, reserve assets are declining sharply (Figure 4). Notwithstanding the loss of reserves, countries with a U.S. dollar-pegged currency (GCC countries essentially)<sup>7</sup> are recording an appreciation of the exchange rate, which erodes competitiveness in the non-oil sector. For such countries, fiscal consolidation aimed at moderating the domestic demand is critical to achieve real adjustment, given the constraints on monetary adjustment.

Oil exporters not pegging to the U.S. dollar will face pressures over currency depreciation, as their external position weakens (Azerbaijan, Kazakhstan, Algeria, and Nigeria) or their currency anchor depreciates (Gabon). The exchange rate depreciation could partially offset the loss of revenue in national currency and support competitiveness in non-oil sectors, but fiscal adjustment will also be required over the medium term to limit the depletion of reserves, especially for countries with limited access to external borrowing.

**Figure 4: Oil exporters -- change (%) in Foreign Exchange Reserves and in the Real Effective Exchange Rate Index (2014-15/2013-14)**



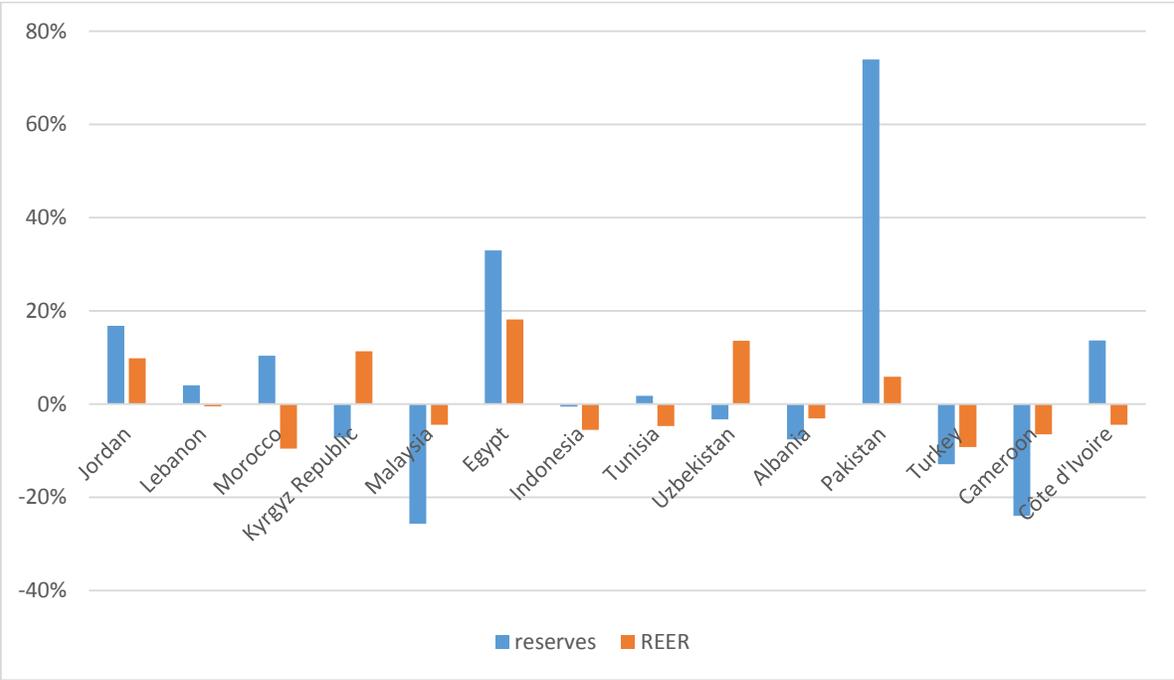
Source: EIU database (October 2015) and author’s calculations.

<sup>7</sup>The United Arab Emirates (UAE) are expected to record an increase in foreign exchange reserves in 2015-2016, but the growth would slow to 10 percent, from 74 percent in 2013/14. For Kuwait, the growth in reserves would slow to 4 percent in 2015-16 from 12 percent in 2013-14. Kuwait’s exchange rate regime is a conventional peg to a basket of currencies. Nevertheless, the Kuwaiti Dinar moves closely with the U.S. dollar.

Most of the oil importers among IDB member countries have not formally pegged their currency to the U.S. dollar. Such countries can benefit a real depreciation to the extent that inflation pressures remain under control. This depreciation is likely to enhance competitiveness, even though the direct external gain from lower oil prices may be reduced. The trade-off will also depend on the size of the external debt.

For some oil importers, the external position may improve as the gain from lower oil price and from structural reforms could overcome the effect of tightening financing conditions (Pakistan, Morocco, Egypt and Cote d'Ivoire). However, it may not be the case for some countries with large commodity exports such as Malaysia, Indonesia or Uzbekistan, which see a reduction in their foreign exchange reserves due to lower export income (Figure 5).

