Fed Policy Rate Increase and Its Impacts

The Federal Open Market Committee decided to raise the target range for the federal fund rate by 25 basis points to 0.25 – 0.50 percent on December 16th 2015. This action marks the end of an extraordinary seven-year period during which the Federal fund rate was held near zero to support economic recovery. This raise is a sign that the central bank believes that the United States' economy is strong enough. Its impact on the rest of the world though is often overlooked.

The reason why the Fed raises interest rate:

- The inflation will rise, over the medium term, to its 2 percent objectives
- Household spending and business fixed investment have been increasing at solid rates in recent months, and the housing sector has improved further; however, net exports have been soft
- A range of recent labor market indicators, including ongoing job gains and declining unemployment, shows further improvement

What happens when the Fed raises policy rate:

- As the United States raises its base interest rates, this in turn will influence yield curve everywhere else and interest rate will be higher for all kinds of loan. This rate hike encourages investors to shift money from abroad back to United States, where they can receive somewhat higher returns. The investors may withdraw money out of developing countries that had offered better returns and invest it into U.S assets
- The problem is when a country owes big debts in US dollars because the investors sell their holdings and leave the country (capital flight out), it leads to depreciation of home currency which automatically makes the country debts relatively more expensive and increases its risk of default.
- Higher interest rate strengthen the dollar against other global currencies and attract capital away from emerging market
- As investment rushes out, asset price fall, companies will go bankrupt and unable to pay back their debts

The increase of policy rate of the FED has been a hot topic for discussion; and the hike is believed to have impact on global investment, foreign exchange and liquidity in the market.

- Since the aftermath of the global financial crisis, emerging market economies have enjoyed ample liquidity from the expansionary monetary policy by the developed countries, especially the US. Thus, the increase of interest rate by the Fed would, to some extent, increase the risk of capital outflow from the emerging economies. In Asia, the economic fundamental and financial market resilience has been strengthened, especially after Asian financial crisis 1997-1998. Hence, the impact of US's rate hike on the region is expected to be limited.
- To Cambodia, most of the foreign capital inflows for investments are mainly foreign direct investment, which is long term and stable in nature. While Cambodia has a very liberal capital account regime, Cambodia's financial market is at early stage of development with few investment options for short term capital and for this reason Cambodia is relatively immune from a sudden capital pullback. In general, often investors invest in Cambodia not as an alternative to the US market, but have always considered Cambodia as a different investment category altogether. Although the

second round effect of the U.S interest rate hike could spill over from the region onto Cambodia, it is however expected to be very limited as Cambodia has robust economic growth and sound macroeconomic fundamentals which has been the major factors pulling capitals into Cambodia over the last decades. Therefore, Cambodia as an investment destination should remain almost as attractive as before. For the construction sector, mostly in the condominium segment have been mainly funded by foreign investors and buyers who expected high return from their investment and thus a mere 0.25% increase in the US base rate would not be enough to turn these investors away from Cambodia yet.

- The hike rate would translate into higher cost of capital as Cambodia also borrows from the international market. Eventually the cost of debts would increase to account for the higher U.S fed fund rate; but, it will do so only gradually over a fairly long period of time. Nonresident deposit and debt, the liabilities which are most sensitive to fed fund hike remains a small portion of Bank's source of funding. While MFI and MDI, source a sizeable amount of debt from abroad, albeit still a small figure, these debts are often fixed in interest rate and very long term. Therefore, higher funding cost among local financial institutions in the near term is not expected.
- As the U.S Federal Reserve raises the policy rate while the U.S economy is gaining traction, the U.S dollar is expected to further appreciate in the international market. However, as Khmer Riel (KHR) is maintained in a relatively stable level relative to the US dollar, further appreciation of the US dollar also means the appreciation of the KHR against other currencies. Over the next quarters, this might affect the competitiveness of Cambodia's exports. Nevertheless, as Cambodia's export are mainly to the U.S and Europe where the economies are recovering, the expected higher purchasing power of these economies would more than offset the impact of the dollar appreciation.
- The Fed interest rate hike is believed to attract capitals to flow back to the U.S economy. Therefore, it could have implications on liquidities in many countries around the world. To Cambodia, the banking system has very little liabilities to the U.S so the withdrawal of the U.S assets from Cambodia would be negligible. However, Cambodia's banking system is dominated by investments from the region, so Cambodia could receive second round effect once the regional economies see further capital outflows and the regional financial condition is tighten. Yet, the effect is expected to be limited. This is because the proportion of non-resident funding source of financial institutions in Cambodia remains small and any non-resident debts are locked in for the long term. In the meantime, Cambodia's banking system is operating with abundant of liquidity surplus and their sources of funding are mostly from domestic rather than external sources. Therefore, it is expected that there would not be any liquidity concern.