Carlos del Toro/Unsplash.com

Engin Akyurt/Unsplash.com

**Claudia Maya***

# High Interest Rates and a Strong Dollar, Lethal for the Developing World

The world economy is experiencing the highest inflation rate in the last forty years. Economic growth and the possibilities of a rapid recovery seem unlikely, an inheritance in part of two profound crises: one is the 2008-2009 financial debacle, whose repercussions can still be felt more than a decade later; the other is the crisis stemming from the Covid-19 lockdown. Added to all this are supply chain problems and a dangerous deterioration of geopolitical conditions. This scenario affects global stability with alarming consequences for countries that are highly dependent on external trade and finances and who use the U.S. dollar as a means of payment.

To deal with persistent inflation, central banks have adopted the most conventional monetary policy measures both in developed and emerging countries, with constant hikes in interest rates. As a result of this "normalization" of monetary policy, the conditions for international financing have deteriorated, sparking uncertainty, thus contributing to higher risk and global instability.

Vulnerabilities have sharpened not only in financial markets and institutions, but also at a country level, since increasing interest rates have contributed to greater pressure on conditions for obtaining credit, the depreciation of local currencies, greater trade imbalances, and high exposition to volatility in markets and commodities prices. On the other hand, the return of financial capital flows to dollar-denominated assets is accelerating, contributing to the depreciation of other currencies. In this way, emerging markets and other developed economies are confronting a multitude of challenges and risks derived from a stronger dollar, which, added to the increased

* Claudia is a researcher at the Center for Research on North America (CISAN, UNAM); you can contact her at clmaya@unam.mx.

While the United States may undergo a short-term recovery, other countries could experience unsurmountable economic breakdowns, as history has already shown.

interest rates and capital flight, translates into higher costs for financing. This raises the price of imports and feeds back into the inflationary process, and it all accentuates balance of payment problems and paves the way to stagflation or other financial crises.

The hegemony of the dollar is a fundamental element in this developing crisis, at the same time that it continues to be the basis of integration, since its global acceptance as the principal means of payment means that other economies have to acquire dollars to make their payments abroad, whether to purchase goods and services or to meet their financial commitments. Although the U.S. Federal Reserve (FED) acts based on domestic objectives, its behavior affects the rest of the world. Obviously, with the dollar as the world's reserve currency, any modification of its value affects all the planet's economies. Thus, the FED's sharp upticks in interest rates and strict monetary conditions could precipitate a recession in highly indebted countries.

While the United States may undergo a short-term recovery, other countries could experience unsurmountable economic breakdowns, as history has already shown. The expectation is not irrelevant: history justifies the fears surrounding a tougher FED economic policy. Every time it has restricted its policy, it has sparked financial disasters, particularly in emerging markets, and it is probable that history will repeat itself in the economies that are highly exposed in dollars and have strong capital flows.

In the last four decades, FED monetary policy has changed the course of capital flows to emerging economies. History shows us the high degree of correspondence between changes in monetary policy, mainly interest rate variations, and financial debacles in the region. One episode was the 1982 "Debt Crisis," when Paul Volcker, as head of the FED, promoted increasing federal fund rates to reduce domestic inflation, hiking it from 11.2 percent in 1979 to 20 percent in 1981. The result was economic and financial disaster for Mexico and the rest of Latin America.

Another episode took place under Alan Greenspan, who slowed down monetary policy and showed that even a small adjustment in the interest rate (0.25 percent) could have a huge effect on short- and long-term financial asset prices and on the costs of debt for companies and countries. For their part, the emerging countries were devastated, experiencing financial bankruptcies of the companies with the highest foreign-currency-denominated debts throughout the 1990s.

The FED does not currently discard the possibility of sparking a recession to fight inflation in the Volcker tradition. On a world level, this political response to inflation in the United States and the advanced European countries, justified by the World Bank and the IMF, would worsen the balance of payments situation, spark a debt crisis, unleash capital flight, and cause the depreciation of currencies in less developed countries. This would generate a crisis that would be much more severe than that of 2007-2008, damaging even more the developing world in the framework of a pandemic that is still not over. VM

## Further Reading

IMF, "Global Financial Stability Report," October, 2022.

Maya, Claudia, "The fed, Monetary Policy, and the Effect on Emerging Economies," *Voices of Mexico*, no. 101, Summer 2016.

Erol Ahmed/Unsplash.com