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# MENA Pulse

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## KEY FACTS

- **The Federal Open Market Committee (FOMC) decided to increase its key policy rate by 25 basis points to 1.75% at its March 20-21 meeting.**

- **We forecast US interest rates based on different monetary policy rules, concluding that rates will go up somewhat less than markets are expecting, with the fed funds rate peaking below 3%.**

- **Given their fixed exchange rate pegs to the US dollar, GCC central banks will be forced to follow the Fed's lead. Local interest rates will likely rise in line with those in the US over the next 24 months.**

## Interest rates set to rise further

Welcome to the second edition of MENA Pulse. The focus this month is on the US Federal Reserve's recent interest rate hike and its implications for the GCC countries.

There is no doubt that both global and local interest rate developments are of the utmost importance to our clients – and to investors and consumers in the Gulf region in general.

The analysis undertaken by Lars Christensen and his team at Markets & Money Advisory shows that the Fed is likely to continue hiking interest rates in 2019 and 2020.

Given the pegged exchange rate policies of GCC countries, their central banks will automatically 'import' any changes in US interest rates.

That said, the Federal Reserve does not solely determine GCC interest rates. The analysis also shows that oil prices play a key role in shaping the spread between GCC and US rates.

We hope you will enjoy MENA Pulse and look forward to discussing its contents with you.

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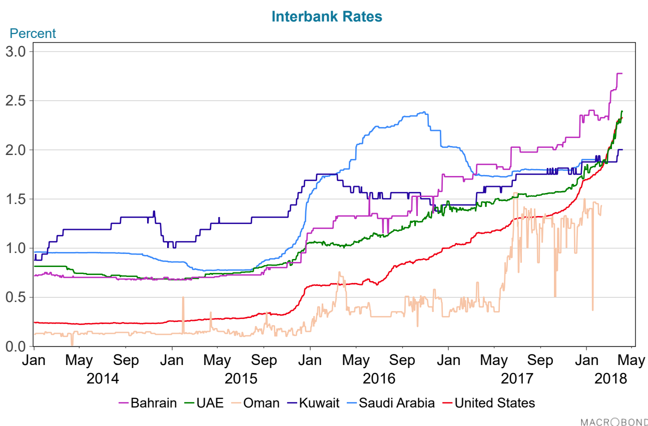
## The Federal Reserve set to continue hiking interest rates

Jerome Powell has taken over from Janet Yellen as the new Federal Reserve chairman, and at his very first Federal Open Market Committee (FOMC) meeting on March 20-21, he (and the rest of the FOMC) decided to hike the Fed's key policy rate by 25 basis points to 1.75% and signalled that more rate hikes are coming.

In this edition of MENA Pulse, we take a closer look at the outlook for interest rates in the US – and therefore also for the GCC countries as well. As nearly all of the GCC currencies are pegged to the US dollar, there is a very close relationship between monetary policies and conditions in both places. In fact, we have already seen that the GCC central banks have followed the Fed's lead and hiked interest rates further.




## Powell has signalled a more rules-based approach

It is clear that Jerome Powell does not want to rock the boat. Yet he appears determined to move Fed policy toward a more rules-based approach than was typical under the leadership of Yellen and Ben Bernanke, who both seemed to prefer a more discretionary style.

On February 27, Powell submitted the Federal Reserve's annual Monetary Policy Report to the US Congress, where he also testified.

In his written testimony, Powell had this to say, among other things:

*'In evaluating the stance of monetary policy, the FOMC routinely consults monetary policy rules that connect prescriptions for the policy rate with variables associated with our mandated objectives. Personally, I find these rule prescriptions helpful. Careful judgments are required about the measurement of the variables used, as well as about the implications of the many issues these rules do not take into account. I would like to note that this Monetary Policy Report provides further discussion of monetary policy rules and their role in the Federal Reserve's policy process.'*

Five monetary policy rules are highlighted in the Monetary Policy Report – all variations of different types of Taylor rules. The Taylor rule, as formulated by Stanford University economist John Taylor , stipulates that the central bank should move its key policy rate up and down with inflation, relative to the inflation target and the output gap. Hence, if inflation and/or economic activity increases (decreases), then the Fed should hike (cut) its key policy rate.

In the Fed's formulation, it uses an unemployment gap (the difference between actual unemployment and the natural rate of unemployment) rather than an output gap.

