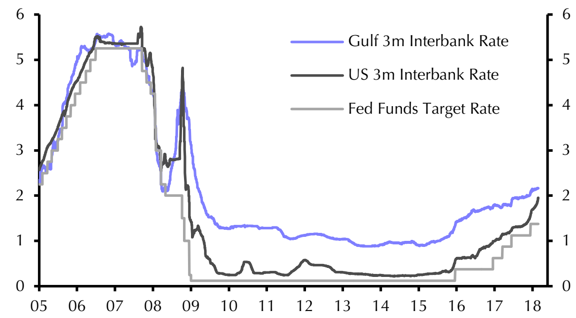
# MENA ECONOMICS UPDATE

## What do higher US interest rates mean for the Gulf?

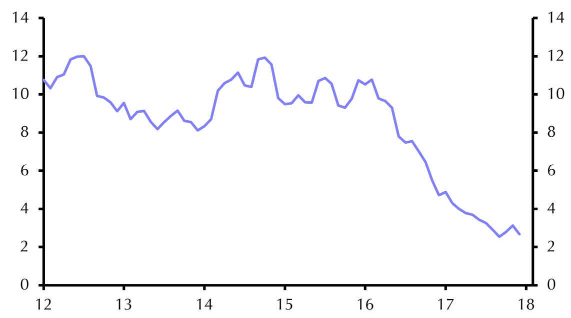
- **The Gulf's dollar pegs mean that further rate hikes by the US Federal Reserve will be imported into the region, keeping a lid on credit growth and pushing up government borrowing costs. This is unlikely to derail the economic recovery but it is another reason to expect economic growth to stay subdued.**
- The upbeat tone of new US Federal Reserve Chair Jerome Powell's testimony to the House earlier today suggests that another 25bp interest rate hike at the FOMC's meeting in March is a near-certainty. And with fiscal stimulus on the way, we now expect the Fed Fund's target rate to be raised to 2.75-3.00% by end-2019, from 1.25-1.50% at present.
- For the Gulf countries, the main concern is that they will have to import tighter monetary policy from the US. **The region's commitment to dollar pegs and free movement of capital means that these countries are forced to adopt US monetary policy**. Otherwise, by virtue of the so-called "impossible trinity", capital would flow abroad. So when the Fed raises rates the Gulf economies have to follow suit.
- Admittedly, interbank interest rates in the Gulf have risen at a slower pace than those in the US in recent years. (See Chart 1.) That has reflected a narrowing of spreads as fears of currency devaluations faded. But as we argued recently, that process has probably now gone too far. **If we are right in expecting oil prices to drop back and geopolitical tensions to linger, spreads are likely to widen again meaning that interest rates in the Gulf are likely to rise at a faster pace than those in the US over the next couple of years**.
- There are two main channels through which higher interest rates will affect the Gulf economies. **First, rising borrowing costs are likely to weigh on credit growth**. On the face of it, the onset of Fed rate hikes in late-2015 was the trigger for a sharp slowdown in credit across the region. (See Chart 2.) But this is a somewhat misleading picture. Credit growth was propped up in 2014-15 as delayed payments from governments on the back of the collapse in oil prices forced firms to turn to banks for temporary financing.
- Policymakers could try to mitigate the impact of higher interest rates by relaxing macro-prudential policies or lowering reserve requirement ratios. Even so, a backdrop of rising interest rates and low oil prices means that credit is unlikely to provide significant support to economic growth over the coming years.
- **Second, higher government borrowing costs are likely to put pressure on fiscal positions**. Most countries have turned to debt issuance in recent years to finance budget deficits and, as a result, debt-to-GDP ratios have risen. The effect on the overall fiscal position could be offset by the higher yield that Gulf sovereigns would receive on their large holdings of US Treasuries.
- Those countries with large debt burdens and smaller FX savings – notably Bahrain – are most vulnerable to a rise in borrowing costs and may be forced to implement fresh austerity measures in order to prevent budget deficits from widening.
- **Overall, rising interest rates are unlikely to derail the Gulf's economic recovery this year**. The impact should be more than offset by slowing austerity as well as the fading drag from last year's OPEC-agreed oil output cuts. **That said, it's another reason to think that GDP growth will remain weak by past standards.**

**Chart 1: Interest Rates (%)**




Sources: Thomson Reuters, Capital Economics

**Chart 2: Gulf Private Sector Credit (% y/y)**




Sources: CEIC, Capital Economics

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