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Interest rate explosion – are developing countries and emerging economies the losers?

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The collapse of Silicon Valley Bank and the emergency sale of Credit Suisse alarmed the global financial sector. The effects of inflation and interest rate hikes by major central banks are far from over – further liquidity bottlenecks are imminent. The situation is even more difficult for developing countries and emerging economies. They have little monetary and fiscal leeway, but suffer severely from the effects of the restrictive monetary and interest rate policies of industrialised countries. How did the current situation come about and what effects and hazards is it causing?

Low interest rate policy phase

As a result of the 2008 financial crisis and the 2013 European debt crisis, the major central banks in the US and Europe pursued a sustained low or zero interest rate policy. Developing countries and emerging economies also benefited from this expansionary monetary policy for a long time. Investors were looking for higher returns in countries with a riskier market environment. Companies were sufficiently liquid to become active in new markets. Investors saw new growth opportunities in which they wanted to participate. In addition, low interest rates also helped countries to lower their debt burdens.

Inflation phase

Even before the coronavirus pandemic, there was emerging evidence that the policy of "cheap" money was coming to an end. Speculation bubbles had formed on the equity and real estate markets, and the value of money became increasingly diluted. The value of money inevitably had to be fixed in order to stop inflation from weakening the purchasing power of income and assets. The coronavirus pandemic acted as an accelerator. Economic growth collapsed in many countries due to low demand. At the same time, inflation increased. The reason for this was a supply backlog – due to bottlenecks in production and supply of goods, prices rose, particularly for raw materials, building materials and electronics. Finally, the Russian war of aggression on Ukraine led to an abrupt and very steep rise in energy and food prices, thus pushing inflation to levels that have not been seen in a long time.

The end of low interest rate policy

To counteract this trend, the US Federal Reserve (Fed) and the European Central Bank (ECB) abruptly raised interest rates from spring 2022 onwards. This led to an appreciation of the key currencies and a shift in global financial and investment flows towards industrialised countries. The US dollar benefited from the interest rate hikes and appreciated against other currencies. As a result, imports became cheaper for the US, which had a positive impact on inflation in the United States, among other things.

Effects on developing countries and emerging economies

The effects of the coronavirus pandemic had already led to a significant increase in government bond issuance and a general increase in debt. These countries issued a record amount of USD 3.5 trillion in debt on the financial markets in 2021, around 40% more than the three-year average before the pandemic.

In response to high inflation (often due to higher energy and food prices for imports), the depreciation of local currencies against the US dollar and capital outflows, many central banks in developing countries and emerging economies have also raised key interest rates significantly. However, policymakers, who already have fewer monetary and fiscal instruments at their disposal, are often hardly able to act and face a dilemma: If they keep interest rates low, they fuel inflation or weaken their currency. If they raise interest rates, they jeopardise economic activity and growth.

In order to take actions that avoid a deep recession, those responsible in developing countries and emerging economies must therefore strike a balance between monetary policy and national debt. The special challenge is that managers of international equity funds are drawing money from emerging markets, and insurance groups are withdrawing from government bonds. Higher yields in developed markets – due to interest rate hikes – now make emerging market bonds less attractive.

Conclusion

In order to ensure that developing countries and emerging economies do not become the losers in interest rate policy through no fault of their own, the major central banks must take greater account of the global ripple effects of their policies. There is not only a risk that the positive developments of previous years will be wiped out, but also that the situation in regions such as Eastern Europe, Latin America and Africa, in particular, will continue to intensify in the coming years. Preventing long-term damage will require a dual strategy. Developing countries and emerging economies can create better conditions for private capital through bold structural reforms. However, the international donor community must also provide stronger financial stimulus as long as high interest rates and high inflation continue. ■

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