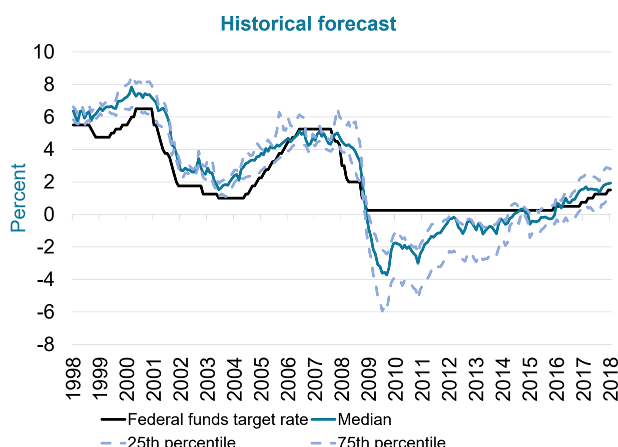
Inspired by the Monetary Policy Report, we have made our own list of policy rules, which overlaps with the Fed's list.

The rules are: 1) a Taylor rule; 2) a balanced rule (or a Taylor rule that reacts more aggressively to changes in unemployment); 3) a price level target rule (a Taylor rule that takes historical misses of the inflation target into account); 4) a so-called Mankiw rule (where the key policy rate is determined by the difference between core inflation and unemployment), and 5) a nominal GDP target rule (in which we assume a rolling target for NGDP based 2% inflation and an estimate for potential real GDP).

Our first three rules are the same as the Fed's.

In calculating each rule, we use our own estimates of the so-called natural interest rate. We have also used both headline and core inflation for the first three rules. That gives us a total of eight variations of the policy rules. While all these policy rules have followed a similar pattern historically, at any specific point in time significant variations between them can occur.

The graph below shows the median (and the 25th and 75th percentile) 'forecasts' for each of the eight different rules and the actual fed funds rate historically.




As the graph shows, the 'median' rule has tracked the ups and downs in the US policy rate rather closely – particularly when we look at the direction.

Given the present monetary stance, it is particularly notable that the median rate forecast has tracked the actual rate changes in the Fed's present 'hiking cycle'. The first rate increase came in December 2015, and this more or less exactly coincided with the moment when the median rate rose above zero, after having been negative since late 2008.

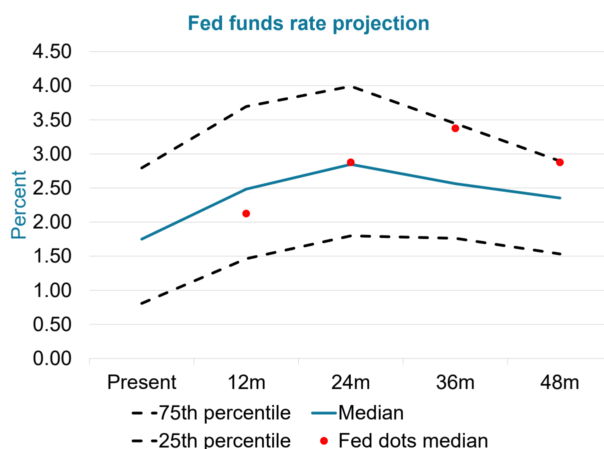
## US rates will peak at less than 3% in this cycle

Since the new Fed chairman has stated so clearly that he tracks a set of policy rules when making rate decisions, it makes sense to use such policy rules to forecast the future path for rates. This we have done.

Our rate forecasts are based on the following assumptions.

First, we use our own forecasts for core and headline inflation. Both are expected to rise slightly above the Fed's 2% inflation target in the medium term. This is quite close to the Fed's own forecasts.

Second, we use the FOMC's forecast for unemployment in 2018-2020, which sees the jobless rate falling gradually to 3.6%. Beyond 2020, we assume unemployment starts to increase gradually to 4.5%, in line with the Fed's assumptions about the natural rate of unemployment.




Our simulations show that the main scenario is for the Fed to hike its key policy rate to close to 2.5% over the next 12 months. The tightening could occur, for example, through two more 25bp increases this year and another 25bp hike in the first quarter of 2019. This is in line with what the Fed has been signalling and with market pricing.

Perhaps more interestingly, our simulations indicate somewhat less upside for interest rates in 2019-2020 than the Fed has indicated. They put the fed funds rate at somewhere between 2.75% and 3.00% within the next 24 months, meaning that we should probably not expect rates to increase by more than 100bp from the present level.

It should be noted that these simulations assume that US unemployment will drop to 3.6% in early 2020. While this is not completely unrealistic, we think the risks to this assumption are skewed to the upside. That suggests the interest rate path could be lower, particularly during 2019.

On balance, we think it more likely that US rates will not rise above 3% over the next 24 months. Furthermore, as we assume that the unemployment rate will begin to rise to 4.5% after 2020, the fed funds rate should probably converge towards 2.50%.

This is lower than the median expectations of FOMC members, who expect the fed funds rate to converge towards 2.90% in the long term.

Evidently there is some inconsistency between US policymakers' expectations about inflation and unemployment and their expectations about future rate hikes.

The FOMC's median forecast pushes the fed funds rate above current 10-year bond yields (around 2.8%), which would mean an inversion of the yield curve. Historically, such inversion has nearly always been a very strong predictor of a recession.