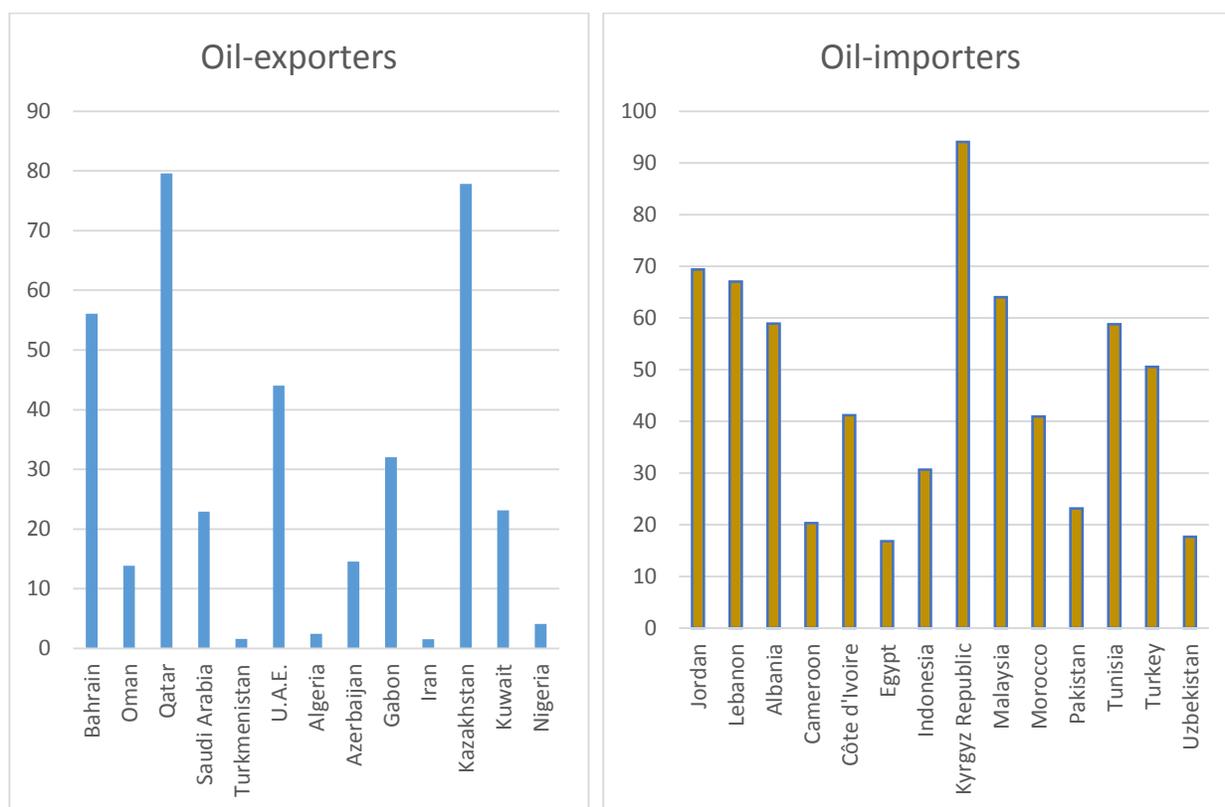
**Figure 5: Oil importers -- change (%) in Foreign Exchange Reserves and in the Real Effective Exchange Rate Index (2014-15/2013-14)**



Source: EIU database (October 2015) and author's calculations

For countries with a large debt stock, an increase in the debt service (in national currency) can further deteriorate the external position. Likewise, the tightening of financing conditions and exchange rate volatility could increase debt at risk in some countries (IMF, 2015a). Among oil exporters, Qatar and Kazakhstan present the highest level of foreign debt with an average around 80 percent of GDP over the last three years (Figure 6). Inside the group of oil importers, Kyrgyz Republic could be particularly exposed to external financing conditions given the large size of its foreign debt (94 percent of GDP on average).

**Figure 6: Total foreign debt as a share of GDP (%) –2012-14 average**



Source: EIU database (October 2015) and author's calculations

## Conclusion

As the international community is preparing to implement the post-2015 agenda on sustainable development, IDB member countries are facing different challenges in relation to the slump in oil prices, weak global outlook and local conflicts. The prospective normalization of U.S. monetary policy, the related capital outflows from emerging market economies and the appreciation of the U.S. dollar will further compound those challenges.

In the face of multiple external shocks, there is no “one-size-fits all” policy approach for IDB member countries. The resilience or capacity to adjust will depend on the structural features of each economy, including the degree of economic diversification, the exchange rate regime, the size of fiscal buffers, access to financial markets etc.

As a rule of thumb, fiscal consolidation is a key recommendation to adjust to lower income and tightening financing conditions. It is especially important for countries lacking flexibility in their monetary instruments, due to fixed exchange rate regimes (GCC countries essentially).

Oil importers generally present a positive outlook. Countries with improved external position and relatively low debt levels (Pakistan, Cote d'Ivoire, and Morocco) have an opportunity to deepen reforms aimed at enhancing productivity and social inclusion through higher quality and better-targeted expenditures. For countries with a relatively high external debt (Kyrgyz Republic, Jordan, Lebanon) or heavy dependence on other commodity exports (Indonesia, Malaysia, Uzbekistan), the tightening of financing conditions will probably outweigh the benefit of lower oil prices. As a result, fiscal consolidation will have to be implemented as well. This will make structural reforms particularly difficult to put forward.

Over the medium term, member countries need to accelerate the implementation of diversification strategies, allowing the private sector to play an increasing role in the economic activity and jobs creation. Improving the business environment and strengthening the institutional framework will be instrumental in this regard.

The drop of oil revenue and the potential decline in financial inflows in many of the IDB's high-income and upper-middle-income member countries imply some additional challenges for the Bank in mobilizing resources to address the clients' needs. Against this backdrop, there are opportunities for the IDB Group to enhance its catalyst role in providing development solutions to member countries. In this regard, it is critical to explore further innovative approaches based on blended finance and partnership with various stakeholders to leverage and catalyze public and private sources of financing.

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