If the Fed does indeed hike rates above 3% over the next 24 months, this very likely would cause a recession sometime in 2019 or 2020, forcing policymakers to reverse course aggressively.

In conclusion, with medium-term inflation expectations anchored close to 2% and policy rates safely above the Zero Lower Bound, different policy rules can be used to simulate future scenarios for US interest rates. These show that the Fed is likely to meet market expectations for rate increases over the next 24 months, with the hikes likely to slightly 'front-loaded'.

Under any scenario, however, it is hard to see the fed funds rate moving above 3%.

## Higher US rates will push up GCC rates

As mentioned above, the GCC countries all operate fixed exchange rate regimes and all, except Kuwait, have their currencies pegged to the US dollar. Consequently, any change in US policy rates (in either direction) will be 'imported' more or less automatically by the GCC central banks.

To state the proposition in a different way, the Federal Reserve is the fundamental determinant of interest rate developments in the GCC. The reason for this is what economists call the impossibility trinity.

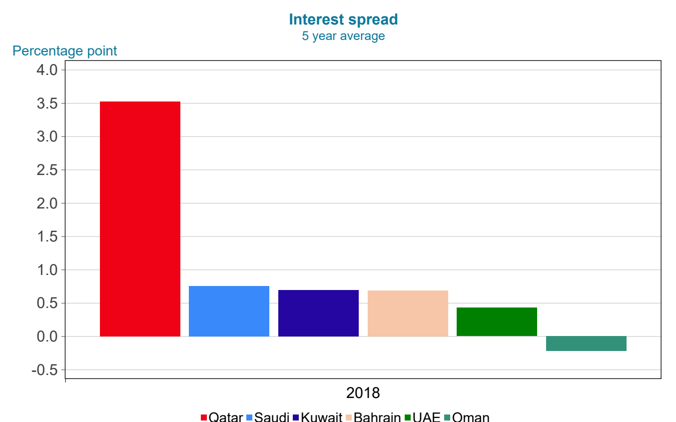
The impossibility trinity states that if a country has free capital movement (as the GCC states mostly have) and its currency is pegged, then it cannot set interest rates on its own.

This means that when the Fed hikes rates, the GCC central banks must either follow its lead or abandon their dollar peg. So long as the GCC central banks wish to maintain pegged exchange rates (and there are no signs at all that anybody in the region is contemplating a change in monetary regimes), there is no way to avoid a rate hike.

## But what about the spread?

While in the past there has been a nearly one-to-one relationship between Fed and GCC interest rate changes, the relationship is not perfect. If we examine the historical correlation closely, we can see a certain spread between interest rate levels in the US and the GCC countries.

Essentially, this spread shows the credibility of the dollar pegs in the region. If investors expect a country to devalue its currency against the dollar, for example, they will demand 'compensation' or a risk premium over US interest rates. It should also be noted that the rate spreads to some extent reflect liquidity (or lack hereof) in the GCC money markets.



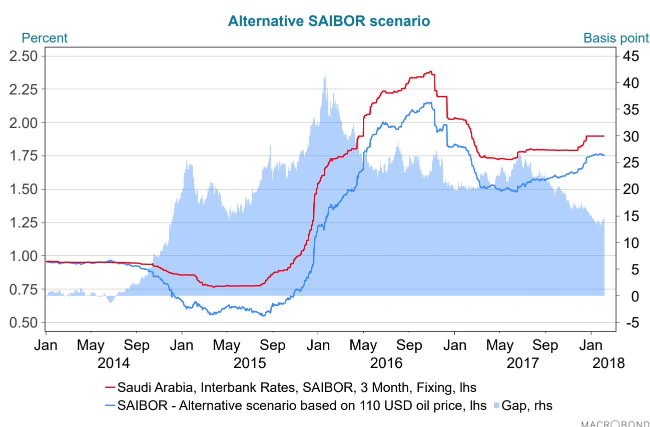

Surveying the region, we also see a quite strong correlation between oil prices and the rate spread.

The correlation is particularly evident for the most oil-rich countries, such as Saudi Arabia and Kuwait, and less so for the UAE, which is much less dependent on hydrocarbon exports.

To illustrate this phenomenon, we have examined the statistical relationship between US/Saudi Arabian rate spreads, used it to analyse the impact of oil price changes on Saudi interest rates.

Since 2014, global oil prices have dropped markedly. Brent dropped from about 110 USD/bbl in 2014 to about 30 USD/bbl in early 2016, before recovering to about 70 USD/bbl today.

These price fluctuations had a significant impact on Saudi interest rates. The graph below charts the actual changes in Saudi rates compared to their probable levels had oil prices remained at 2014 levels. As the graph shows, Saudi interest rates rose sharply during 2016. This obviously coincided with the Federal Reserve initiating its tightening cycle (in December 2015), but there is also evidence that falling oil prices helped push up Saudi rates.




Our statistical analysis indicates that the 2014-2015 drop in oil prices led to a subsequent increase in Saudi interest rates of at least 30-40 basis points. Clearly, other factors – including concerns about the fiscal situation and the strength of the dollar – also contributed, but the oil price decline certainly played a part in tightening Saudi monetary conditions in 2015-16.

It should be noted that the relationship between Saudi interest rates and the oil price is probably not linear (as we assume in our statistical analysis) and therefore our estimates may slightly understate the impact of changing oil prices on Saudi interest rates.

In conclusion, our analysis suggests that the Federal Reserve will probably continue raising interest rates over the coming 12-24 months, with the fed funds rate peaking close to 3%. As the Fed continues to hike, we are likely to see a parallel increase in GCC money market rates. However, the scale of this movement will also depend on other factors – primarily oil prices – that our analysis has shown to be important for rate developments in the GCC countries.

| Real GDP | Forecast | | | |
|---|---|---|---|---|
| y/y% | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | 1.7 | -0.1 | 1.5 | 2.1 |
| Kuwait | 2.5 | -2.3 | 4.4 | 3.6 |
| UAE | 3.0 | 1.3 | 3.4 | 3.3 |
| Qatar | 2.2 | 2.7 | 3.1 | 2.7 |
| Bahrain | 3.0 | 2.8 | 1.8 | 1.7 |
| Oman | 3.0 | 0.0 | 3.6 | 3.0 |

| Gross fixed investments | Forecast | | | |
|---|---|---|---|---|
| % of GDP | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | 29.5 | 27.9 | 28.3 | 29.0 |
| Kuwait | 27.0 | 24.7 | 24.7 | 25.0 |
| UAE | 25.1 | 22.7 | 23.1 | 22.5 |
| Bahrain | 25.7 | 23.1 | 22.1 | 21.9 |
| Oman | 38.0 | 34.0 | 33.1 | 33.9 |

| Exports | Forecast | | | |
|---|---|---|---|---|
| y/y% | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | 5.1 | -3.8 | 2.1 | 1.1 |
| Kuwait | 1.1 | -9.5 | 5.0 | 3.6 |
| UAE | 6.5 | -2.1 | 4.5 | 2.0 |
| Qatar | 3.0 | 3.6 | 2.3 | 1.0 |
| Bahrain | -0.8 | 9.1 | 3.7 | 2.0 |
| Oman | -9.7 | -2.3 | 3.5 | 6.2 |

| Imports | Forecast | | | |
|---|---|---|---|---|
| y/y% | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | -15.6 | -8.1 | 1.6 | -0.1 |
| Kuwait | 4.3 | 1.6 | 2.3 | 3.1 |
| UAE | 3.9 | 1.9 | 3.0 | 0.9 |
| Qatar | 13.0 | -8.5 | 8.6 | 5.1 |
| Bahrain | -4.6 | 16.8 | 7.3 | 6.9 |
| Oman | -10.4 | 0.0 | 1.9 | 3.5 |

| Inflation | Forecast | | | |
|---|---|---|---|---|
| y/y% | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | 3.5 | -0.2 | 5.0 | 2.1 |
| Kuwait | 3.5 | 2.7 | 2.8 | 2.7 |
| UAE | 1.8 | 2.3 | 2.9 | 2.3 |
| Qatar | 2.7 | 0.6 | 4.6 | 2.0 |
| Bahrain | 2.8 | 0.9 | 3.2 | 2.1 |
| Oman | 1.1 | 3.1 | 3.4 | 3.7 |

| Government balance | Forecast | | | |
|---|---|---|---|---|
| % of GDP | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | -17.2 | -8.7 | -7.4 | -5.0 |
| Kuwait | 0.3 | 1.5 | 1.5 | 0.8 |
| UAE | -4.1 | -3.4 | -2.2 | -1.4 |
| Qatar | -3.9 | -1.0 | 0.5 | 1.5 |
| Bahrain | -17.8 | -13.2 | -11.9 | -12.0 |
| Oman | -21.6 | -13.2 | -11.7 | -9.2 |

| Current account | Forecast | | | |
|---|---|---|---|---|
| % of GDP | 2016 | 2017 | 2018 | 2019 |
| Saudi Arabia | -4.3 | 0.9 | 0.2 | 0.9 |
| Kuwait | -4.5 | -0.5 | -1.1 | -1.2 |
| UAE | 2.4 | 2.0 | 2.1 | 2.3 |
| Qatar | -4.9 | 2.6 | 0.9 | 1.5 |
| Bahrain | -4.7 | -4.6 | -4.2 | -3.8 |
| Oman | -18.6 | -14.4 | -13.2 | -11.2 |

**Source: Markets & Money Advisory and Swicorp.**

## Disclamer

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